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LEGAL, REGULATORY AND JUDICIAL REFORM

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PETER MURRELL is a Full Professor at the University of Maryland, Department of Economics and Director of the Mongolian Economic Transition Project at the IRIS Center since 1991. In 1991-92, Dr. Murrell was a Fellow at the Woodrow Wilson International Center for Scholars in Washington D.C. Dr. Murrell's current interests include the dynamic of economic transition in post-socialist systems, including the theory of reform, the routes of path dependence in reforming countries, the effects of privatization, and the changing structure of foreign trade. He received his B.Sc. and M.Sc. from the London School of Economics and his Ph.D. from the University of Pennsylvania.

MANCUR OLSON is Principal Investigator and Chair of the IRIS Center at the University of Maryland. He directs research and provides technical assistance related to the role of institutional factors in economic development and the transition of formerly communist countries. Since 1969, Dr. Olson has served on the University of Maryland faculty and has been Distinguished Professor of Economics since 1979. He served as Deputy Assistant Secretary of the U.S. Department of Health, Education and Welfare from 1967-1969. Subsequently, he was an Assistant Professor of Economics at Princeton University. Dr. Olson has been the recipient of many fellowships and scholarly awards including an Honorary Fellow of University College, Oxford. He has also served as president of numerous academic associations and societies. He received his Ph.D. in Economics from Harvard University, was a Rhodes Scholar at University College, Oxford, and received his M.A. from Oxford University.

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14 Implementing Legal Reform in Transition Economies

Charles Cadwell[1]

Four years into the transition in the former Soviet Union there are many dramatic changes—many of them can be described as successes of the reform effort. In Russia, the focus of this chapter, most prices are free, state control of economic decisions has collapsed in broad parts of the economy, money has value, and there have been democratic elections. At the same time the establishment of the rule of law has been elusive.

Lawyers and economists from the West have played an active part in advising reformers across the former Soviet Union and in Eastern Europe. At the University of Maryland's IRIS Center, we have been fortunate to be able to conduct research on the transition and to work with reformers in Russia, Ukraine, Armenia, Poland, Kazakhstan, and Mongolia[2] as well as in many other countries outside the region[3]. This chapter draws on that experience as well as on others' observations to suggest that the development of the rule of law can be enhanced by attention to several characteristics of the transition. The premise is that clearer thinking about the process of transition and people's incentives will increase the impact of our so-called "technical" assistance. A related idea suggested here, but not fully developed, is that this same understanding would lead reformers themselves to be more successful as

[1] I appreciate the helpful criticisms of both my economist colleagues and fellow-lawyers, including Peter Murrell, Christopher Clague, Leonid Polishchuk, David Fagelson, and Lane Blumenfeld. This draft is improved on account of their suggestions, though shortcomings remain my responsibility.

[2] IRIS work in these areas has been supported by a variety of agreements with the U.S. Agency for International Development, dating back to 1990. Specific IRIS legal reform projects are listed in the Appendix.

[3] Mainly in Nepal, India, Chad, Egypt, Morocco, Madagascar, Costa Rica, and the West Bank/Gaza.

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they took into account the lessons of public choice or collective choice economics.

There has certainly been plenty of legal reform in Russia and other transition societies. In this chapter I emphasize steps to support the adoption *and implementation* of new legal arrangements, using a view of "legal reform" that is broader than simply adoption of new rules. While the relevance of this broader usage seems self-evident, the delivery of much assistance, as well as the approach of many reformers in country, is conducted in a way that makes it more difficult to achieve the broader goal.

The need to develop such institutions is increasingly recognized, even by those commentators who early on emphasized shocking society with macroeconomic, trade and price reforms, and changed ownership structure as the main reform steps. However, even if there is agreement that certain institutional arrangements are a priority, there are no clear theories of how one develops such institutions. Part I describes some characteristics of the reform process that illuminate missing foundations of the rule of law.

Part II draws some lessons from that experience to suggest how outsiders can contribute, suggesting an approach that moves beyond the traditional "technical" assistance, in which a small group of outside experts huddles with a tight group of experts from a key ministry.

1 Characteristics of the Reform Process That Detract from the Establishment of the Rule of Law

There are numerous examples of law development that illustrate the difficulty of the transition. These difficulties may be substantive in that the laws do not reflect market principles, or depend on the existence of enforcement or implementation institutions that do not exist. However, an underlying condition is the slow development of appropriate political institutions, without which the development of substantive rules is severely impeded.[4]

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[4]Lawyers who have reviewed the process of law reform in the former Soviet Union have provided detailed analyses of the substance of various legal regimes (land law, energy law, telecommunications, etc.). These usually include

At the same time it should be noted that there are positive signs, surprisingly perhaps. Despite centrifugal forces that sap the ability of the center to govern, courts are functioning and governmental bodies are subject to political control. Privatization of major portions of Russian industry occurred largely within the established procedures.

1.1 Responsibility for reform is disputed.

The arena in which legal reform is being attempted is both competitive and unorganized. It is competitive in that there are lots of interests seeking to secure their advantages at a time when most of the old arrangements have lost their legitimacy and utility. This has resulted as the "owner" of most property has ceased to function effectively. The winners and losers from the decline of old structures are now competitors. There are even those, both inside and outside of government structures, with a stake in the current chaos. Thus, it is not surprising that the direction and pace of reform is disputed.

The arena for reform is unorganized in several ways. In the past there were known, even though not democratic, methods for resolving or suppressing differences. Steps to work with democratic government structures remain incomplete, leaving some problems unaddressed and others ineptly resolved. This problem has several sources and manifestations, both constitutional and otherwise. Constitutional sources include overlapping responsibility for policy initiative without clear procedures for resolving disputes, both between the center and regions, and among centers of power at the federal level. Other sources stem

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a description of the various limitations to the effectiveness of the proposed solutions. These limitations include unclear or conflicting governmental responsibility, scarcity of trained personnel and lack of capital assets or technology upon which implementation is dependent. Recommendations of these authors are of reduced practical use since their implementation depends on the prior alleviation of these limitations. In short, these analyses typically describe the end state of legal reform but not the path to get there. Springer (1994) provides a summary of several such articles. Others have taken considerable effort to account for the political and institutional context in crafting their advice (see Black et al, 1994).

from the lack of experience with transparent decision-making or with development of public support.

The concern here is not that power is shared, or that there are checks and balances built into the constitutional arrangements. Rather it is that roles have been defined too broadly, without mechanisms for resolving disputes; there are many checks but few balances.

Federal separation of powers or conflict of powers?

The locus of initiative for steering and designing the reform process is disputed, even after the elections and adoption of the current constitution in December 1993. Peter Ordeshook has described these formal contradictions in some detail,[5] highlighting the conflicting incentives to support the rule of law that the constitutional arrangements build into the relationship between the President and the Duma, and the center and the regions. Both the legislature and the President can legislate (the Duma through legislation, the President through decree). Each can veto actions of the other. Ordeshook suggests that constitutional arrangements provide several opportunities for executive–legislative confrontation, while the electoral system gives Duma leaders elected from party lists an incentive to claim the same national mandate as a nationally elected President. Legislatures in which representatives have a primary interest in their own districts do not give rise to the same type of competition for ownership of a national mandate. Parliamentary systems in which the executive is a creature of the Parliamentary majority obviously solve the problem in a different fashion. In Russia, the arrangements borrow a little from both approaches, creating a problematic "middle" path.

Although the two branches have operated relatively cooperatively since the failed coup of October 1993, this cooperation has not generated clear direction for reform. The failure of the Government to win passage

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[5] There are contradictions inherent in the U.S. Constitution as well, but decades of working with the document have allowed for the development of mechanisms to overcome the contradictions. Examples include the role of the Court in reviewing legislative acts and the existence of "independent" regulatory agencies as arms of the Congress with both executive and judicial functions.

of the second stage of the privatization law in May 1994 led to resort to decree (and the possibility of later legal challenge). The signing of a "Civic Accord" among the President and most political parties in the Spring of 1994 was largely an empty and unenforceable exercise that did not prompt any coalescing of policies, approaches, or priorities. The announcement in the Spring of 1995 of parliamentary groupings headed by the Prime Minister and the Speaker of the House reflect coalescing of groups around power rather than ideas or visions for reform.

Competing visions of the federation

The problems inherent in the constitutional arrangements between the center and the regions can be summarized by four observations: (1) the lengthy and detailed enumeration of shared and exclusive powers in the Constitution for *oblasts*, *krais*, and other subnational units does not in fact clarify areas of unique capability, ensuring that there will be competition and confusion;[6] (2) the acceptance of special tax arrangements and other privileges for some regions suggests that all the constitutional provisions are negotiable; (3) the development of local constitutions apparently requires approval of the center;[7] and 4) apparent federal control of electoral processes suggests that party decentralization or Duma activity respective of regional autonomy will be minimal (Ordeshook, p. 13).

The development of local constitutions by regions and republics is occurring with a similar lack of framework. In the drafts and in those that have actually been adopted, there is wide variety in the mechanisms for defining and then implementing executive and legislative

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[6] At a five-day IRIS workshop with the authors of regional constitutions, not one of the representatives of the Federal Government or the various regions could identify a power granted to the regions by the Constitution that was not also granted to the Federal government. This was in response to a question concerning the scope of Articles 71, 72 and 73 posed by Peter Ordeshook.

[7] Interview with Leonid Smirniagin, Member of the Presidential Council and Chief of the Regional Branch of the Analytical Center of the President of the Russian Federation, October 1994.

responsibility in a way that shares power (Lysenko, 1995), and in their treatment of subregional units (guaranteed "equal rights" as subjects of the Russian Federation by Article xxx of the Federal Constitution).

Of course, these constitutional weaknesses reflect a larger uncertainty rather than being the sole source of competing interests in Russia. The uprising in Chechnya and Federal response to it represent an extreme, but the political dialogue since December 1993 does not suggest the imminence of a consensus on political rights that might lead to a second wave of clarifying constitutional expression. One view suggests that patterns of disrespect for law, coupled with deep regional differences of interest will lead to further dissolution of the empire, the carving out from Russia of yet smaller territories (Stern, 1994).

Ad hoc arrangements continue: A 1995 privatization decree purports to establish a process but postpones the decision of who owns the several thousand properties. The cost of not deciding "process" issues is paid again and again, without a pattern emerging that could be formalized into constitutional or other regularizing provisions. In failing to take account of the incentives built into political arrangements or in leaving the battles for a later day, the designers of Russia's new democratic arrangements have dispersed and confused the roles of various levels and organs of government, leading to continuation of the uncertainty and shortened time horizons that turn investors away and officials into the equivalent of roving bandits.[8] Old methods of administrative decision and executive decree largely continue.

Organization and management of the executive creates additional uncertainty

While policy disputes within the executive branch are a part of most government, and while their resolution often delays promulgation of important legislation (consider, for example, health care reform by the Clinton Administration), in Russia policy free-lancing has been taken to

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[8] A general review of the functions of constitutions in the transition environment is found in Elkin et al. (1993). Suggestions for achieving the consensus required to adopt such constitutional arrangements are outside the scope of their article.

new heights. In January 1994 after the announcement of the Russian government's budget, the *Washington Post* carried a lengthy story quoting by name several cabinet ministers to the effect that the budget would be disastrous for this or that sector of Russian society. Few chief executives in Western democracies would tolerate this level of public dissent by ministers. Even after Presidential resolution of intragovernment disputes, senior executive branch officials nonetheless feel free to carry the fight to the Duma.

Many observers have described two executive branches, one headed by the President and one by the Prime Minister (see, for example, Malia [1995]). The initiative for policy may rest in one or the other. Officials in ministries have their own connections to the President or his advisors, which let them compete with officials on the President's staff. The number of decrees declaring who is in charge of a particular policy is but the superficial sign of more turbulent currents. Responsibilities assigned in this environment are not fixed.

The likelihood that authority will continue to be disputed has been increased by many new laws providing that implementation or enforcement is the responsibility of several ministries or levels of government at the same time. While there are occasions in which one might want bureaucracies to compete, such as when they compete for exclusive jurisdiction over a particular transaction,[9] overlapping implementation exacerbates the uncertainty that the adoption of legal rules aims to reduce. Especially when the level of societal agreement on basic economic norms is low, this dispersion adds to the chaos. For example, a draft law on prices prepared by Duma staff authorized enforcement of price regulations by several ministries and levels of government (Alexeev

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[9] The effects of monopoly in the area of legal dispute resolution on development in France, compared to that in England where legal systems faced competition from other jurisdiction are discussed in Greif and Kandel (1993, p. 8). They describe the relative efficiency of the British contract enforcement mechanisms stemming from the ability of private parties to select for their disputes. In Russia, the problem is not that branches compete for jurisdiction, but rather that assertions of jurisdiction do not bar others from claiming it as well.

et al., 1994). IRIS experts found similar problems of unclear implementation responsibility exist in the Mongolian antimonopoly statute and price law.[10]

The problems of inconsistent formulation and dispersed implementation affect both Russian and foreign businesspeople. One observer has suggested that such conflict and confusion may be the main source of the problems of contract enforcement. The Soviet 1964 Civil Code differed from those in the West in the allocation of property rights and the adjudication of conflict between governmental units, rather than in contract norms (Rubin, 1994, p. 28).

Differences between lawyers and economists and the capability of judges

For seventy years judges and lawyers were subjugated to a set of ideas about economics. The resulting distrust of economic arguments about legal rules has been a drag on the legal reform process. While legal drafters express commitment to market reform, and their work reflects significant change from the existing Code, their backgrounds and training limit their ability to think systematically about the economic implications of legal rules. The preferred method is to use their considerable knowledge of formal Western legal rules to fashion modifications to the formal Russian legal rules. This "technical" approach has much to recommend it in terms of taking into account the existing understanding and practices of Russian law. It suffers in that the framework that then drives legal thinking is the structure and logic of the Civil Code, not an integrated vision of the role that government plays in ordering economic life.[11]

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[10] Kovacic and Thorpe (1994) and Murrell et al. (1992). In Peru different ministries issued conflicting decrees with no attempt at reconciliation. The consequences are described in Keefer (1992).

[11] Kovacic (1995) has described the commercial, political, and public institutional context for reform of competition policy. The description and the lessons drawn are highly compatible with the examination of political organization and processes here.

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In the drafting of the Civil Code, there was considerable debate about whether there should be a single Civil Code or whether it would be more effective to proceed with a series of targeted reforms—a securities code, a law on sales, a company law, etc. Lawyers tended to favor a Code, economic reformers a series of narrower reforms. The development of a narrow piece of legislation could presumably be accomplished with a smaller group and would require less expertise in Civil Code issues. However, it would also tend to lead to more inconsistencies with existing provisions. This would in turn lead to implementation responsibilities that overlapped and conflicted with existing authority, creating confusion among practitioners and judges who need to deal with the inconsistencies.

At the same time, the difficulties of Russian legal drafters in developing a working vocabulary of market economics and collective choice does not suggest that simply adopting wholesale some Western version of a law will be any more effective in accelerating the transition. Differences in the institutional settings of both the transplant and the recipient, and the need to advance reform through a democratic, albeit roughly functioning, process make prior examples of successful transplantation less apt.[12]

On the implementation side of legal reform, the existing cadre of judges has no training and little else in their backgrounds that prepare them to interpret new commercial rules for a market economy. The exception would be judges involved in international arbitration who have been exposed to market concepts related to contracts, credit, banking, transportation, and insurance. Attempts to alter the curriculum at law schools will not have an effect for years to come. Beyond the matter of

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[12] Some have suggested that there are examples of successful wholesale adoption of a foreign legal regime that have accelerated economic growth. Post-War Japan is often an example given of such a process. For a discussion of the difficult soil in which Russian application of Western ideas is being implemented, see the discussion of privatization in Frydman and Rapaczynski (1994, pp. 168–209). Chapter 6 reviews the faults of early assumptions that simply reducing the role of the state would permit markets to flourish or that privatization would alter the incentives of special interests on the policy process.

training, there are simply dozens of areas in which judges have no practical experience. Areas of concern that have been expressed to us include prosaic matters of administering courts, cases, and parties. Ideas about the complementary interaction of law and commerce are often entirely new.[13]

While Part I of the Civil Code, adopted in October 1994, represents dramatic progress in both updating and combining commercial rules, dozens of other laws remain to be written to implement the Code's general prescription, and a myriad of arrangements and agreements predate the Code. Even if the judiciary consisted of the most talented individuals in Russia, they would face a difficult time providing clarity on the fog of new and old laws, decrees, and rules. The Code is far from perfect. Its 453 sections contain many provisions on property and contract freedom that are inconsistent with markets. Many of these provisions reflect political battles that were lost or not taken on as the whole Code was pressed on a fractious Duma. Others reflect choices made by the drafters, others simply oversight.

Despite these obstacles, the existing Courts are working to implement the Code. A February 1995 Supreme Court Decree lays out guidelines for interpreting the Code during the transition period. The decree provides guidance on how pre-existing contracts or disputes will be handled, how the Court will handle gaps left until Part II of the Code is adopted, and how various statutes of limitation will be applied. However, this guidance is not likely to fill the more critical gaps in training, experience, or substantive legal provisions.

1.2 Old interests are still powerful

The demise of central control and the nominal privatization of many firms has not changed the reality that these firms and their workers are still part of large and politically active organizations with existing

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[13] An IRIS workshop September 25 — October 6, 1994 for Arbitration Court judges was enthusiastically received, especially the portion dealing with economics and the law. However, it elicited the following comment from one participant: "This is great information, unfortunately our colleagues in Russia will never get it."

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relationships to ministries, banks, and local and national administrators.[14] These firms are better able to make their needs and views heard than any of the new or yet unformed entities that will have a much greater stake in successful reform. Some have suggested that privatization has simply effected a "transfer of valuable resources from the control of . . . state bureaucrats. . . to others, and one of the primary effects . . . is to enfranchise the new owners and make them more powerful, not only in the economic, but also in the political sense" (Frydman and Rapaczynski, p. 175).[15]

In a vacuum of government disorganization and undeveloped constitutional or other norms about appropriate political and legal processes, these existing interests are likely to do relatively well (Orlov, 1995). Privatization weakens but does not eliminate the claim on state support. Pre-existing relationships with both officials and with revenue and expenditure processes give these interests comparative advantage, even though the world is dramatically different than it was six years ago. If the new owners were true outsiders, the lack of such relationships would increase their incentive to make difficult business decisions about production, workforce size, marketing, etc. The acceptance of the current privatization scheme by workers and managers reflects their understanding of this point.

This does not mean that Russia would be better off and that there would be more respect for law if privatization had not occurred, but that the expectation that change of formal relationships would quickly lead to demand for public provision of stable legal rules has been overly optimistic. While the formal structure of government has changed, the behavior of government has not, and the past structure of interests, which

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[14] A survey of mangers of state-owned, privatized, and always private (i.e., new) firms in early 1994 apparently shows identical views on reform topics among state-owned and privatized firm managers, in contrast to the views of new or private firms (Kossals at al., forthcoming).

[15] The power of these new owners, both managers and workers, is likely to be such that requests for intervention will undermine the system of property rights that is the ultimate aim of the program (p. 183).

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still exists, exercises influence in familiar ways.

An explicit political strategy of mass privatization was to acknowledge the de facto owners (workers and managers) in designing the privatization plan and at the same time to create a large number of people with a stake in continued reform.[16] These new owners would demand institutionalization of property rights, enforcement of contracts and other institutions that flow from rule-bound government. The demand has been slow in emerging. Listen to the description of a key reform leader, Yegor Gaidar: "A significant proportion of entrepreneurs, particularly at the local level, consists of people connected in one way or another with the former and current nomenklatura, who have signed up for nomenklatura capitalism and can conceive of nothing else for themselves" (Gaidar, 1995, p. 18).

1.3 Mechanisms of democratic debate are unformed and unfamiliar.

Elections in Mongolia, Russia, Hungary, Bulgaria, Lithuania, Estonia, and Poland suggest that a pace of radical changes not explained to the public are not politically sustainable. Much progress can be made during windows of opportunity that Lescek Balcerowicz has called times of "extraordinary politics" (Balcerowicz and Gelb, 1995, p. 26). Poland made considerable progress during such a time; Yegor Gaidar implemented many changes that are largely irreversible. But the ability to see these programs through has been slowed by uneasy and uncertain electorates.

The highly developed mechanisms that exist in other democracies for proposing ideas, conducting public debate, and adapting to public reaction are not well developed in the transition societies. While even under communism advancing a particular policy required that support be won by persuasion and organization of interests, the targets and methods of such persuasion have changed. Use of the media, coordination of complementary interests, use of economics and technical expertise in the political process, and processes of compromise and conciliation are all

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[16] Another was to eliminate the role of the bureaucracy, cutting them out of enterprise decision-making.

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new tools in the new environment.

The routines of communication about policy, plans, and their execution that exist among the branches and levels of government in established democracies are not in place in Russia. While there are individuals who operate quite flexibly in both the executive and legislative branches,[17] and while there are many ad hoc communications, there are no routine or formal mechanisms.

Data that would inform many debates does not exist or is of poor quality. The applied economic skills needed to analyze it are in short supply. There is a profusion of analytic centers attached to the Government and the Presidency, but their roles are not clear.

2 Implications for Assistance

These characteristics of the reform process in Russia suggest that as outsiders attempting to support particular developments or to influence others, we need to be realistic about the extent to which our effort will alter the course of events. Experience suggests four aspects to an approach to assistance:

> (1) Implementation of laws and decrees needs to be the primary goal, not a hoped-for side benefit of the immediate interaction. Thinking about who will be required to implement or comply with new rules, whose approval is needed in order to adopt them, and who will disseminate information about them leads early on to expanded views of participation and to thinking of assistance as educational rather than simply technical. It probably also argues for fewer and more sustained interactions. It will involve working with a wider set of people and thinking about how to communicate with the broader public.
>
> (2) This approach requires that outsiders understand local thought processes and context, though

[17] One source of this flexibility is the current ability of members of the Government to also serve as members of the legislature.

not necessarily that they trim their advice as a result of this understanding. The problems in Russia and elsewhere are not simple, and at the same time the Russian hosts for this assistance want to have access to the highest quality advice. Since that advice is not always available for continuous service to the Russian transition it is important to find ways to provide that advice on a sustained, though not continuous, basis.

(3) To carry their own reforms forward, local implementers of reform need to understand economics. It is not enough to mimic Western legal models or learn standard economics. Implementers will benefit strongly from attention to the process and incentives inherent in the scheme for which they have responsibility. While the slogans of market economics are simple to grasp, the implications for real policy development are not always straightforward. Developing this understanding takes time and effort. As prospective implementers of new rules for a market economy, these people must understand the new institutions.[18]

(4) Uncertainty over with whom to work or which policy opportunity will first present itself implies that assistance needs to be flexible in design. While ultimately the work must develop into specific tasks and activities, these cannot really be known until one is involved in a process with a variety of counterparts.

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[18] An alternative argument might be, "Set up the new tools. They'll use them, make a few mistakes, and learn how eventually." This approach presumes that the new tools or rules will be attended to at all. In Mongolia, price decontrol looked to be working well from the center. At the local level, price regulators continued their prior activity. In late April 1995, local UlaanBaatar administrators announced new meat price controls and the establishment of a price commission to address a broader range of goods. Meat is again in short supply.

2.1 What reforms should be supported?

The key institutions of a market economy are property rights, mechanisms for enforcement of contracts, and reliable and peaceful ways of organizing political debate. Functioning securities markets, credit markets, and private distribution systems are built on these basic institutions. Lacking basic contract enforcement institutions, complicated trading rules and computer systems will be difficult to implement.[19] Spending scarce resources to renovate and outfit a building for a Mongolian stock exchange may have had some symbolic value, but its main effect may have been to deflect the attention of key people toward a secondary institution.

From the need to deal with basic institutions and from the confused political process there are two related lessons. The first is that the concepts of secure property rights and impartial contract enforcement will come up in any of dozens of specific policy areas. It is difficult, if not impossible, to determine in advance which area will provide the best opportunity. Land law, company law, privatization, insurance, banking, and dozens of other areas all share a reliance on fundamental ideas about the incentives created by private property and the economics of contracts. It is less important which of these initiatives is the vehicle than it is that the assistance result in local understanding of ideas and concepts that underlie the experience of successful market economies. Insuring that the interaction between donor and recipient communicate these concepts and understanding will insure that a cadre of articulate local experts can participate more capably in legal developments that may arise. This means that the mix of experts and the agenda for interaction ought to be different from what might be indicated by purely "technical" assistance.

The second lesson is that a key contribution of outsiders can be to focus on implementation concerns. If it is important to have a registry system to go along with a collateral law, then thinking about implementation will lead one to think about the structure of the law itself, where the registry is located, how firms and lenders interact with it, and the host of other practical and legal issues. Identifying these issues earlier

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[19] See Greif and Kandel (1993) for a description of the lack of attention to contract enforcement among reform advocates.

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may lead to different conclusions about where responsibility for policy development and implementation ought to be lodged, and it may force attention to budget issues and identify beneficiaries who can help support the proposed law. In short, a focus on implementation can help overcome the divided responsibility currently limiting progress in several areas of law.

A January 1995 World Bank paper on the Bank's own legal technical assistance contains many pertinent lessons consistent with our own at IRIS related to the importance of local ownership of reform efforts, long-term commitment by donors, the value of broad participation and the importance of understanding local conditions. Given the Bank's role and governance, other of their lessons are understandable, even if not ones that would be universally useful.[20]

2.2 Local participation

Whenever possible, donors should avoid creation of counterpart monopolies for the receipt of technical assistance. As the discussion earlier suggests, it is not at all clear who is best placed to advance reform. Not only do personalities change, but the roles of whole ministries or branches of government are not well defined. In addition, given the basic constitutional mal-arrangements that limit the ability of

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[20] These recommendations tend to be aimed at Bank participation, not participation by others in technical assistance. Nonetheless, non-Bank donors and providers of technical assistance may have different views with respect to the utility of recommendations such as those suggesting that the Bank take the lead in coordinating multilateral and bilateral legal technical assistance or that legal assistance be in accord with the Bank's non-interference in politics. Because of the Bank's self-limitation as to topics, required relationship to loan or grant activity, and the limited range of assistance, it may not be best situated to coordinate particular legal reforms. Further, the political aspects of reform may well be the most fundamental ones to worry about. (The question of who owns property is intensely political and needs resolution before privatization.) Nongovernmental providers of technical assistance can provide important capability to those involved in political processes. Bi-lateral donors, with fewer internal governance constraints on the nature of involvement in particular countries, can take these issues on more directly.

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any particular actor to make a reform "stick," the likelihood that a particular counterpart will be the best one over the course of the interaction is greatly reduced.

There are more important reasons to avoid creating a counterpart monopoly, which go to the process of reform. Ministries or other bureaus with nominal charge of a particular issue see things through the "old lens of command and control," leading them to develop their ideas in secret and keeping proposals from public discussion as long as possible. There is no reason for donors to participate in this approach. Instead, donors can contribute to successful broadening of public debate, especially among the idea elites who lead opinion in democracies: journalists, academics and researchers, and officials in competing centers of power.

Acting on this approach in Poland, IRIS located its assistance effort for development of a collateral law[21] in Warsaw University and later the American Studies Center, in a deliberate effort to avoid creating a counterpart monopoly. Choosing to lodge assistance in one of the competing bodies would have alienated the others, all of whom have a voice in the ultimate reform. The result in Poland has been that the ministries of Finance and Justice, the Central Bank, the law professors who serve as civil code guardians, and the banking community have jointly developed a proposed reform that enjoys broad support. In effect, assistance in Poland has contributed to the organization of a coalition with an encompassing interest that has overcome the narrower concerns of particular factions or industries. The process has demonstrated alternative, more open, and informal patterns of discussion, debate, and compromise.

In Mongolia, in discussions with key officials on how to structure assistance on economic policy reform, we were pressed hard to cede designation of participants to a single government ministry that would dictate on this issue. Our insistence on a broader approach led us to include key people from the private sector, the parliament, political parties, and academia. The current Prime Minister, who attended and benefitted from the first workshop, would never have made the list had

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[21] For a description of the changes in Polish secured lending rules see Dwight and Reichenbach (1993).

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the process been monopolized. The participation of legislators, economists, and officials helped bridge substantive and semantic gaps that existed even within that narrow policy community in a small country.

In Russia, IRIS was directed to work with a particular player in the civil code reform effort—a group that included representatives of most key ministries, the Duma, and the Supreme Arbitration Court. This group was charged with the main responsibility for the draft code. Efforts to encourage them to open their process to broader public discussion have met only modest success. Further, their contest with other executive branch interests has slowed the introduction and adoption of the new code. Hindsight suggests a better approach: Avoid a "client" relationship with a particular counterpart and organize activities that make expertise available to a range of Russian interests. To do otherwise snares the donor "technical experts" deeply in internal political matters.

It could be argued that such client relationships are necessary to build the trust of officials such that they will share information and strategies. While it is probably true that counterparts will be more open with advisors who they feel share a partisan perspective, and proposals can be developed more quickly and easily by smaller, closed groups, opportunities to spread ownership and build indigenous capacity will have been lost. An assistance process that contributes to closed policy development fails to develop the broader political support needed to pass and implement new rules. The progress of privatization policy may be an example of this.

A participation strategy developed by the U.S. Agency for International Development notes that assistance must help to "build the degree of social consensus that . . . [is needed] . . . to carry out and sustain changes in policy or social and economic programs" (Atwood, 1994). At the same time our experience suggests that it is unrealistic to expect poor people or small-business owners to participate in the rewriting of a civil code, even though it is their interests that are most at stake. (Large, politically connected entities have less need for the rule of law; they can obtain administrative recourse or enjoy bargaining advantages, etc.) Efforts to involve diverse and, as a result, encompassing interests may be the closest substitute for direct involvement of the impoverished.

Beyond the value of broader participation as a way of improving

the substance and building support for change, an additional benefit may be the training function of involvement in the process. Judges who have helped to develop new commercial laws are better placed to spread capability for implementation.

A final point in thinking about with whom to work: It is dangerous to assume that participation is beneficial if it means simply helping existing interests get organized. If the interest are narrow, the outcome is likely to be so as well.

2.3 What sort of assistance?

Sustainable reform of legal institutions occurs as laws are implemented and as they come to affect the behavior of firms and individuals. For this evolution to occur, not only must the formal rules be appropriately fashioned, a variety of actors need to understand and accept them. Since it is not realistic to support the detailed operation of the various bureaucracies, it is essential to build capability among local individuals and organizations. This effort is more likely to succeed if launched at the beginning of assistance than after the adoption of new laws.

This concern drives choices about counterparts; it also suggests that assistance is much less "technical" than it is educational. We are not fixing washing machines, but rather creating an ability either to fix machines independently or indeed to design new ways of washing. The mix of skills and ideas needed for this task reaches beyond standard economics or the arcana of Western legal mechanisms. In some respects it is less important which particular policy is the focus of assistance than which sets of ideas about that policy are communicated.[22] If new laws on land, securities, and price regulation are developed without communicating basic concepts concerning property and its incentives for

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[22] Kovacic and Thorpe (1994) describes how assistance on development of an antimonopoly law was conducted in a fashion which transferred key ideas about the organization of incentives related to the substance and implementation of a law, how this information supported development of a law that enjoyed informed local support and how the lack of sustained interaction nonetheless limited the effectiveness of otherwise productive assistance.

economic activity, or without attention to how they will be implemented in that society, then the assistance—no matter how good in a narrow technical sense—will be ineffective.

Anyone who has taught will recognize that while heads may nod in understanding during a lecture, incorporating the concept into one's thinking often takes longer. Similar problems affect the planning of assistance. Developing new institutional arrangements (surely independently enforced contracts and clear private property rights are new in the former Soviet Union) and involving diverse actors and interests in this development is not a matter of installing a replacement part or giving a single lecture. Even if armed with a clear understanding of theory and of Western examples, advocates of particular reforms will face issues, interests, and objections that are unique to their situation. They operate in an environment in which mechanisms of open policy debate and advocacy, as well as compromise, are not familiar.

Others have made the point that solutions need to be compatible with capability for implementation ("keep it simple") and that rules that require decades of interpretive experience assure, at best, chaotic implementation by businesspeople, officials, and judges (see Kovacic, 1995; Black et al., 1994). This line of reasoning suggests that progress will not unfold in a straight line or occur quickly. Sustained interaction between donors and recipients will be important. A requirement for success is the presence of long-term advisors who can identify suitable moments for interaction and provide local context for senior experts and day-to-day support for the variety of counterparts. These persons should be thinking about the structure and process of decision-making. In Mongolia, it was only after considerable examination of this type of issue that the existence of a "Main Department" in the government was discovered, performing many of the functions of the prior Politburo, but out of the sight of most donor experts and officials. An example of successful application of the use of long-term advisor and short-term experts is our experience in providing assistance on the Mongolian antimonopoly policy. This initiative sprang from the interaction of our long-term advisor with key policy leaders on other issues rather than from detailed project design or a two-year project planning exercise. There is considerable value to ensuring that top outside experts are prepared to have frequent and repeated exchanges with counterparts, both in person

and through fax, e-mail, or return visits. [23]

While assistance such as short-term training and study tours are helpful if conducted as a part of longer-term interaction, IRIS experience in Russia, Poland, Nepal, Chad, and Mongolia suggests that absent sustained interaction, one ought to have limited expectations about the effect of such activities. As frustrating as it is for us to host study tours that generate much interest and a brief exchange without a chance to plumb the details of issues, it is similarly frustrating for local officials and others to host a series of short-term "development tourists."

2.4 Focus on benefits for new and small firms.

The problems described as "too much civic society" or the undue influence of existing interests are one reason to believe that the interests of existing large firms will not be neglected during the transition. Less likely to benefit from decisions made at the center are new and small firms. The importance of concern for the environment in which they operate may be may be found on the pattern of economic growth. In Poland, while privatization of large firms has proceeded haltingly, growth has been dramatic and its benefits widely dispersed as thousands of new small firms have been formed and grown. It is not necessary to agree that small or new firms will always play a dominant role in job generation to recognize their importance in the transition process.

In market economies, the "creative destruction" of firm entry and exit is an important source of growth.[24] In Korea, for example, 80–90% of GNP in the 1970s was accounted for by factors of production that were engaged in activity different from in the early 1960s (Krueger, 1992). In formerly socialist economies, the number of firms to be privatized is finite, and the number of those firms that will survive is smaller. Yet the economic activity upon which growth will be based will occur in thousands of firms and organizations that do not even exist

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[23] See Kovacic and Thorpe (1994) on the costs of not providing for availability of outside expertise over the course of law development and implementation.

[24] Davis, S., J. Haltiwanger, and S. Schuh. (fortchoming).

today. To provide benefits to wide numbers of individuals and firms there must be clear institutional arrangements and enforcement of contracts, coupled with searching attack on regulatory barriers to entry. A reform process centered on government interaction with existing firms is not likely to spread the benefits of reform widely and provide positive incentives to new entities.

Thus, in delivering assistance it is useful to organize activities in ways that illustrate competitive processes, increase access to newcomers, and demonstrate transparency. This will both improve the product at hand and transmit important policy development "technology." A recent example of such a process is the World Bank's selection of sites for access to a large housing loan facility. A large number of cities have been invited to compete for access to this loan. The basis for the competition is a variety of policy measures and commitment to implementation steps that create more open markets in related support and service sectors. As an outside entity the Bank can be credible in establishing clear and transparent rules, impartially applying them, and deciding with known criteria. These same efforts can be made in allocating space in coveted foreign-based workshops or access to assistance-supported equipment or other resources.

3 Conclusion

While there are differences among economists and other experts concerning the best set of measures and the pace or sequencing of reform, our work suggests that there are ideas that are important to share widely among the policy-making elite and eventually a broader public. The reform process, to be sustained, needs to result in the construction of such a consensus. Assistance to the reform process, if it is to be sustainable reform, will have support for such consensus as a unifying goal for a variety of activities.

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Appendix

IRIS Legal and Economic Reform Projects in Transition Economies

1. Mongolia "Support for Economic Transition" 1991–present. Areas of interaction include competition policy, privatization, land law, fiscal decentralization, environmental policy, and insurance.

2. Poland "Small Business Regulatory Reform" 1991–present. Areas of interaction include secured lending and intellectual property.

3. Russia "Commercial Law" 1993–present. Areas of interaction include Parts I and II of the Civil Code.

4. Russia "Economics and Institutions in Russia," a collaborative policy research and dissemination project with the Institute for the Economy in Transition and others, 1993–present. Areas of interaction include investigation of the role of interest groups, regional distribution of growth and income, financial effects of privatization on firms, and development of regional constitutions.

5. Russia "Natural Monopoly," support for the Ministry of Economy, 1994–present, in the areas of regulation of electricity, gas, telecommunications, and transportation.

6. Ukraine "Antimonopoly," support for the Antimonopoly Committee, 1994–present, in the areas of energy privatization, financial services competition, and consumer protection.

7. Ukraine "Customs Administration," development of training program for customs officials, 1994–present.

8. Lithuania, Bulgaria, Macedonia "Collateral Law," 1995–present, extension of Poland efforts to other central European countries.

9. Armenia "Economic Policy Analysis," establishment of a Center for Policy Research to build Armenian policy research capability, 1994–present. Topics include underground economy, agriculture, and Armenian comparative advantage.

10. Kazakhstan "Economic Education," with the Kazakhstan Institute of Management Economics and Research, 1994–present.

2 The New Institutional Economics And Economic Development

Christopher Clague[1]

1 Introduction: From Physical Capital to Human Capital to Social Capital

In the early postwar period when economists turned their attention to economic development, they thought that the key difference between rich and poor countries lay in the amount of physical capital per person. What was needed to launch a country on the path of self-sustained growth was a rise in the ratio of investment to income from something like 5% to 12% or more. Poor countries were unable to do this on their own, since people were so impoverished that their consumption could not be compressed any further. Thus foreign aid in the form of investible resources was essential to enable poor countries to escape the poverty trap created by their inability to save and their rapid rates of population growth. In the 1960s, after the remarkably successful Marshall Plan assistance in Europe and the disappointing experience of foreign aid in the less-developed countries, the concept of capital was broadened to include human capital, the lack of which was considered another critical obstacle to development in poor countries.

Although both physical and human capital accumulation are essential to economic growth and development, interpretations of the problem of economic development have shifted in recent decades. First, we have observed countries where high rates of physical capital accumulation have been accompanied by only modest economic growth. Second, we have observed some countries in sub-Saharan Africa and South America where education has expanded rapidly but growth has not taken place. Third, and most fundamentally, we have broadened our focus to include the incentive structures that lead to the accumulation of physical and human capital and to technological progress. In this endeavor, attention has turned to the explanation of economic policies and

[1] I thank Karla Hoff for perceptive comments on earlier drafts. The usual disclaimer applies.

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fundamental economic and political institutions. In some formulations these institutional arrangements have been called "social capital" (Coleman, 1990). Whether we try to understand social capital or institutions generally, we need to think about types of social interactions that were long not part of standard economics.

Economists and other social scientists studying less-developed countries have been aware that the institutional environment in these countries differed from that in the highly developed countries. In the early post-War decades there were intense debates about the degree to which standard neoclassical economics needed to be modified in application to less-developed countries. The view was frequently expressed that standard neoclassical economics was based on institutions that existed in the industrial or advanced countries but that did not necessarily exist in the underdeveloped countries. There emerged after World War II a subdiscipline called "development economics," which assumed that the institutions of the economy were different. However, there was little attention among economists to the evolution of these institutions or to deep explanations of them.

By the early 1980s standard economics was making a comeback in the field of development and Hirschman could say that most economists accepted "monoeconomics," or the idea that the same type of economics applied to both developed and less developed countries. However, the increasing acceptance of standard economics in the study of the problems of poor countries owes a great deal to a reorientation of the field of economics to make it more amenable to examining the determinants and consequences of institutions. The next section explains this reorientation in economic theory, and the following one describes the various strands of literature that are called the New Institutional Economics (hereafter, NIE). Section 4 then presents some contributions of the NIE to the study of economic history and economic development, and Section 5 examines what determines the prevalence of corruption in scoiety and its effects on economic development.

2 Reorientation in Economic Theory

The core of economics can be defined in terms of its basic assumptions and its subject matter. The basic assumptions are individual

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utility maximization with exogenous preferences and a well-defined structure of information; the core subject matter is decisions within markets of consumers, producers, investors, and traders. In the last couple of decades the basic assumptions have been modified, primarily by the incorporation of the phenomena of costly information and limitations on human capacity to process it, and the subject matter of economics has been extended to such nonmarket phenomena as the operation of organizations and the behavior of politicians, bureaucrats, and voters.

With a well-defined information structure, exogenous preferences, and unlimited capacity for processing information, models tend to be "clean," that is, they give strong, unambiguous conclusions. Utility maximization under these conditions is a powerful engine, which traditionally set economics apart from the "softer" social sciences. However, pervasive uncertainty is undeniable, as is the fact that in modern economies people spend a great deal of time and effort in acquiring and processing information. These observations have two important implications. One is that people simplify their decision-making by employing rules of thumb; the other is that trust in others becomes important, in part because it greatly reduces uncertainty and the cost of acquiring information.

In recent decades the subject matter of economics has expanded in many directions (Hirschleifer, 1985); of particular interest in the present context is the application of economic reasoning to the rules of the game, in two senses. One is the decision of individuals whether to obey the existing rules; the other is the collective action of people to change the inherited set of rules. Neoclassical economics had assumed that the rules of social interaction were given, in the form of the rules of a market economy, and that people obeyed the rules of the game. These assumptions made sense in the neoclassical world of perfect information, for violations of the rules could be easily detected and the perpetrators punished. Once the question was posed, however, its salience could not be denied, and a great deal of research effort has gone into trying to explain how the rules of the game might evolve in theory and how they have evolved in history.

The extension of the subject matter of economics has reinforced the modification of the basic assumptions. The core set of assumptions

of utility maximization with exogenous preferences under well defined information structures is less appealing when applied to politicians, bureaucrats, voters, organization members, criminals, and mothers than when applied to the traditional subject matter of neoclassical economics. In particular, the study of the evolution of cooperation via the theory of repeated games leads to recognition of the important role of focal points, which can become symbols with affective content. The study of the evolution of norms leads to economic theories of how moral sentiments develop (e.g. Sugden, 1986). This is an example of an economic theory in which preferences are endogenous. As will be discussed in more detail below, this step represents the crossing of a line that economists have traditionally regarded as a firm boundary of their discipline.

Many economists have felt that a phenomenon has not been properly explained unless it emerges from a model based exclusively on rational self interest. If the analyst appealed to altruistic motivation, or if she said that choices were constrained by cultural norms, that was regarded as an unsatisfactory explanation. In recent years economists have been more willing to countenance relaxation of the traditional assumptions. There has been work on the benefits to individuals of having a conscience (Frank, 1988) and on the efficiency and inefficiency properties of shared mental models (Denzau and North, 1994). This willingness to accomodate a richer conception of human motivation and to countenance greater limitations on rational calculation of individual advantage has emerged, in my opinion, because of the broadened subject matter of economics as well as the reorientation of the basic assumptions of economic theory.

Methodologically there is no compelling reason to stick to the postulate of rational self-interested calculation with exogenous preferences. Stiglitz (1986) suggests criteria by which we judge theories; these include simplicity (fewer assumptions are better), internal completeness (the assumptions should be as "primitive" as possible), consistency with available data, predictive power (predicting empirical regularities that have not yet been noted), and ability to make specific predictions in a variety of contexts. If people form groups and internalize group goals in predictable ways, then models incorporating these regularities will perform better by the various criteria than models based on the postulate of individual self-interested motivation.

The New Institutional Economics, described in the next section, represents a kind of "expanded economics." Like standard economics, it focuses on the choices people make in their lives. But it enriches the simple rational choice model by allowing for the pervasiveness of information problems and human limitations on processing information, the evolution of norms, and the willingness of people to form bonds of trust. The NIE seeks to explain not only individuals' choices with a given set of institutions but, more important, the way that individuals' beliefs and choices affect the evolution of the institutions themselves.

One way of illustrating the new orientation of the NIE is to consider the role of culture in economic outcomes. Economists have often made light of cultural explanations, arguing first that people in different cultures tend to want the same things, and second that since cultural variables have not been satisfactorily measured, explanations based on culture have been empirically vacuous. Economists who have downplayed cultural explanations, such as Balassa (1988) in his remarks on the successful economic development in East Asian countries, stress that what matters are policies and incentives. The analyst following the NIE approach can agree with Balassa that this is what matters, but she can point out that *individuals' incentives depeend on the behavior patterns and the cultural norms of the rest of society* (see the discussion of corruption in Section 5 of this chapter, and chapters 15–17).

In this connection it is useful to distinguish between *individual culture* and *community culture*. Individual culture is what the individual carries with him as a result of having been brought up in a particular culture. It is what differentiates an immigrant from the natives in a country. There is abundant evidence that migrants tend to adopt the behavior patterns of their new homes, at least in their economic decisions, and in this sense individual culture is usually not a serious obstacle to economic progress. (See Borjas, 1988, 1994 on the earnings of immigrants in the United States.) Community culture, on the other hand, is the set of norms, attitudes, and values of an entire community, and it of course affects the incentives of individuals to behave in particular ways. Community culture tends to reinforce and be reinforced by the patterns of behavior in the community, and it is obvious that the behavior patterns (institutions) and the associated cultural norms can be a serious obstacle to economic progress in the community (for example, corruption

in government and popular disdain for politicians and bureaucrats).

3 The New Institutional Economics

In the NIE institutions are defined as socially devised constraints on individual action (North, 1994). They are sets of rules that are recognized and frequently followed by members of the community, and which impose constraints on the actions of individual members. Of course the fact that people follow the rules may make the community much better off than it would be in the absence of any rules, and in that sense institutions are liberating rather than constraining. Nevertheless, at the individual level they impose constraints on behavior.

Thus broadly defined, institutions can be many things (Nabli and Nugent, 1989). They can be organizations, or sets of rules within organizations. They can be markets, or particular rules about the way a market operates. They can refer to the set of property rights and rules governing exchanges in a society. (The individual actors that are constrained by the rules may be organizations, and indeed frequently are.) They may include cultural norms of behavior. Obviously the rules can be either formally written down and enforced by government officials, or unwritten and informally sanctioned. The rules need not be uniformly obeyed to be considered institutions, but the concept does imply some degree of rule obedience. If the rules are generally ignored, we would not refer to them as an institution. Thus we may speak of the selection and replacement of political leaders in a particular country as not being "institutionalized" (as Huntington, 1968 does).

There are several different strands of literature in what is called the New Institutional Economics.[2] For our purposes these may be distinguished as follows.

3.1 Markets and hierarchies, or transaction cost economics

This branch is closely associated with the work of Oliver Williamson (1975, 1985). His early work addressed a question that had

[2] Although the categories are somewhat different, my conception of the NIE is basically consistent with Lin and Nugent (1995), who provide a fuller treatment of many of the topics mentioned here.

been largely ignored in the economics literature, although it had been raised by Coase in 1937: Why did certain transactions take place within organizations rather than between separate firms in a market? The topic is central to industrial organization, and it has important implications for the understanding of vertical integration, mergers, and anti-trust policy, and in this sense Williamson's work deals with the core subject matter of economics. However, Williamson altered the basic assumptions of economic analysis with his emphasis on the complexity of economic life, pervasive uncertainty, bounds on rationality, and opportunism. He argued that to understand why firms internalize transactions, one must take account not only of the limitations of human beings (that is, bounded rationality and opportunism) but also of their capacity and willingness to develop relationships of trust. Transaction cost economics has gone on to study the employment relationship, the nature of contracts in the business world, and many of the topics that are also treated under the next heading.

3.2 Economics of imperfect information

This broad category might be called the "economics of costly and asymmetric information." This literature began with two problems in the insurance industry, adverse selection and moral hazard. It has come to include the economics of screening and statistical discrimination, principal–agent models, theories of mechanism design, the economic theory of organizations, bargaining theory, and theories of incentive-compatible contracts. In contrast to transaction cost economics, this literature typically does not introduce moral considerations or other "soft" assumptions. The information structure is spelled out precisely and people are usually individualistic utility maximizers. Much of this literature is quite technical.

It is worth noting that some of the pioneering contributions in this literature were inspired by reflection on problems encountered in poor countries: Akerlof's lemons principle, Stiglitz's work on screening, and the large literature on sharecropping, which evolved into the literature on optimal contracts and merged with principal–agent theory. This observation helps to explain why mainstream economics is more applicable to less-developed countries than was thought to be the case in the 1950s and 1960s.

3.3 Economics of property rights

The property rights literature that emerged in the 1960s (classic references include Alchian (1965) and Demsetz (1964)) made the point that the structure of property rights is crucial to economic efficiency and economic progress. At a conceptual level, this literature clarified the many different dimensions of individual rights to use, rent, sell, destroy, modify, donate, and transform property and the ways in which the rights of some parties to treat their property affect the rights of others. One of the themes of this literature is that a variety of property rights structures can be reasonably efficient, provided that individuals are free to enter into contracts and that these contracts can be enforced. Thus whether the responsibility for damages caused by a defective product initially lies with the buyer or the seller is not important if the responsibility can be shifted by contractual provision. Similarly, if tenants suddenly acquire property rights in the land they have been renting, in theory there is no barrier to efficiency as long as these rights can be traded.[3] What this literature has condemned as particularly inefficient is a situation where such contracts are either prohibited by law or for other reasons are not enforceable in practice, and consequently landlords discharge tenants or refuse to take them on for fear of losing their property rights to the land.

The view that the initial allocation of property rights does not have efficiency implications has been strongly qualified by recent work in the economics of asymmetric information. In that literature, the initial allocation of wealth has implications for the efficiency of resource allocation, even if there is complete freedom of contract that courts will enforce (subject to the information limitations of the judicial process). For example, a potential creditor may be willing to lend to a potential entrepreneur only if the latter has enough wealth to make credible his commitment to the project (for other examples, see Hoff, 1994).

There has been a great deal of variation through history in the structures of property rights. Scholars have attempted to explain both why property rights changed in particular periods and how these structures affected economic efficiency and progress. The delimitation

[3] I ignore here the question of whether the process by which the property rights are changed alters expectations about their continuation.

and enforcement of property rights is a costly process; one of the early insights of this literature was that societies generally do not define and enforce property rights to resources that are not scarce, but as particular resources become scarce, through say population growth or technological change, societies tend to establish property rights in these resources (Demsetz, 1967; Feeny, 1988).

An explanation of property rights structures requires (1) an understanding of the behavior of the state, which normally plays an important role in defining and enforcing property rights, and (2) consideration of custom, social norms, intellectual structures, and ideology (North, 1981, 1990). This is a tall order, and economists don't usually claim to have comprehensive theories of these phenomena. Nevertheless, they have attempted to use the tools of economics to gain insight into these matters. Some of these attempts are described under the next heading.

3.4 Collective action

The economic theory of collective action grew out of the theory of public goods. Mancur Olson (1965) saw that the concept of a public good, which he defined by the nonexcludability criterion, and the associated free rider problem, could fruitfully be applied to a great variety of group goals, not just to the construction of pieces of physical infrastructure. Olson was keenly aware of the cost of information, and the rational ignorance of members of a large group plays a central role in his theory.

The theory is concerned with the conditions under which groups of people with a common interest will perceive that interest and act to achieve it. (For a recent review of this literature, see Sandler, 1992). Groups are more likely to act when the number of individuals concerned is small, when they interact frequently and can communicate easily with one another, and when they share common values and beliefs. Large groups can act collectively, but usually only when political entrepreneurs create organizations that provide rewards to the entrepreneurs and "selective incentives" to the members—individual punishments or rewards that provide incentives for individuals to contribute to collective goals. Many potential large groups remain latent. Groups are more likely to form where there are a few members with a significant stake in the

outcome. In the case of very large groups, in which no members have significant size in relation to the total group, where the technology of supply is that of summation of individual efforts, people will typically not make large sacrifices of personal welfare in order to contribute to the supply of the public good. The evidence indicates that people will make small sacrifices, such as bothering to vote or making small contributions to charity, even when the personal payoff is less than the cost, and on infrequent occasions some people will make large sacrifices, including even risking their lives, for collective goals, but most people in the ordinary run of their lives do not make large contributions to public goods unless there are enough private benefits from their actions (i.e. selective incentives) to make it worthwhile. Large groups do come into existence, mainly through institutional devices that provide these private benefits.

3.5 The evolution of cooperation and norms

Cooperation can emerge spontaneously between two parties, even when each is an egoist and they are potentially in conflict. In the last two decades a large literature in game theory has explored the conditions under which cooperation is likely to emerge. The likelihood of cooperation depends on the nature of the game (whether it is Prisoners' Dilemma, Chicken, Assurance, etc.) and on the probability of continued play with the same partner. This literature has merged with the literature on collective action as researchers try to understand cooperation in groups of all sizes and try to design institutional structures that make cooperation the best strategy in two-person encounters.

Noncooperative game theory has been fruitfully applied to the explanation of the institutions that preserve and maintain common property resources (Ostrom, 1990; Ostrom et al., 1994). In order to explain the empirical phenomena of cooperation as observed both in the field and in the experimental laboratory, these researchers have found it useful to modify the assumptions of classical game theory in the direction of placing less emphasis on the ability or willingness of participants to calculate their best strategies and more emphasis on their ability to find workable heuristics or norms that structure their cooperative efforts. Noncooperative game theory has also been used to explain the phenomenon of social order in stateless societies (see Bates, 1983,

Chapter 1 on the Nuer in Africa, and Eggertsson, 1990, pp. 305–310 on the Icelandic Commonwealth AD 930–1262). But as Johnson (1994) forcefully points out, particularly for the case of the Nuer, this social order relied on shared symbols, or cultural focal points. These symbols structure the way people think about their options.

There are many important links among these five strands of NIE literature. Understanding why property rights change or do not change involves consideration of the conditions under which collective action and cooperation take place. Collective action is clearly relevant to explaining the formation and behavior of the state, including the choice of economic policy. The insights from transaction cost economics and the economics of imperfect information, though they are mainly derived from the study of the private sector in market economies, are also fruitful in explaining the behavior of politicians and bureaucrats.

The study of institutions inevitably includes their evaluation from a normative point of view. There are some interesting differences among the five branches in this regard. In the Williamson-inspired transaction cost literature, where the basic property rights and political institutions are taken as given, there is normally a tendency for organizational forms and types of contract to evolve toward efficiency, from the point of view of the participants. The principle of competition applies to organizational forms and types of contracts, just as it does to choices of technology. Given a regime of private property, and in the absence of important externalities, the organizations and contracts that private parties arrange would tend to evolve toward social efficiency as well. The imperfect information school, however, shows that information problems generate externalities, so that contracts that are *pairwise* Pareto-efficient can often be socially inefficient, and thus there are many opportunities for an honest and efficient government to remedy market failures (Hoff et al., 1993, Chapter 1). Where individuals can spend resources to acquire information to increase their shares of a fixed pie, as often occurs in insurance markets, it may be efficient to have a government regulation that prohibits people from collecting or using that information. Although the early property rights literature included many examples of the emergence of private property rights in conditions where efficiency called for them, it was soon recognized that changes in institutions require cooperation and collective action, which may not emerge at all, or which

may emerge among groups with narrow interests that are sharply in conflict with those of society at large (North, 1990). To the extent that the powerful set the rules, there may be a tendency for the rules to benefit the powerful, but that does not necessarily imply a tendency toward social efficiency (Knight, 1992). Moreover, the rules may emerge out of the uncoordinated actions of different parties and may not serve well the interests of any of them.

Thus society's political institutions and property rights structures may be inefficient and may block economic progress. But it is even more inefficient if property rights, contract enforcement, and political succession are not institutionalized.

4 Illustrations of an Institutional Approach to Problems in Economic Development

This section is intended to give the reader the flavor of some of the NIE analyses that have been applied to less-developed countries and to the economic history of the now developed countries. A recurrent theme is that in order to deal with the questions posed, an expanded economics is necessary.

4.1 Interpretations of rates of growth and income differences

Why do poor countries remain poor? A long tradition in economics addresses this question with the intellectual framework of the aggregate production function. In a simple version of this approach, poor countries are poor because they lack physical and human capital. In this view, growth rates are interpreted as the results of accumulation of these factors, or in other words as the result of investment rates and growth of education and training. The vast literature on the "sources of growth," following Denison's pioneering work, is based on the idea that countries are on the frontier of some sort of production function, and a large literature in international economics has interpreted income differences and comparative advantage in terms of factor endowments and common production functions.

It is true that poor countries have small amounts of physical capital per head and have labor forces that are not highly educated. But it does not seem to be true that these factors of production are highly

remunerated in poor countries, as would be the case if the simple aggregate production function story were true. In fact highly skilled workers generally earn much more in rich countries than in poor ones, and capital flows from South to North as well as from North to South.

Of course economists familiar with less-developed countries have long been aware of the perversities of policies and institutions that lower the productivity of capital and labor, or in other words, that make production functions differ across countries. But systematic analyses of *how* the policies and institutions change the relationships between inputs and outputs have been rare.

In recent years economists have become aware of the importance not only of the economic policies of governments but also of the *credibility* of government promises to carry out announced policies (Brunetti and Weder, 1994). Underlying differences in credibility of policy announcements are differences in the institutions of policy-making. In many less-developed countries policies are changed by executive decree with no prior notice and without reconciliation of the terms of the new decrees and those of prior decrees. In such an environment property rights cannot be secure. Similarly, in many less-developed countries government bureaucrats have a great deal of discretion in the application of business regulations, and their decisions are not predictable by the businesses. The challenge is to come up with evidence that these differences in institutions matter for growth.

Researchers with an institutional focus have made two sorts of contributions in this area. One is to find *systematic* deviations of economic outcomes from those predicted by an aggregate production function approach. Such deviations provide indirect evidence that institutional differences are at work in generating these outcomes. The second is to find direct measures of the institutional environment of countries and to relate these to economic outcomes. Examples of each are given below.

Consider a scatter diagram where on the vertical axis we plot the rate of growth of per capita income of countries from 1960 to 1990, and on the horizontal axis we plot the level of per capita income at the beginning of the period. A regression line fitted to these data will have approximately a zero slope; that is, there is no strong tendency for poor countries to grow faster or slower than rich countries. However, the

dispersion of the rates of growth is much larger for the poor than for the rich countries. Thus the data resemble a cone, with the large end of the cone at the bottom of the income scale and the small end at the top. This pattern of the data is consistent with the interpretation that those poor countries that get their institutions and policies right will grow faster than rich countries, because the poor ones have greater opportunities for "catch-up" growth, while countries that have their institutions and policies badly wrong will not only be poor but will also have low rates of growth.

Now consider adding other variables to the growth-rate regression. In addition to initial income level, a standard set of "conditioning" variables includes the levels of primary and secondary education, some measure of political instability, and some measure of government intervention in the economy (Barro and Sala-i-Martin, 1995; Brunetti, 1995; Alessina and Perotti, 1994). With these variables controlled for, the relationship between initial income and subsequent growth is now strongly negative. This is the phenomenon of "conditional convergence," which says that if a low-income country provides education to its labor force, avoids the wrong sorts of government intervention in the economy[4] and avoids political instability, it will grow rapidly.

This evidence, which is consistent with an institutional interpretation of growth rates, is quite indirect. Recently some researchers at IRIS and elsewhere used direct measures of the institutional environment of countries in explanations of economic growth. These include "risk guide" variables, which are assessments by experts of the risk of investing in particular countries, a measure of "contract-intensive money" that reflects property and contract rights, and entrepreneurs' perceptions of the risk that they will be adversely affected by changes in government regulations. When added to standard growth and investment regression, these institutional variables turn out to be statistically and economically significant (see Chapter 3 below and the references cited there).

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[4] It is not clear *which* measures of government policy and political instability explain growth. as the results depend on which other variables are in the regression equation. See Levine and Renelt (1992).

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4.2 Why are services cheap in poor countries? Why do poor countries have comparative advantage in primary products?

Questions involving comparative advantage and comparative costs have usually been addressed in the economics literature in the framework of the factor-proportions model. The comparative advantage of countries in particular products depends, in this model, on the factor endowments of countries and the factor intensities of the commodities. This model has affinity with the aggregate function approach described in the previous section, in that production functions are often assumed to be the same in different countries, or if these functions are different, they differ in a way that is neutral across commodities.

An institutional approach to comparative advantage would recognize that commodities differ in the degree to which they depend on a well-functioning institutional environment that provides secure property rights, effective contract enforcement, and reliable physical infrastructure. In addition to the concepts of capital-, labor-, and skill-intensive goods, we might think of property- and contract-intensive goods. Examples of property and contract-intensive services would be banking and insurance. The prediction would be that countries with good institutional and physical infrastructure would have comparative advantage in these services. Casual observation seems to bear that out.

Clague (1991) has presented a model of comparative advantage in which goods are distinguished according to whether their production can benefit from either large organizations or extensive interaction among different enterprises. Some commodities and services are quite "self contained," in that their production does not benefit much from an elaborate division of labor that requires coordination within large organizations or across different firms. The hypothesis from the model, then, is that countries with poor property rights, contract enforcement, and physical infrastructure institutions would tend to have comparative advantage in self-contained goods and comparative disadvantage in goods that are the opposite of self-contained. The model helps to explain why some services (those provided by restaurants, hotels, taxicabs, barbers, and repair persons) tend to be cheap in poor countries: These services are relatively self-contained. The model also helps to explain the strong tendency for poor countries to have comparative advantage in primary products, for these tend to be more self-contained than manufactured

products. Within manufactures, poor countries tend to have comparative advantage in the goods which, even in the favorable institutional environment of the rich countries, are relatively self-contained and are produced in relatively small organizational units.

4.3 Sharecropping

In many countries sharecroppers are near the bottom of the socioeconomic ladder and are often perceived by observers to be the victims of exploitation by landlords, who are typically much better off economically and higher ranking in the social and political spheres. The practice was widely considered to be "feudal," or in other words, a remnant of a domination relationship between landlord and tenant, and it was legally prohibited in many countries as part of land reforms. The topic attracted considerable interest among economists during the 1970s, and one of the successes of the emerging theory of asymmetric information was a convincing account of why landlords and tenants would *both* prefer a sharecropping contract to either a fixed-rent contract or a wage contract. A wage contract has the obvious disadvantage of giving the cultivator little incentive to apply effort, above that required to avoid being discharged, and it imposes a burden of labor monitoring on the landowning employer. A fixed-rent contract, which makes the cultivator the residual income recipient of the outcome of the crop season, provides a strong incentive for effort, but it forces the cultivator to bear the risk of crop variability, a risk which the poor cultivator is usually thought to be less willing to bear than the richer landowner. Furthermore, an annual rental contract gives the cultivator-renter little incentive to build up the fertility of the soil, since the landowner has the right to replace the current tenant (or threaten to do so) and raise the rent.

Even when risk considerations are left aside, it can be shown that the sharecropping contract provides a more efficient harmonization of the interests of landlord and cultivator than either of the other two alternatives, in conditions where building up the fertility of the soil is a relevant consideration. One intuitive explanation of this result is that each of the other contracts involves one large "distortion," or gap between effort and reward, while the share contract involves two smaller distortions. Since the efficiency loss of a distortion is approximately proportional to the square of the size of the distortion, the sharecropping

contract is less inefficient than the other two (Barzel, 1989).

But this explanation still leaves a puzzle. According to Barzel's theory, the terms of the sharecropping contract, that is, the share of the crop allocated to the cultivator and to the landowner, as well as the ancillary conditions such as the production responsibilities of the two parties, should vary with the varying relative scarcities of land and labor. Yet one of the striking empirical regularities of the sharecropping literature is that the shares tend to be simple fractions (such as equal halves or one-third/two-thirds) and the shares in a given community are remarkably stable, even as labor and land scarcities vary over time.

How can this puzzle be explained? The following explanation is based on Murrell (1983). In view of the importance in many agricultural contexts of building up the fertility of the soil, it is highly desirable for the landlord and the cultivator to have a long-term relationship based on mutual trust. The cultivator wants to be confident that the landowner will not replace him as long as he works diligently and invests in the fertility of the land. The landlord wants to find a tenant who will do just that. A disadvantage of the fixed-rent contract is that it presents the parties with a conflict situation when circumstances, such as prices, change. A change in the rent is perceived as a gain for one party at the expense of the other. In a sharecropping contract, this conflict is muted, since the parties' returns move together automatically as prices change. Moreover, a landowner who proposes a share that departs from the standard one in the community is likely to be perceived as unfair and untrustworthy and he will suffer the consequences of that perception. Consequently as prices and resource scarcities change, it is the ancillary conditions of the contract rather than the shares that change. The ancillary conditions are less precisely defined and less easy to compare across contracts than the shares and hence can be changed somewhat without incurring the charge of unfairness.

4.4 Merchant law and medieval trade

It has long been recognized that the development of a legal framework in which contracts could be enforced was essential for the development of commerce in medieval Europe. The new insight coming out of the NIE is that the emergence of the legal institutions of this commerce could be explained in terms of the largely self-interested

actions of the participants.

The emergence of a rule of law is often thought of as the development in the community of a stronger commitment to morality, a greater willingness to put the interests of the community ahead of one's private interests. Economic historians steeped in the ideas of the NIE have explained these institutions instead in terms of the self-interested actions of the actors. The story they tell is not a testament to the rising level of human morality; rather it is mainly a story of selfish people constructing institutions that happened to benefit society (for examples of this literature, see Greif, Milgrom, and Weingast, 1994; Greif, 1993, 1995).

Consider the problem of the Ruler of a city who wants to encourage long-distance trade to take place there so that he can tax it. How can the Ruler convince the merchants that he will not seize their goods? One might think that a reputation mechanism would suffice, since a Ruler who was known to have acted arbitrarily against merchants would lose commerce. But this mechanism is not sufficient; the Ruler might create confusion about whether a particular merchant has broken some law and deserved to have his assets confiscated, so it would not be clear to other merchants whether the Ruler had acted arbitrarily or not. From the point of view of the Ruler, any particular merchant's future trade is of marginal importance, and consequently the Ruler has more to gain from seizing the merchant's assets than from taking the tax revenue from his present and future trade.

Thus the Ruler, in order to make a credible commitment not to abuse merchants' rights, has an incentive to encourage the merchants to organize into a guild, the officers of which would be charged with incurring the expense to determine the facts of disputes between the Ruler and particular merchants and then informing the members of the guild if the Ruler had acted arbitrarily.

But the existence of such a guild is not sufficient to deter the Ruler from arbitrary confiscations. Once a trading center has developed a substantial volume of trade (and a sizeable population with demands for goods), the announcement by the guild that the Ruler had acted arbitrarily would not deter all merchants from trading there. A partial boycott would lead to more profitable opportunities for trade. Thus to provide an effective deterrent against arbitrary actions by the Ruler, the guild must

have means to force the members to respect an announced boycott. The German Hanseatic League is an example of a guild with the power to do this, since the individual merchants needed to be members in good standing in order to enjoy trading privileges in their home towns. The expansion of trade between the 11th and the 14th centuries in Europe was not due to technological breakthroughs, but rather to the emergence of interlocking institutions that served to make contract compliance and respect of property rights the best strategies for most of the participants most of the time.

4.5 Corruption, Bureaucracy, and Development

The study of corruption in less-developed countries, once eschewed as politically incorrect (Myrdal, 1968), has recently attracted a great deal of attention from economists. One issue is what determines the prevalence of corruption in a society. Another is the effects of corruption on economic development.

On the first issue a number of models have shown how societies starting from similar situations may wind up with different levels of corruption (Andvig and Moene, 1990; Clague, 1993; Sah, 1988). In other words, in these models there are "good" and "bad" equilibria, with low and high levels of rule obedience. The models depict different situations but a common theme is that the probability of getting caught and punished for breaking the rules declines as the number of violators increases. Thus in the "good" equilibrium, an individual who contemplates rule violation faces a high probability of getting caught and punished, and so people rationally choose to obey the rules. In the bad equilibrium, on the other hand, the probability of getting caught is low and so people rationally choose to violate the rules. The modification of attitudes along with behavior tends to reinforce the conclusion that societies evolve along different paths and that in particular it is difficult to escape from a "bad" equilibrium where there is pervasive corruption. The difference between individual and community culture (see p. 4 above) is again illustrated by the observation that when individuals leave a society where corruption is rampant and migrate to a society where it is rare, they tend to adapt themselves to the new environment, where there are typically strong incentives not to break the rules.

Another determinant of the prevalence of corruption is the nature

of government activity. Where the state limits its role to the protection of property rights and the enforcement of contracts between private parties, the enforcement of the rules is made easier by the fact that usually at least one of the private parties is eager to help the state perform its duty. People want to have their property protected and to see that other parties live up to their contracts with them, and they are usually willing to cooperate with the authorities in providing information and otherwise to help the authorities bring violators to justice. When, on the other hand, the state intervenes in the operation of the private market in such a way as to forbid private parties from making a transaction that both parties want, the task of law enforcement is much more difficult. The so-called "victimless crimes" of gambling and prostitution are examples of law violations that are extremely difficult to prevent. In many countries, governments attempt to control prices, license foreign exchange, and impose burdensome regulations on business, and these rules create strong incentives for bribes of government officials to look the other way. Of course a government needs to provide physical infrastructure and to collect taxes, so its activity cannot be limited to the night watchman role.

The second issue concerns the effects of corruption on economic growth. It seems that its effects can vary widely, depending on the circumstances. Consider the case where government permits must be obtained to carry out an economic activity. Shleifer and Vishny (1993) provide an analysis of the industrial organization of corruption. Where the permits are controlled by a bureaucracy that is effectively controlled from the top, there is a monopoly in the supply of permits and the monopolist will set his bribes (and the associated quantity of permits) so as to maximize his revenue. In this case, the briber "gets what he pays for." Where the different permits are controlled by independent authorities, the per-unit bribe will be higher, and the level of output lower, than in the monopolist equilibrium. The different authorities impose negative externalities on one another, which they don't take into account in their independent decisions, and the consequence is that the aggregate amount of bribe revenue and the level of output both suffer. The worst case is where there is free entry into bribe collection, for in that case, the per-unit bribe rises without limit and the economic activity that depends on the permits declines toward zero. This analysis is in

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striking analogy to Olson's roving bandit (see Chapter 5 below). The case of monopoly in the issue of permits corresponds to the autocrat who establishes secure property rights, whereas the case of free entry into bribe collection is one where the government is too weak to guarantee the permit holders the right to carry out the activity to which the permit is supposed to entitle them.

It is often remarked that corruption exists in all societies, including rich ones and rapidly growing ones. It is easy to imagine circumstances in which corruption does little or no harm to economic growth. If the government imposes burdensome regulations on business, the non-enforcement of these regulations, purchased by bribes, may be more efficient than enforcement. To take another example, if the costs of government contracts for infrastructure are inflated by 10 per cent by required payoffs to politicians, the deadweight loss from these transfers is likely to be small, provided the needed infrastructure is provided[5]. On the other hand, corruption can be extremely costly to growth when it severely impairs the incentives of potential innovators (Murphy, Shleifer, and Vishny, 1993; Olson, 1982, Chap. 3), as it is likely to do when it accompanies heavy government regulation of the private sector. Established businesses will tend to have ongoing cooperative relationships with corrupt officials, and they will have enough financial resources to pay hefty bribes. Potential entrepreneurs armed only with good ideas are not likely to be able to break into the charmed circle.

The study of bureaucracy, like that of corruption, has traditionally lain outside the purview of economists, including those working on economic development. These topics have been left to other social sciences, where there are large literatures on them. However, the economics of organization (Moe, 1986; Tirole and Laffont, 1992), which is a branch of the economics of imperfect and asymmetric information, has in the last two decades offered a different perspective on organizations from that of classical sociology, behavioral political science, and the field of public administration. As would be expected, in the economics of organization the emphasis is on reward systems, monitoring

[5] To be sure, in these cases one must consider the effects of rule violations on the attitudes of the rest of society toward rule obedience.

systems, and individual and group incentives (see Klitgaard, Chapter 17 below).

The application of these ideas to bureaucracy in less-developed countries is long overdue. It is clear that the performance of government bureaucracies has a major impact on the pace and character of economic development. Major positive contributions to development have been made by bureaucracies in Japan, Korea, Taiwan, and Botswana (Levi and Sherman, Chapter 18 below; Clague, 1994), while ineffective and corrupt bureaucracies have held back development in many countries. A deeper understanding of why government bureaucracies perform the way they do would contribute a lot to our understanding of why growth rates differ.

I hope this chapter has persuaded the reader that the NIE offers a useful framework for thinking about numerous problems in economic development. The rest of this book is devoted to providing further evidence.

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CAER Discussion Papers

Reform of the Legal, Regulatory and Judicial Environment - What Importance for Development Strategy?

Clive S. Gray

CAER Discussion Paper No. 10, August 1991

HIID

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REFORM OF THE LEGAL, REGULATORY AND JUDICIAL ENVIRONMENT - WHAT IMPORTANCE FOR DEVELOPMENT STRATEGY?

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LEGAL, REGULATORY AND JUDICIAL REFORM

1.1 BACKGROUND

During the 1970s it became clear that many poor countries, probably a majority, in pursuing policies that were heavily shaped by ideology, vested interests and/or an overarching concern with equitable distribution of the fruits of development even before there was much fruit to distribute, had built severe imbalances into the structure of their economies. One major manifestation of imbalance was that large spheres of economic activity were reserved to government enterprises that turned out to be riddled with corruption and otherwise incapable of generating significant value added. Another major manifestation was that incentives to export both traditional and new products were dampened in favor of substituting imports to meet demand from a local market that, in large part because of poor export performance, turned out to be sluggish.

To combat these imbalances the international development community urged the countries concerned to undertake programs of 'structural adjustment', and redirected a significant portion of financial assistance to support such programs. Elements common to most of the programs were: pursuit of factor-pricing policies that pointed towards free markets in foreign exchange and capital, thereby inter alia raising agricultural producer prices; restraint of government expenditure and bank credit to curb inflation; and reform of the public enterprise sector through introduction of 'hard budget' constraints, contract programs, and privatization.

In 1989 the World Bank and UNDP (IBRD 1989) looked at 31 sub-Saharan African countries regarded as needing structural reform and classified them according to the intensity of their reform programs; 19, or roughly 60 per cent, were judged as having applied 'energetic' programs (Group 1), while the remaining 40 per cent were rated as having 'weak' programs or none at all (Group 2). A comparison of economic indicators (unweighted averages) as between the two groups showed that relative prices were inducing more efficient resource allocation in Group 1, while parameters such as agricultural output, exports, investment and savings performed better in Group 1. On the other hand, during the last period for which comparative data were available, 1985-87, growth of real GDP and per capita consumption performed poorly in both groups and negligibly better in Group 1 than in Group 2 (GDP: 2.8 vs. 2.7%, consumption: -0.4 vs. -0.5%).

The experience of the dynamic export-oriented economies of the Far East warns us not to expect an immediate supply response from "getting the prices right". A realistic exchange rate and other market-oriented policies must be securely in place for a few years before entrepreneurs develop confidence in the government's commitment and are willing to risk their assets. However, whether out of concern that the response has thus far been less than might have been expected, or that remaining obstacles to efficient resource allocation will mute the response when the time comes, the international development community is now looking beyond the policy changes featured in structural adjustment and examining other areas where measures could be taken to accelerate growth. One such area, the subject of this paper, is the legal, regulatory and judicial environment.

Succeeding sections will pinpoint the role of the legal-regulatory-judicial (LRJ) environment in affecting resource allocation and entrepreneurial initiative in poor countries. Phenomena that cause the LRJ environment to impede economic efficiency will be identified, and options for reform will be examined. Attention will focus initially on three pillars of the legal system underlying every market economy, namely security of

private property, enforcement of contracts, and assignment of liability for wrongful damage.

Next, the discussion will consider supplemental categories of business law that facilitate the creation and funding of institutions necessary for efficient production and distribution of many goods and services. It will then review six common fields of business regulation that present options for removing obstacles to efficiency (if only by dismantling the regulatory structure altogether): namely licensing & concessions; regulation of labor, the financial market and prices; control of restrictive business practices; and official conflicts of interest.

Since legislation alone does not define the LRJ environment, the discussion will conclude by examining the functioning of the institutions that determine how the system operates in practice, namely the machinery for settlement of disputes and enforcement of judgments, as well as institutions that affect the transparency of that operation, notably the press.

1.2 THE LEGAL, REGULATORY AND JUDICIAL ENVIRONMENT FOR DEVELOPMENT

The LRJ environment is taken here to comprise the set of rules, institutions and practices governing business transactions. It is a truism that an LRJ system that has evolved within a tribal or feudal society is not adapted to the transactions that characterize a market economy. Most developing countries inherited from their former colonial masters LRJ systems that were consistent, at least in outward appearance, with business transactions characterizing pre-World War II industrial societies.

Again in nominal terms, many of the systems were updated to postwar conditions before independence, and nearly all developing countries have subsequently modernized them, often following quite faithfully recent legislative advances in the former metropole or other industrial democracies. At the same time many of these countries have retained LRJ restrictions over prices, marketing institutions, employment practices, foreign trade, investment and finance that the colonial powers instituted to meet wartime conditions--e.g. the monopsonistic agricultural marketing boards established in British colonies during the war. This has led to the striking peculiarity that most poor countries have a plethora of LRJ mechanisms that protect monopoly, inefficiency and corruption, while mechanisms required for competitive market efficiency are ineffective or absent.

Even when a poor country is endowed with appropriate legislation and institutions it does not automatically follow that implementation proceeds in such a way as to promote the formation of a market economy. The experience of such economies suggests that three additional elements must be present to a greater or lesser degree:

i. A machinery for settlement of disputes in whose integrity and effectiveness economic agents place a minimum level of confidence;
ii. An apparatus for enforcement of judgments under (i) whose integrity and effectiveness likewise enjoy the agents' confidence; and
iii. A minimum degree of consensus among economic agents as to what constitute reasonable rules of the game, and a minimum level of willingness to adhere to the rules;

At first sight it might appear that elements (i) and (ii) would suffice to impose the rule

of law in business transactions, but without the consensus under (iii), the machinery for settling disputes and enforcing judgments would be swamped and thus ineffective. It can be argued that effective institutions under (i) and (ii) are a prerequisite to achieving the required consensus. Without machinery for dispute settlement and enforcement of judgments the incentive to adhere to rules is severely impaired.

The question now arises: what are the principal causes, in poor countries, of:
(a) absence of LRJ rules and mechanisms that favor an efficient market economy,
(b) the plethora of rules and mechanisms unfavorable to competition and efficiency, and
(c) weakness of implementation of 'good' rules and mechanisms?

The first, probably most important answer is linked to the sources of political authority in the Third World. In many countries, notwithstanding the trappings of democracy, individuals and groups hold political authority over extended periods by virtue of (i) their hereditary positions in tribal or clan-directed societies, (ii) their material wealth, starting with but not limited to holdings of land, and/or (iii) their access to means of repression, notably the armed forces and the police.

The meaning of rule of law is that the legal system is sufficiently insulated from the locus of political authority to give persons not sharing in that authority a minimum degree of confidence that their rights under the law will be upheld if they follow its rules. In many poor countries this condition is not fulfilled. A person not sharing political authority cannot be confident that his property will not be confiscated; that his legitimate interest will be upheld if a customer or supplier violates a contract; that he will be able to collect damages from a party responsible for a tort; that he will be subject to (more or less) equal treatment under various types of regulations; or that, other things being equal, he will have equal access to concessions offered by the government to encourage investment, production and employment.

Such circumstances discourage investment by economic agents other than those sharing in the political authority, and restrict the circle of parties with whom they are willing to enter into other than instantaneous transactions. In effect, one is reluctant to conclude contracts with agents other than those with whom one shares kinship or other social ties that facilitate enforcement outside the formal legal system. Clearly such a situation hampers efficient allocation of resources and retards economic growth.

Pari passu with the weakness of human resources that impedes governance at many other levels, implementation of legal systems so as to promote economic efficiency is also obstructed in poor countries by lack of training and experience on the part of the responsible personnel. Some countries seem to be oversupplied with persons skilled at manipulating the law, but others certainly have fewer than they need. Even if the national supply is adequate, the government's weakness often deprives the public sector of its fair share of legal draftsmen, judicial administrators, effective prosecutors, and so on.

Reviewing different areas of law, this paper will examine possible shortcomings in the legislation currently in force in certain poor countries as well as in its implementation, and consider options for reforming these legal systems so as to enhance efficiency and growth.

1.3 THE CONCEPT OF AN OPTIMAL LEGAL SYSTEM

No pretense is made that A.I.D. or any other authority knows enough about the cultural background and constraints of individual countries to write ideal laws and design optimal means of implementing them. From the economic viewpoint, an optimal legal system must satisfy two conditions: (i) for a given set of social benefits generated by the system, it must minimize the sum of transaction costs associated with it; and (ii) the incremental social benefit generated by another measure of regulation would barely offset the additional transaction costs created thereby. Transaction costs are of two types: (1) costs incurred in conducting legal procedures, and (2) inefficiencies that arise in seeking to evade those procedures.

An example of transaction costs is those associated with the licensing of businesses. Some persons desiring to practice a trade decide to seek the required permits, while others decide to pursue the trade without the permits. The first group incurs application and registration fees; legal honoraria; other out-of-pocket expenses; and the opportunity cost of the time spent conducting such procedures and waiting for authorizations. These are transaction costs in the first sense. A member of the second group may have to pay protection money; he may also find it necessary to conduct his trade on a smaller scale and in a more transient manner than he would in the absence of licensing, thereby producing less, incurring higher unit costs and generating lower value added. These are transaction costs in the second sense.

Clearly a legal system does not achieve optimality by reducing transaction costs to zero. Just as society may decide democratically that new drugs should be tested and approved for human use, so also it may decide to zone some urban areas for nonbusiness use, or out of health or safety considerations restrict certain trades to specified areas. (Government may also restrict entry to reduce competition faced by current practitioners, but this is a less reasonable social objective, indeed in most cases a perverse one.) If these restrictions are to be enforced, then some transaction costs are unavoidable. Certain trades will be difficult to close altogether to operators without permits; suppression beyond a certain point would involve administrative costs in excess of the social cost posed by their operation.

An important element of transaction costs is the insurance premia that economic agents pay in order to limit the risk of having to cover damages caused by their actions (in the absence of insurance coverage, the cost becomes the risk of having to cover damages directly). Both damages and, accordingly, premia that suffice to compensate for them are minimized to the extent that (i) agents pay premia in proportion to the probability of causing damages, and (ii) the legal system establishes rules for assessing damages objectively and assigning them fairly to those responsible. Lack of such rules makes costs less predictable, increases risk and poses obstacles to entrepreneurial initiative.

Saying that to each set of social objectives there corresponds an economically optimal LRJ system does not carry us far towards deciding what LRJ system is optimal for a given country. One reason is the variability of social objectives pursued by different governments at different times, and by different social groups, even individuals. Obviously it is not up to A.I.D. or any other outside agent to set social objectives for a sovereign country.

A case in point is ownership of agricultural land. In western industrial societies this is private property, subject to the same LRJ treatment as any other asset class. As will be shown in section 1.4.1 below, some Asian countries with vigorous market economies have pursued social objectives through programs of land reform in which holdings above certain sizes were confiscated at prices well below market. Others, especially in Africa, follow the policy that generalization of fee-simple ownership would prejudice legitimate interests of holders of subsidiary rights without compensating economic benefits.

A second reason for caution in prescribing a unique LRJ system is our lack of knowledge as to which of several alternative approaches to a legal or regulatory issue will yield the most efficient results. What transactions costs would have been incurred in the absence of a particular legal scenario? In what cultures is a comprehensive code more efficient than a common-law approach leaving it to the courts to formulate the law incrementally? What variant of corporation law represents the most efficient model for a particular environment--that of Delaware, New York, or Britain? Should one eschew current western models and look for earlier, less sophisticated variants? What is the interaction between the legal and political systems? Are some models more efficient in a multi-party versus a one-party state? In an inflationary versus a stable economy? What are the trade-offs between equity and growth? Is growth helped or hindered if small entrepreneurs have the same access to a sluggish judiciary as a captain of industry?

Notwithstanding these uncertainties one can properly take note of the increasing worldwide consensus that competitive market economies, equipped with safety nets for vulnerable members of society, perform far better in satisfying the wants of the masses than other types of economies. Therefore it is appropriate to seek general principles of LRJ reform suited to making competitive market economies function better, while watching out for cultural and other factors that call for variants of the overall strategy.

This will be done in the succeeding sections by first considering three basic elements of a legal system suited to a market economy, namely property, contracts and torts; next examining three further areas of business law, viz. company law, bankruptcy and secured transactions; then turning to six areas of business regulation, i.e. licensing & concessions, labor regulation, financial market regulation, price control, control of restrictive business practices and official conflicts of interest; and finally looking functionally at three categories of implementation, namely dispute settlement, executive enforcement and institutions promoting LRJ transparency.

Before proceeding to the first area of legal substance it is appropriate to acknowledge the intellectual debt owed by this field of analysis to the writings of the Peruvian economist Hernando de Soto, especially in his acclaimed work The Other Path (1989). No other writer has yet assembled as much evidence of the obstacles posed to economic activity by a distorted LRJ environment.

1.4 FOUNDATIONS OF A LEGAL SYSTEM FOR A MARKET ECONOMY

As noted by de Soto, property rights, contracts and extra-contractual liability (known by lawyers as 'torts') are the three foundations of a legal system suited to a market economy. The following sections consider briefly the relationship of each of these to development. Implicit in the discussion is not only the substance of the relevant laws but their manner of implementation, that is the extent to which the intent of the laws is realized through the machinery for settlement of disputes and executive enforcement.

1.4.1 Property Rights

In neoclassical economics a system of property rights is economically efficient if the rights are universal (i.e. all property is owned by someone, whether the party is private or public), exclusive and transferable. The theory says that property with no legal owner is

likely to be abused; an owner without exclusivity will incur uneconomically high costs in protecting his claim; while transferability ensures that property accrues to operators capable of realizing the highest value added from it. Property law serves to establish and enforce property rights, settle disputes and assign rights among legitimate uses that are incompatible.

Going beyond these precepts neoclassical economics predicts that private ownership of the means of production will ensure substantially more efficient use of them than state ownership. Little more need be said about this in an era when state ownership has been resoundingly discredited and societies that until recently espoused doctrinaire communism are struggling to create and apportion individual property rights that will generate the incentives needed to revive production.

A dramatic illustration of the returns from facilitating private ownership in a poor country is provided by de Soto's estimate from a sample of 37 informal residential settlements in Lima, that investment in an average house in settlements where occupants were able to obtain land title was worth nine times that in houses whose occupants could not obtain title. This does not mean, of course, that the state may not have a legitimate interest in protecting certain domains from settlement, in which case denial of title can be justified.

Not surprisingly, de Soto finds that a business' ability to defend its rights in property is correlated with its status vis-à-vis licenses or permits required to operate legally. If the business chooses not to acquire or is denied legal status, then its access to the legal system to defend the property it uses in trade against encroachment by the state or private interests is severely limited. No one would argue that such access should be provided to anti-social enterprises, but De Soto's thesis, to which we return in discussing business regulation, is that rent-seeking bureaucrats and/or established businesses seeking a shield against competition have elevated the costs of registration and licensing far above the value of any social benefit generated thereby. Thus, reform in this area would not only enhance the value of much business property owned by small businessmen, along with their incentives to acquire, create and use such property, but it is also desirable on its own merits.

Postwar experience in some poor countries has led many economists to conclude that the neoclassical paradigm of private ownership as a key to efficient use of resources needs to be qualified where concentration of holdings passes certain limits. This applies particularly to ownership of land, and specifically in agricultural areas juxtaposing large individual or corporate holdings with smallholder agriculture and landless rural labor. Some experience--for example, that of Japan, Korea and Taiwan--suggests that state-imposed land redistribution, apart from its merits on grounds of equity, can lead to more intensive use of factors. Taiwan's land reform was conducted with sufficient skill so as to leave displaced landowners with incentives and some wherewithal to spearhead industrialization. This formula has not yet been put to the test in countries such as the Philippines, Morocco and much of Latin America, where landowners retain sufficient political clout to resist land reform.

A different type of qualification emerges from experience in rural Africa, where some administrations, encouraged by donors, have introduced individual land titling with the intention of stimulating agricultural investment through formation of a land market and use of land as collateral for bank credit. Evidence from several provinces of Kenya (Shipton 1989, Atwood 1990) suggests that this effort has often failed to produce the desired results. Traditionally, land is subject to hierarchies of rights and duties that shift as

children grow up and parents age. Individual titling suppresses the interests of subordinate rightsholders both within the family-- particularly female members--and outside it. Irrespective of the effect on resource allocation, the impact on social equity is decidely adverse. In areas where both mixed farming and herding are practised, with land rights subject to seasonal oscillation, interests of the pastoralists likewise tend to fall by the wayside.

At the same time the efficiency benefits of titling are thrown into question by the fact that only a minor fraction of successions and other post-titling transfers are registered. Meanwhile lenders' attempts to foreclose on land posted as collateral and resell it are frustrated by neighbors and kinsmen. Hence the banks remain aloof from smallholder credit.

This experience has encouraged social scientists to reexamine traditional land tenure systems in Africa and reconsider their supposed inefficiency. The current tendency is to stress the security of tenure associated with many systems, the finding that tenure issues are not a major obstacle to innovation, and the fact that, even under traditional systems, much de facto transfer occurs from relatively inefficient cultivators to persons who use more inputs and obtain higher yields. As for credit, this can be secured by chattel mortgages in livestock or machinery, cosignatures by patrons, and group guarantees, as seen in rotating savings and credit associations. A current hypothesis, linked to the discussion of financial market reform below, is that liberalization of that market through legalization of informal credit would increase the supply of credit and lower interest rates to farmers.

In a nutshell, issues of property in agricultural land highlight the tension between theory and observation, leading us to qualify the neoclassical paradigm regarding individual property. In some Asian countries with highly unequal land distribution, imposition of ceilings on holdings has had a beneficial impact on both equity and resource allocation, while in some African countries imposition of individual titling on a complex web of tribal rights and obligations has compromised equity and failed to promote growth.

1.4.2 Contracts

Any exchange of goods or services involves at least implicit contracts. Contract law spells out the terms of implicit contracts, such as undocumented sales, and establishes procedures for implementing the terms of both implicit and written contracts, for settling disputes about implementation, for determining remedies for breach of contract, and in general for meeting contingencies not all of which can be anticipated even in a written contract. Contracts are particularly important for setting the terms of those transactions and relationships which stretch over a period of time.

Economically, contract law is subject to two tests: (1) it should enable parties to match their preferences, and (2) it should maximize predictability, meaning that it produces outcomes that the parties would have specified in their contract had they foreseen the relevant contingencies from the outset. An important condition for passing test No. 2 is that contract law must allocate risk in a fair manner.

De Soto's analysis of the informal sector in Peru illustrates the obstacles faced by a businessman who cannot resort to enforceable legal contracts. His inability to incorporate or form partnerships restricts his access to debt and equity capital, thus limiting the size of his venture and ability to realize economies of scale. The lack of effective guarantees for

performance by unrelated customers and suppliers restricts his willingness to deal outside a circle of close social contacts subject to informal guarantees. Lack of access to enforceable loan contracts restricts the circle of borrowers whom a financier can service. Nonavailability of enforceable rental contracts dampens readiness to invest in rental properties, thus restricting the supply of rental housing--a phenomenon also associated with rent controls (and not only in poor countries).

1.4.3 Torts (Extra-Contractual Liability)

Tort law defines the responsibility of operators vis-à-vis parties with whom they have no contractual relationship. It identifies wrongful damages caused by action and inaction, enacts procedures for assessing their value, and thus lays the basis for insurance to spread risk efficiently, in the process enhancing predictability for business operators.

Tort law is subject to two economic tests: firstly, it should ensure that parties whose interests are wrongfully harmed will receive full, but not excessive, compensation. (Since in practical terms some awards will exceed actual damages while others will underestimate them, the criterion becomes one of ensuring that 'expected' compensation is equal to damages.) Failure of the law and its enforcement to meet this test imposes transaction costs in the form of measures (i) to forestall wrongful damages that might be inflicted by competitors and others, and/or (ii) to compensate for excessive awards. The resulting costs and risks involved may deter operators from production (this is not limited to poor countries--cf. U.S. obstetricians who retire rather than pay insurance premia required to cover recent jury awards).

The second test is that the law should induce operators to take efficient precautions to avoid causing damages. Precautions are efficient when the incremental expected damage they avoid barely offsets their incremental cost. (Absolute precautions are not efficient because they are tantamount to non production). Operators can minimize their risks through liability insurance, at which point insurers assume the burden of ensuring precautions.

The issue arising most often in practice regarding torts is one of implementation rather than legal substance. In many countries small, poorly connected agents have little chance of collecting damages from powerful operators. The intervention of some court systems in transactions of the market economy is either too inefficient or too easily bent in favor of the powerful to give the majority of operators much confidence in that remedy. This may be offset partially by transferring the onus of collecting damages to an insurer capable of defending its own interest. The resulting costs must be reimbursed through relatively high premia (cf. collision auto insurance). For all businesses this increases operating costs; for those not properly registered, insurance is often not accessible.

1.5 SUPPLEMENTAL BUSINESS LAWS

1.5.1 Company Law

The essential function of company law is to limit the liability of shareholders to their shares. Without such protection, equity investors in an enterprise whose assets are exceeded by its liabilities are themselves liable up to the full extent of their assets. Under such conditions few investors would be inclined to help capitalize enterprises over whose

operations they had little control. In the production of many goods and services in a modern market economy, realizing economies of scale requires capitalization far exceeding the means of the entrepreneurs directly involved, their families, and/or partners.

Equity financing achieves its potential within the framework of securities markets, which do not yet play a significant role in most poor countries, though efforts have recently intensified to launch them.

1.5.2 Bankruptcy

The establishment of orderly procedures for transacting an enterprise's cessation is a vital component of business law. Bankruptcy is a normal, even necessary phenomenon in a market economy; its rate varies with the business cycle, but there is an underlying healthy rate for every economy.

Governments of poor countries often try to stifle bankruptcy of not only state-owned but also private enterprises on the ground that it leads to unemployment and wastage of capital. The result, however, is that scarce resources drain into inefficient enterprises, in the process creating unfair competition for efficient ones. Owners of bankrupt enterprises are also prevented from wiping their slate clean and getting a fresh start.

In cases where enterprises cannot be kept afloat, lack of adequate legislation and supervision vitiates orderly establishment of priorities among creditors and opens the de facto liquidation process to fraud. This increases the risk faced by financial institutions, creating costs which they must pass on to borrowers.

1.5.3 Secured Transactions

So as to facilitate investments financed at least in part by credit, creditors must be assured of ability to realize their collateral without delay in the event a borrower defaults on service payments. In some poor countries the law and its implementation are biased in favor of borrowers; there and in many other countries the realization of collateral is a tedious and expensive process. This has the effect of diminishing the creditworthiness of new borrowers and thus hampering investment.

1.6 BUSINESS REGULATION

1.6.1 Licensing & Concessions

In many poor countries issuance of permits to enable enterprises to start up is a tedious process that imposes significant costs on would-be investors without generating a corresponding social benefit. De Soto offers precise data regarding the burden of official authorization procedures on aspiring Peruvian investors. In the case of housing, a group of low-income families desiring to build legally on state wasteland must spend on average 6 years 11 months to obtain the required permits. Adjudication of the land alone requires 207 bureaucratic steps, involving 48 different government offices and taking 3 years 7 months. The process would cost the average family $2,156, equivalent to 4 years 8 months of the minimum wage.

Simulating the opening of a store, de Soto & associates found the required procedures would take 43 days and cost 1 year 3 months equivalent of the minimum wage. Petty traders joining together to build a market would need 8 years to obtain the necessary permits. Obtaining approval for a mini-bus route would take a group of owners 26 months, while 27 months would be required for a single owner to obtain a concession to ply the route.

Taking a sample of 50 informal manufacturers, de Soto et al. found that the direct recurrent cost of keeping abreast of legal procedures would have amounted to nearly 350% of after-tax profit and 11.3% of production costs, 73% of this corresponding to nontax legal costs. Surveying 37 legally established manufacturers, they found that 40% of the administrative staff's working hours were devoted to complying with bureaucratic procedures.

In deciding whether to license new enterprises or expansion of existing ones, some governments take it upon themselves to police entry into particular sectors on commercial grounds and/or second-guess the commercial judgments of entrepreneurs. In 1985 India's Ministry of Industry rejected over 100 investment proposals on one or more of nine different grounds, of which three were (i) the existence of adequate capacity in the sector in question, (ii) the proposal fell short of "minimum economic capacity", and (iii) the feed-stock or raw material required by the project was not available (Gray 1991). Considering that efficiency calls for a constant movement of enterprises into and out of a given sector, it is difficult to reconcile such a licensing policy with efficiency.

Concessions consist of benefits which governments offer to businesses, both foreign and domestic, to induce them to invest, particularly in manufacturing. Typically they focus on exemptions from taxation. Many countries offer duty free import of capital equipment, and/or exemption from profits tax for a fixed period of years; drawbacks of customs duties on imports used to manufacture goods for export is another common feature. This latter benefit may take the form of declaring an enterprise to be a duty-free zone, or agreeing to its inclusion within an industrial estate that enjoys such status. Another common concession involves granting an enterprise access to government-controlled real estate on terms more favorable than are available on the private market. Some investors secure promises of protection against competing imports or against approval of investments by third parties that would compete for the same local market.

More often than not the results of these packages are disappointing, in that they attract less investment than expected. For their part many would-be investors complain about the bureaucratic tangles they encounter in seeking approval of concessions, involving a need to secure clearance from a multiplicity of agencies, engendering lengthy delays and escalation of investment costs, sometimes including payment of bribes. Some countries have witnessed repeated efforts to reform the system, typically through establishment of a superagency with the authority to ensure 'one-stop shopping' for aspiring investors.

As with most types of regulation, legitimate social objectives militate against giving every operator all the concessions he might ask for. Granting investors extraordinary protection against competing imports and investors is in most cases a recipe for economic stagnation. In this vein, the Fiat Motor Company's enlisting Kenya government ministers in helping it in 1976/77 to break the exclusivity previously granted to another motor vehicle assembler was probably an economically positive development, notwithstanding its overtones of corruption.

The decision-making authority should have the competence to decide what concessions

are undesirable and the power to refuse them. At the same time there should be a standard set of concessions whose approval is subject to as little administrative discretion as possible, so as to enhance the transparency and predictability of the system and minimize openings for corruption.

It should be noted that no system of licensing and concessions can or should guarantee commercial viability of an investment, nor protect it against ill-advised macroeconomic policies that bring about inflation and overvaluation of the exchange rate.

1.6.2 Labor Regulation

Most poor countries have detailed labor codes that end up by curbing employment creation in the formal sector. Adopted in response to a combination of pressures from trade unions, politicians seeking support from formal-sector wage-earners, and intellectuals who believe that labor regulation can improve the welfare of the masses, the codes typically include minimum wages, required supplements for overtime or night work, minimum safety and health conditions, vacation periods, participation in the social security system, restrictions on firing (which often requires government approval), severance pay, and procedures for settlement of labor disputes. Minimum wages often differentiate between agriculture and the rest of the economy, and sometimes between geographical areas.

All these provisions increase the cost of hiring labor for those employers, notably the formal sector, who are subject to government supervision. Security from dismissal hampers discipline and reduces workers' incentives to become more productive. Operators respond by substituting capital equipment and other factors of production for labor, and for some operations prefer to hire on a part-time and/or casual basis rather than expand the regular payroll. The stricter the code, the greater the risk that some potential investors will be deterred from any commitment. Strict codes also reduce mobility of labor between firms and industries, limiting the cross-fertilization of skills which is reported to yield positive results in economies such as Taiwan, Hong Kong and Singapore. (On the other hand Japan does very well with labor mobility that is much more limited than in western industrial economies.)

Unrealistic increases in the minimum wage unaccompanied by fiscal and monetary discipline aggravate inflation to the detriment of the development effort. Here again the effect is to restrict employment in the formal sector below what it would otherwise be, involving an obvious social cost.

A system of labor regulation is efficient when the social benefit of the marginal increase in job security and working conditions for formal-sector workers barely offsets the social cost of the marginal reduction in total employment in the formal sector. Beyond this point, greater equity for the minority of a poor country's labor force privileged to work in the formal sector is clearly offset by loss of job opportunities and thus income (and equity) for less fortunate citizens. Political dynamics in some poor countries, where the leadership concedes the demands of organized labor without being aware of the impact on job creation, has carried labor regulation well past this equilibrium.

The same dynamics makes it difficult to rescind any component of a labor code. However, growing appreciation of the benefits of market orientation has made policymakers increasingly aware of the social cost of limiting enterprises' freedom of manoeuver. Senegal in 1988 abolished a requirement that all hiring by formal-sector

employers be conducted through public labor exchanges. The severe fiscal crunch facing most governments has stiffened their bargaining posture in minimum wage negotiations. Many governments are in the process of replacing restrictions on job loss resulting from bankruptcy, cessation of operation or reductions in force, with versions of the 'safety net' long characteristic of western industrial economies, notably unemployment compensation, 'golden handshakes', and social welfare benefits in cash and kind. The Eastern European countries are in the forefront of this movement.

1.6.3 Financial Market Regulation

The essence of credit is the exchange of present claims over resources for future claims. Since no one would enter into such an arrangement without some mechanism to enforce future claims, the functioning of a credit market is particularly dependent on the LRJ environment.

Many poor countries have long been accused of engaging in financial 'repression', meaning that controls on deposit and lending rates of interest, resulting in negative real rates, together with sectoral allocation of credit, have constrained the formal financial sector to a relatively limited role. Inter alia deposits have been diverted to nonbank institutions offering less security.

Structural adjustment programs have typically called for liberalizing the financial market by freeing interest rates and relying on indirect measures to keep credit expansion in line with prudent monetary policy. Reserve requirements constitute one such measure, though currently less popular than the discount rate and open market operations with government securities.

In some countries the reforms have hampered borrowers' ability and/or willingness to repay loans on time. Higher nominal interest rates have impeded their ability; moreover, where a borrower was once concerned to maintain his creditworthiness with a particular lender in order to secure additional loans at low real rates, it may now be in his interest to delay repayment while borrowing elsewhere at rates equivalent to the market rate demanded by his customary creditor.

Judicial systems in most poor countries are unprepared to deal on a low-cost and timely basis with the enforcement of contracts involving loan repayment. Timeliness is particularly important because the value of collateral may deteriorate as the borrower procrastinates. Anticipating heavy transaction (i.e. foreclosure) costs, lenders may find unprofitable some credit transactions that would otherwise increase efficiency by shifting resources into more productive uses. Hence one facet of desirable LRJ reform is to reduce these transaction costs, while retaining safeguards that protect borrowers from unjustified creditor claims. Costs of foreclosure must be low enough to pose a credible threat, i.e. they must not offset recovery of any part of the outstanding debt.

Some aspects of financial reform presuppose substantial upgrading of the market's LRJ environment via the infrastructure for prudential regulation. Financial liberalization increases competition among lending institutions for both deposits and borrowers and induces them to take greater risks than they did in a 'repressed' environment. The system of government supervision designed to control these risks is not one of the modes of regulation that structural adjustment seeks to abolish or restrict; quite the contrary, notwithstanding the difficulty of the task (cf. the current U.S. savings & loan experience).

Examiners must analyze loan portfolios to look for concealed self-dealing in the form of loans benefitting related parties of an institution's principals; they must also look for nonperforming loans whose status is disguised by refinancing. A recent shakeout in Kenya's financial sector highlighted the low educational status of the central bank's examiners and their lack of incentive to persevere in ferreting out details of their subjects' operations. The result was a series of failures that has certainly lessened the flow of savings into the financial system. In a nutshell, inefficient bank examiners cost an economy much more than do non functioning agricultural extension agents.

In the same connection a country's LRJ system must be prepared to deal with insolvency of financial institutions. This is analogous to the previously cited need for efficient bankruptcy procedures, although in the present case the stakes tend to be higher because of the number of creditors (depositors) involved and the impact of failure of any financial institution on confidence in the sector as a whole. The ideal is a system of insurance for depositors, accompanied by intensive supervision; in its absence, some governments have tended to overreact to insolvencies by drawing on the budget to cover deficits, indemnifying even guilty parties. This has encouraged laxity in both operation and supervision of financial institutions.

Financial regulation in poor countries has traditionally been yet another instance where excessive restrictions on entry coincide with inadequate attention to matters that government ought to regulate. Liberalization has involved reducing these barriers to entry, although few disagree that special licensing (i.e. chartering) procedures are called for in view of the banks' power to create money. As with licensing of other categories of businesses, true promotion of competition requires that this be conducted transparently, based on standard criteria such as capital adequacy and non exceptionable managerial profiles.

Comprehensive reform entails thinking constructively about the role of the informal financial sector, which has traditionally been at best ignored, often subjected to harassment. Informal lenders have recourse to social relationships with borrowers and their families to ensure a high rate of repayment. In some countries they take as collateral post-dated checks, default on which is subject to criminal rather than civil penalties. In the extreme they rely on strong-arm tactics to recover movable assets. The informals depend very little on the formal legal system, even if it does not go so far as to outlaw them.

It has become increasingly clear that this sector alone can service the credit needs of large groups in society. Informals can play a key role in retailing credit which the formal sector provides them in the role of wholesaler. The question arises as to what if any regulation can effectively touch the sector and is desirable to limit abuses. To begin with a revision of the approach of outlawing informal finance is called for since, to the extent it has any effect at all, it only drives the activity underground and increases costs. It makes more sense to recognize the profession, perhaps warn the public about the lack of guarantees for deposits, and provide a legal basis for prosecuting misinformation and other types of fraud.

Finally, poor countries are currently the object of generous technical assistance aimed at helping them develop securities exchanges and associated regulatory bodies. In most countries the main obstacle to development of securities markets is the lack of adequate information about the financial condition of entities wishing to raise funds. The LRJ system must be capable of defining and enforcing requirements to provide reliable and relevant information--including rules to deal with insider trading abuses and other forms of

fraud. Also required is a basic framework for the protection of minority interests.

1.6.4 Price Regulation

The majority of governments of poor countries have at one time or another instituted legislation and machinery to control wholesale and retail prices of so-called 'essential' goods and services. Traditionally such measures have been motivated by a populist concern to protect the masses or selected groups from exploitation by producers and traders. Some governments (and not only in poor countries) have resorted to across-the-board price controls as a measure to control inflation.

Nowadays the consensus based on observation of price control in poor as well as not-so-poor countries is that its results are generally perverse. Its most severe drawback is to curtail supplies, leading to shortages which raise prices for many consumers, often among the poorest, who lack access to regulated distribution channels within which the controlled prices are enforced. Producers and distributors incur evasion costs, thereby raising the cost of distribution. Based on the accumulated evidence, most structural adjustment programs call for reducing controls to limit them to products of public utilities and other so-called 'natural monopolies'.

An AID-funded research program by Moroccan government and university economists examined the impact of price controls and their removal on the business environment in that country. The study found that a substantial share of management energy was devoted to seeking positive action on requests to raise price ceilings in response to cost inflation. Firms tended to regard the ceilings as simultaneously minima and maxima, so that price competition was suppressed, and market shares remained static. Firms invested enough to retain market share but refrained from targeting export markets in the expectation that permitted margins on the home market would not cover the costs of breaking into foreign markets. Finally, the study found that, instead of causing inflation beyond that induced by inescapable cost factors, liberalization introduced an element of dynamism that made the respective markets more competitive and forced producers to become more efficient.

1.6.5 Competition Policy

Competition policy is widely regarded as a logical complement to free trade (and alternative to price control) in holding prices to levels compatible with efficiency. Free trade does a good part of the job vis-à-vis tradeable goods and services, but all industrial countries have found it desirable to take supplemental measures to promote competition in the domestic market.

The LRJ environment as a source of anti-competitive practices. The 'trusts' whose behavior inspired the modern world's first active competition policy in the United States were, of course, private, but in many poor countries today anti-competitive practices are more an outcome of government intervention in the economy than they are of actions by private operators seeking to undermine competition or conspire against consumer interests. Governments award de jure or de facto monopolies to enterprises, public and private; favored enterprises receive overt and hidden subsidies and benefit from rigged government procurement; conversely licenses, concessions, foreign exchange and credit are denied to competitors. Much of this behavior is associated either with outright corruption, that is bribes paid by domestic and/or foreign operators, or with conflict of interest, where

government officials maintain a personal stake in enterprises whose operations are influenced by their regulatory actions. (This phenomenon is treated specifically in the following subsection.)

These practices substantially increase both the costs of doing business and the risks to which enterprises are subject. Management resources are devoted to buying favor with officialdom. Conscious that their financial health depends on the favor of the current government, and aware that many governments lead a precarious existence, enterprises are more cautious about new investments than they would be if they could rely on their own business acumen.

The most important departure in curbing government-directed anti-competitive practices is adoption of the package of reforms identified with structural adjustment, that is substitution of the market mechanism for allocation of resources by government decree. This involves allowing the foreign exchange and interest rates to reach equilibrium levels, so that foreign exchange and credit are no longer allocated by administrative fiat; it involves placing all imports, except those controlled for health and security reasons, under Open General License; and it involves the pursuit of macroeconomic policies that restrain budget deficits and inflation, thus forestalling the pressures that lead governments to reimpose discretionary import and credit controls.

Apart from these measures, regulatory regimes need to be revamped to maximize transparency and minimize official discretion. Laws that regulate licensing of enterprises should be supplemented with written regulations that specify clearly the criteria under which licenses will be granted or denied. The same holds for concessions.

Control of restrictive business practices (RBP). A majority of industrial economies did not follow the U.S. and Canada in enacting legislation against RBP by business operators until after World War II, but all of them now practice RBP control as an essential part of their policy toolkits. The EEC polices RBP in intra-European trade and harmonizes legislation among its members, while the OECD coordinates competition policy among the wider community of western industrial nations.

Conversely, few non-European developing countries have thus far adopted anti-RBP legislation. The current number is around ten, including four in Latin America (Argentina, Brazil, Chile and Colombia), five in Asia (India, Korea, Pakistan, Sri Lanka and Thailand), and so far only one in Africa (Kenya). There is some question as to the appropriate stage in a poor country's development for adopting such a measure. Korea did very well before establishing its Office of Fair Trade in 1981, although it did so then in response to a strongly felt need arising from weakening private initiative, overconcentration of economic power among conglomerates, and unfair trade practices by firms with substantial market power (Gray 1991).

Notwithstanding variations in enforcement, there is a broad consensus among RBP-control authorities in these and the industrial countries as to what practices should be prohibited or restricted. India's Monopolies and Restrictive Trade Practices Commission reflected this consensus in summarizing its cases in 1985 as follows: restrictive zoning of dealers; tied sales; refusal to supply; collusive boycott of a supplier; discriminatory pricing or discounting; exclusive dealing; resale price maintenance; collusive tendering; price fixing; and a single supplier's abuse of market power to manipulate prices (Government of India, 1987).

There is much less consensus, even in industrial countries, as to what constitutes a ceiling on market share beyond which mergers and acquisitions should not be permitted to go. Poor countries justifiably point out that minimum economic scale in many industries is tantamount to a bigger share of a small market than of a large one. Where this is true, free trade that exposes producers to foreign competition is a preferable means of preventing abuse of market power.

In the hands of an administration not dedicated to the spirit of competition policy, RBP control legislation can become simply one more instrument for interfering with business initiative. This is illustrated by a recent experience where the inaugural uses made of a competition policy apparatus were perverse, aimed at frustrating initiatives by businessmen from an ethnic minority. Such moves, even if motivated by concerns of equity for an economically disadvantaged majority, undermine efficiency and retard growth.

One can argue that in this case introduction of an RBP control mechanism was premature. Experience suggests that in a society where arbitrary behavior by the administration is common, it is better not to undertake such regulation unless most decision-making power can be assigned to a judicial or quasi-judicial tribunal staffed by persons in whose integrity the business community will have a certain level of confidence.

It is also important to enact procedures ensuring timeliness and transparency in the tribunal's operations, and to provide for judicial review as to compliance with the law. An RBP control apparatus that interprets normal competitive behavior as unfair practices, discriminates among entrepreneurs according to ethnic origin, upsets mergers and acquisitions not conferring excessive market power, and/or delays its decisions interminably, increases business risk and deters investment.

1.6.6 Control of Official Conflict of Interest

It is becoming increasingly apparent that in some poor countries participation by public officials in business activity for their own account is a serious obstacle to the development of competitive markets. Often the pattern is set by a country's ruler, who appropriates shares for himself and/or family members in new as well as existing enterprises. Sometimes this is done through a holding company with diversified interests in agriculture, manufacturing and/or trade. A decision by an enterprise with such connections to move into a particular sphere sends existing operators in that sphere scurrying for cover. If the enterprise chooses to acquire a certain asset, perhaps a competing enterprise in its entirety, at an 'affordable' price, brave is the owner who declines the offer. Brave also is the RBP control official who blows the whistle on the enterprise's unfair trade practices, or its accumulation of market power.

The ruler's behavior opens the floodgates for everyone else in the government, beginning with cabinet ministers but by no means limited to them. Few poor countries have legislation regulating the phenomenon, which is not addressed by standard rules against corruption, even though an official's involvement may begin with a de facto bribe comprising an offer of shares in return for regulatory favor. A Kenya government commission in the 1970s cited civil servants' potential as a dynamic entrepreneurial force, and urged them to enter business as long as it did not impinge materially on their official duties. The predictable outcome: such activity has not only interfered with performance of administrative functions, but represents a major anti-competitive force in the economy.

In many countries the ruler's example is the first obstacle to controlling conflict of interest. Even were it possible to convince him to set a different example, however, no less an obstacle is the low compensation received by civil servants in many poor countries. Few high-inflation countries have maintained the purchasing power of civil service incomes, notwithstanding ad hoc supplements effected by diverting nonsalary appropriations. Hence, civil servants cannot survive without outside income.

Structural adjustment programs address this issue by limiting new recruitment and sponsoring 'golden handshakes' to encourage redundant staff to leave the service. Improved tax collection relieves part of the fiscal pressure, although simultaneous pressure to reduce deficits by compressing expenditure moves in the opposite direction. In some countries only with accelerated growth and an accompanying expansion of the tax base can one anticipate returning to a pay scale that rewards competent civil servants on the basis of their opportunity cost.

1.7 IMPLEMENTATION

One cannot design a regulatory régime conducive to efficiency and economic growth without considering the institutions charged with implementing it. This section will discuss three categories of institutions for settlement of disputes, namely the judiciary, quasi-judicial regulatory bodies, and private arbitration; enforcement by the executive branch; and vehicles for promoting transparency in the LRJ system.

1.7.1 The Judiciary

In many poor countries a judicial system modelled on that of the colonial power exists side-by-side with a customary court system whose experience is limited to disputes over inheritance, land rights and petty trade, as well as domestic and criminal cases. Even in the system imposed by the colonial power many judges lack a modern legal training, and few have been exposed to the complexities of an industrial economy. Their compensation is such a pittance compared to the interests at stake in modern disputes over property, contracts, bankruptcy, secured transactions, and the fields of regulation described in the preceding section, that widespread corruption is unavoidable.

Weaknesses in existing judicial systems prompt many delegates from poor countries at UNCTAD's annual session on RBP to argue that adjudication of RBP control should be entrusted to the executive branch or to a special commission rather than to the judiciary (UNCTAD, various years). Some countries have sought a way out of the impasse by following the French example in establishing a system of commercial courts whose judges receive special training and enjoy a higher pay scale.

The judicial system is generally neglected as an object of technical assistance aimed at strengthening institutions that promote economic growth. Fortunately it is not the sole vehicle for settling disputes in a market economy, as seen in the following two sub-sections. At the same time nothing can substitute for the judiciary in cases where the parties fail to agree on private arbitration, or as the locus of appeal from auxiliary spheres of dispute settlement. It is in recognition of this fact that a high-level colloquium of Moroccan businessmen has called for "modernization of judicial administration and training of the judiciary to understand the problems posed by the workings of competition" (AIPC-CGEM,

1988).

1.7.2 Quasi-Judicial Tribunals

The United States pioneered in developing quasi-judicial tribunals as a vehicle for economic rulemaking and dispute settlement, especially but not solely between government and private parties, independent of both the executive and judicial branches. Twin objects were to ensure greater impartiality and transparency than might be expected either from an executive dependent on the political process or from an anonymous civil service, while sparing the judiciary from becoming mired down in detailed application of economic policy.

In developing countries quasi-judicial tribunals have made their appearance in the fields of labor disputes (eg. Kenya's Industrial Court), regulation of financial markets (eg. Southeast Asian countries), and RBP (nearly all the ten countries cited in section 1.6.5. have established such bodies). Membership of the tribunals typically represents a variety of professions, including but not limited to magistrates. Tribunals differ in the degree of initiative expected of them; some depend on referral of cases from the executive, others generate cases through their own investigative staffs.

Tribunals also differ in their degree of independence from the executive. Some members serve lengthy fixed terms, while others are subject to removal at the pleasure of the head of government or responsible minister. The latter situation inevitably limits a tribunal's readiness to act in a manner contrary to personal or political interests of the executive.

1.7.3 Private Arbitration

This is a relatively untapped field in the developing world, but one offering a way out of the impasse created by persistent shortcomings in the judicial system. In essence it is an approach towards privatizing justice, which may be no less desirable a component of structural adjustment than is the more widely advocated privatization of state-owned enterprises in response to the public sector's demonstrated incapacity to operate commercial enterprises efficiently. To be sure, it requires a legal framework that enforces awards made under binding arbitration, while punishing corrupt behavior by arbitrators. Judicial review must avoid reopening questions of fact, limiting itself to ensuring fair procedures.

Granting land titles to kinship and other groups as an alternative to individual titling is another approach to privatizing justice, since the group then arbitrates among individual and family claimants. An analogous point is the self-regulation conducted by certain professional groups--e.g. doctors, lawyers, accountants, architects, and quantity surveyors--both in industrial and poor countries. This practice is of course open to abuse, as such groups tend to be partial towards the interests of their own members vis-à-vis the public.

Sectors of the judicial establishment in poor countries oppose private arbitration as impinging on their prerogatives and establishing a class of pseudo-judges, much better paid than their public counterparts and not accountable to society. Perfect competence and impartiality cannot of course be guaranteed, but in a competitive system private arbitrators gain business by earning a reputation for those qualities. Recalling section 1.4.2's definition of economically efficient contract law, an efficient arbitrator makes the award that the parties would have agreed to in the contract had they foreseen the contingencies that led

them to summon him.

A scenario that relies on a sluggish, uneducated and often corrupt judiciary to settle property and contract disputes does not create a business environment conducive to investment, exports and job creation. Hence the premium on testing nontraditional approaches--among them private arbitration.

1.7.4 Executive Enforcement

Court judgments and decrees of regulators and quasi-judicial tribunals are of little effect unless the executive is willing and able to enforce them by seizing property and jailing physical persons or threatening to do so. Two categories of problems arise at this stage: one concerning the resources which the executive can mobilize to enforce the law, and the other concerning its readiness to do so in the face of contrary pressures on behalf of interested parties.

As regards resources, a ministry of justice or attorney-general's office is no less subject than other government agencies to fiscal constraints on staff activity. If budgets do not suffice to hire a minimum staff complement, and/or prosecutors' compensation is less than a living wage, obliging them to moonlight, the agency cannot follow up all its tasks in a timely manner and will likely give priority to actions linked to public safety. Even where the budget is adequate, well-financed commercial interests may secure favorable treatment at any stage of enforcement. (Cases in point are by no means confined to poor countries.) This will more likely be the rule than the exception in cases involving personal interests of officials.

In the context of privatizing justice, one way in which the U.S. itself economizes on prosecutorial manpower is to authorize private suits and provide for multiple damages under antitrust law. By contrast, most countries leave it to government agencies to receive operators' complaints and then decide whether to act.

1.7.5 Instruments of Transparency

In every society officialdom tends towards secrecy in the discharge of regulatory functions, and extra-official institutions are needed to promote the transparency that in turn enhances the integrity, timeliness, and predictability of economic regulation. Foremost among these institutions is the press. In an environment of press freedom, economic journalists like nothing better than to expose corrupt and self-interested actions of officials. Unfortunately such an environment exists in a minority of poor countries. Indeed, barring the occasional exposure of corruption by an official who has had a political falling out with the establishment, the press in poor countries is distinguished by its lack of attention to rampant conflicts of interest.

There is reason to believe that freedom of the press is much more closely linked to the cause of economic development than has generally been recognized heretofore. Even in situations where the electorate has little say in the choice of leaders, officials are more cautious about misusing the LRJ system to promote personal interests in the face of regular press exposure. Notwithstanding the sensitivity of the issue, given increasing indications of the detrimental impact of conflict of interest on the business environment and on the initiative of the majority of entrepreneurs, it can be argued that donors should be

addressing it in the context of conditionalities for structural adjustment aid.

At the very least donors should push for freedom of economic reporting, and make it understood that sanctions against journalists who expose conflicts of interest will jeopardize aid arrangements. Economic journalism should also be an object of technical assistance, including scholarships for study of economics.

1.8 CONCLUSION

The goal of this paper has been three-fold: (1) to highlight the role of the legal-regulatory-judicial (LRJ) environment in affecting resource allocation and entrepreneurial initiative in poor countries; (2) to identify typical shortcomings that make this role less positive than it might be; and (3) to examine options for reform. It was shown that the rules and institutions comprising the LRJ environment operate on efficiency via such subsidiary criteria as transparency, timeliness, stability, predictability, access, fairness, equity and integrity.

Clearly, appropriate legislation cannot alone create a favorable environment; there must also be machinery for settlement of disputes and enforcement of judgments which enjoy the confidence of economic agents, while only generalized respect for the rules of the game can prevent the machinery from being swamped.

The rules most conducive to efficiency and growth will vary widely from one culture to another, and even within a given country, e.g. as regards rural land rights. However, experience in countries of differing cultural backgrounds that have made substantial economic progress points to several categories of law and regulation where provisions with broadly similar characteristics, if not certifiably prerequisites for growth, have nonetheless had a positive impact.

The legal underpinning of every market economy seems to be a system that guarantees private property rights, enforces contracts, and assigns liability for wrongful damage. Further categories of business law supplement these provisions by facilitating the creation and funding of institutions in whose absence efficient production and distribution of many goods and services are not possible. Such laws limit company shareholders' liability, create orderly procedures for exit, and facilitate credit and investment through secured transactions.

Finally, the paper reviewed six common fields of business regulation, namely licensing & concessions; regulation of labor, the financial market and prices; control of restrictive business practices; and official conflicts of interest. Each field presents options for removing currently widespread obstacles to efficiency, if only by dismantling the regulatory structure
altogether (as in the case of much price regulation).

It turns out that many detrimental effects of the LRJ environment are traceable to its subjugation to the interests of powerful groups in society, including government officials engaging in business for personal account. Improvement of the LRJ environment is thus closely linked to political reform, over which the donor community's influence is limited. Donors may however be able to enhance transparency by promoting freedom of the press.

Inter alia the discussion in this paper shows how much is still unknown about what LRJ environment is most conducive to efficiency and growth in a given country, and what changes in existing environments would be cost-effective. The field suggests itself as a candidate for expanded research.

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Designing and Implementing Competition and Consumer Protection Reforms in Transitional Economies: Perspectives from Mongolia, Nepal, Ukraine, and Zimbabwe

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Designing and Implementing Competition and Consumer Protection Reforms in Transitional Economies: Perspectives from Mongolia, Nepal, Ukraine, and Zimbabwe

by William E. Kovacic*/

Introduction

In November 1992, I traveled to Mongolia to assist in a process which led to Mongolia's adoption of an anti-monopoly law. During a seminar in Ulaanbataar for Mongolian government officials on merger enforcement, I described how some countries recognize a "safe harbor" in which firms with small market shares can merge without fear of challenge by public antitrust authorities. The translator quickly told me that the safe harbor metaphor lacked meaning in a landlocked nation. After searching for a phrase that would work in a country of no ports but many herders, we decided that "peaceful pasture" was a suitable way to capture the idea of creating zones of transactional immunity.[1]

The discussion of peaceful pastures in merger enforcement provided one reminder of the many challenges posed by efforts to design and implement competition policy laws in countries undergoing the transition from central planning to a market economy. Establishing a competition policy system in formerly socialist or communist nations entails far reaching changes. These include drafting and enacting new legislation; forming new government institutions; educating business managers, government administrators, judges, and the public about the role of competition in a market system; and, in some instances, even so basic a step as creating a policy analysis.

Since 1980, many formerly communist or socialist nations have enacted new anti-monopoly and consumer protection laws or bolstered existing measures.[2] A number of other countries are considering new antitrust or consumer protection statutes to facilitate the

transition from planning to markets.[3] To draft and implement such measures, multinational donor groups and individual western nations have sponsored a wide array of technical assistance programs. Experience with anti-monopoly and consumer protection initiatives since the late 1980s provides a basis for evaluating how these and other law reform efforts can best be implemented in transitional economies. In the past three years, I have participated in antitrust or consumer protection law reform projects in Mongolia, Nepal, Ukraine, and Zimbabwe. Each consultation has been sponsored by the United States Agency for International Development (AID), and the programs in Mongolia, Nepal, and Ukraine have taken place under the aegis of the University of Maryland's Center for Institutional Reform and the Informal Sector (IRIS). This Article draws on these projects to discuss approaches for designing and implementing law reforms.

The Article treats the subject in three parts. It first describes the possible contributions of antitrust and consumer protection systems in promoting the development of free markets in transitional economies. The paper treats consumer protection laws along with antitrust legislation due to the overlap between the two in some transitional economies. Consumer protection laws in transitional economies sometimes contain provisions -- such as a ban on cartelization or restrictions on advertising -- with significant anti-monopoly and competition policy implications. Antitrust laws in such countries occasionally contain consumer protection articles dealing with business torts and deceptive trade practices. The second section discusses features of the transitional economy environment relevant to the design and implementation of antitrust and consumer protection reforms. The third section considers the implications of these conditions in proposing methods for devising and carrying

out antitrust and consumer protection reforms. Although the article focuses on antitrust and consumer protection initiatives, its observations often apply to other economic law reform activities in transitional economies.

I. The Rationale for Antitrust and Consumer Protection Programs

The case for establishing antitrust and consumer protection systems as part of transitional economy legal reform is not self-evident. Commentators have raised three basic criticisms about such measures. The first is that antitrust and consumer protection laws are excessively prone to misapplication, particularly in the form of unduly aggressive or arbitrary enforcement, that can discourage investment and growth.[4] With antitrust laws, a common fear is that enforcement authorities will use limitations on dominant firm behavior to punish all behavior that results in the disappearance of a rival, or to treat dominant firm price increases as evidence of improper exploitation and a basis for imposing loose variants of price controls. With consumer protection laws, a concern is that expansive interpretations of bans against false or misleading advertising will discourage sellers from providing consumers with useful information.

A second basic criticism is that transitional economies can accomplish the most important competition policy objectives more effectively by directly facilitating the movement of goods across national and regional borders. Put another way, the best antitrust policy might consist of greater appropriations for airports, roads, and rail links; policies to encourage investment in communications infrastructure; the elimination of government restrictions on entry; and the dismantling of quota and tariff barriers to imports.[5] Similarly, a consumer

protection policy might best take the form of efforts to increase the reliability of contract enforcement, along with the recognition of doctrines that void agreements induced by fraud.

The third criticism is that efforts to create antitrust and consumer protection systems divert attention and scarce national resources away from more important law reform priorities.[6] During a trip to Kiev in January 1995, I spoke on several occasions with a real estate investment entrepreneur who described how infirmities in rudimentary legal institutions impede investment and commercial activity in Ukraine. The entrepreneur wishes to create a prototype subdivision outside of Kiev, equipped with prefabricated homes built in the United States and providing amenities such as a swimming pool and security guards. Because Ukraine has no law that clearly permits private ownership of interests in real estate, any effort to acquire land (either a fee simple interest or a long-term lease) and build permanent structures is beset with enormous uncertainty. In an environment of austere national resources, an argument could be made for subordinating the pursuit of antitrust or consumer protection legislation to the creation of legal institutions for defining and protecting property rights.

These concerns warrant serious attention. Yet there remains a potentially useful, positive role for well-conceived antitrust and consumer protection institutions in the transition to a market economy.[7] Their potential value comes in three forms. The first deals with government activities that smother or distort market processes. It is important not to underestimate the hostility or skepticism among some elected officials, ministry leaders, and citizens' groups in many transitional economies to market-oriented reforms.[8] In many instances, official opposition to reform is not expressed openly (or is understated), so as not to draw opprobrium from donor entities, such as the International Monetary Fund and the World Bank, which have made

market-oriented structural reforms preconditions for continued financial assistance. Short of overt resistance, government authorities may seek to deflect market-based initiatives through half-hearted implementation of nominal reforms or the use of subtle administrative strategies for continuing state control of economic activity. In many transitional economies, market-oriented reforms have a tenuous foothold in public policy, and the success of efforts to remove the state from unnecessary and destructive intervention in the economy is far from assured.

Antitrust and consumer protection mechanisms can provide an institutional voice within the government for the promotion of markets and opposition to state efforts to suppress market processes. Antitrust and consumer protection institutions can attack government policies that impede the development of markets and help ensure that the state intervenes only to correct genuine market failures. Among other approaches, competition and consumer protection authorities might be given a formal role in reviewing or approving the decisions of other government ministries with respect to such matters as the issuance of licenses and the privatization of state-owned firms. An anti-monopoly or consumer protection agency may be the only formal institutional counterweight to government efforts to deflect or obstruct market reforms.

A second useful function is to deal with private efforts to undermine market processes. There are (and will be) market failures that present serious obstacles to the emergence of markets and are amenable to correction. Business actors in the new market environment may experience a strong inclination to attempt to achieve by private agreement the type of industry-wide orchestration of activity that government ministries formerly performed. Carefully designed and focused antitrust and consumer protection institutions can challenge

private conduct -- such as cartelization and mergers to monopoly -- that seriously threatens the successful operation of a market system.

The third function is to establish institutions that provide actual and symbolic assurance to the public and their elected officials that the move to a market system does not leave citizens at the mercy of market failures. In normal environments, the realistic alternative to anti-monopoly or consumer protection legislation may be far more intrusive forms of government intervention, including direct price controls, broad limits on entry, and continued widespread public ownership of business enterprises.

II. The Implementation Context

Antitrust and consumer protection law reform efforts in transitional economies do not occur in a vacuum. These and other law reform initiatives take place in a distinctive national context, featuring a mix of commercial, government, social, and political institutions and circumstances with important implications for the substance and process of law reform. Studying and understanding these conditions in the host country is crucial to designing and implementing constructive laws. Described below are some of the most important conditions that confront law reform programs in most transitional economy settings.

A. The Commercial Context

To achieve economic progress, market-oriented law reform should flow from a careful evaluation of the structure and patterns of commercial activity in the host country. In many transitional economies, the national commercial context features the following traits.

1. Pervasive role for the state.

In most transitional economies today, the state continues to exercise broad control over commercial activity. The state's influence is the residue of decades of central planning, in which individual sectoral ministries exercised enormous economic and political power through the oversight of state-owned business enterprises. Despite the adoption of economic liberalization measures, transitional economy governments shape commercial activity in many ways, including state ownership and management of business enterprises, severe regulation of entry, diversification, and exit, and controls over pricing. Even where transitional economies have embarked on seemingly ambitious privatization and deregulation programs, state ministries have sought to maintain control over privatized entities by way or regulation or the exercise of ownership interest, or to limit the scope of enterprises subject to privatization. Market-oriented reforms undertaken at the national level can be undermined by regional and local government authorities who continue to impose controls that the national government has disavowed.[9] In approaching economic law reform, it is unwise to overlook the incentive and ability of government authorities at the national, regional, or local levels to undermine reform efforts that threaten to reduce their economic and political power.

Recent experience with Ukraine's efforts to draft a new law for the regulation of natural monopolies illustrates the point. Under Ukraine's privatization program, natural monopoly entities are exempt from privatization. This exemption places a premium on the ability of the natural monopoly law drafting group to devise (and gain acceptance for) a working definition of "natural monopoly" that properly limits the activities subject to natural monopoly oversight. This problem has two dimensions. The first is to identify industry

sectors that today have natural monopoly traits and to provide a mechanism for adjustment that takes account of changes in technology and competitive circumstances. The second is to address the conglomerate, integrated structure of firms that engage in natural monopoly activities.

During the era of central planning in Ukraine and other countries, the absence of strong markets for intermediate inputs and the government's desire to use firms as engines of social policy caused state-owned enterprises to pursue self-sufficiency.[10] Thus, the state pipeline company in Ukraine controls not only natural gas pipelines, compressor stations, and scheduling facilities, but also owns the housing in which its workers live, the retail stores in which they shop, the construction company that services the pipeline and other purchasers of building services, and the farms that produce the food consumed by the pipeline company's employees. Ministries responsible for specific economic sectors in Ukraine have a strong interest in seeing that the concept of "natural monopoly" is defined and interpreted broadly in order to increase the number of sectors exempt from privatization and to prevent the privatization of business entities that are affiliated by the natural monopoly firm, but perform no genuinely natural monopoly activities. A narrow definition of natural monopoly, and the de-conglomeration of firms holding natural monopoly assets, would reduce significantly the ministries' base of economic and political power.

2. Strong residue of commercial behavior shaped by the planning era.

Many transitional economies have implemented law reforms that give commercial entities greater freedom to set prices, select output levels, offer products, and enter markets of their choice. As the government relaxes controls on firm behavior, some

business entities may show a propensity to attempt to recreate privately the types of planning mechanisms that the state formerly supplied. Consider the following examples.

During the November 1992 trip to Mongolia to assist the government in preparing to draft an anti-monopoly law, a team of IRIS researchers conducted case studies in the meat packing, telecommunications, and wool-spinning industries. In the era of planning, Mongolia had a single state-owned meat packing firm consisting of three large slaughtering and processing facilities. At the time of our visit, the government operated the three processing plants as a single firm. It is conceivable that the three plants could be established as stand-alone firms. By late 1992, the government had ended price controls on the sale of animals, and herders had begun to shop their herds around to different meat packing facilities in search of the best price. The manager of one meat packing plant told us that the three meat packing facilities had begun to bid against each other to purchase the best animals for slaughtering. Dismayed by this phenomenon, the plant manager assured us that the competition for good animals would cease. When asked why this was so, the manager said he had just concluded a telephone conversation with his counterparts at the other two meat packing plants, and the trio had agreed on the prices that they would pay to animal herders in the coming year.

A second example involves Zimbabwe. From the mid-1960s until the early 1990s, the Government of Zimbabwe (and the predecessor state of Rhodesia) centrally orchestrated pricing, output, and other business decisions in most industry sectors. Although private ownership of businesses was permitted, government regulation of pricing and production was comprehensive. To implement public controls, many private enterprises adopted

competition-suppressing measures in trade association by-laws. In recent years Zimbabwe has embarked on a broad program to remove price controls and otherwise deregulate private firms, but privately-established limits on business freedom persist. As of early 1992, the rules of the Construction Industry Federation of Zimbabwe (CIFOZ) forbade its members from offering discounts off of standard rate schedules and from making a competing proposal for a project for which the buyer already had begun negotiations with another CIFOZ member.[11] The CIFOZ Management Committee also enjoyed power to restrict the categories of projects (organized by dollar value) for which each member company could submit bids.

3. Pre-reform customs and institutions relevant to the growth of private markets.

Even in an environment of comprehensive regulation or centralized planning, business managers and individual entrepreneurs develop customs and institutions that promote efficient resource allocation and can provide valuable foundations for carrying out economic activity in the post-reform era. These market-relevant customs emerge in several ways. In one setting, customs and institutions take root in the "informal" sector of a heavily regulated economy. In the "informal" sector, economic actors operate at the fringe of legality or in defiance of existing legal commands.[12] Participants in the informal sector often devise market-oriented customs and institutions that can illuminate paths for transforming the heavily regulated "formal sector."

A second variant has emerged in countries such as Zimbabwe, where the state did not assert public ownership over business enterprises in the pre-reform period, but instead superimposed expansive regulatory commands on private enterprises. In such situations, private ownership of business units was officially sanctioned by the state and constituted an

element of the "formal," legal sector of the economy. Despite intrusive government regulation, the rudiments of market institutions developed and survived by virtue of the efforts of private entrepreneurs.

A third source of market-relevant customs and institutions in the pre-reform era is the product of official or unofficial deviations by socialist or communist governments from a regime of strict centralization of economic decision making. To increase production and compensate for the shortcomings of planning, socialist or communist regimes sometimes tolerate the operation of markets and the development of private customs that serve to improve resource allocation and use.[13] Such customs sometimes represent efficiency-based solutions that can be adopted as part of the reform process.[14]

Pre-reform commercial customs and institutions can have important implications for the design of legal reforms. First, commercial actors -- especially private entrepreneurs in the formal and informal sectors -- can provide a base of political support for economic liberalization, including measures to promote competition. Second, individuals who have gained some experience with market processes can be a source of new entry and expansion in the post-reform economy. Third, private enterprise participants in the formal and informal sectors rarely enjoyed effective recourse to a well-established, judicially-enforced system of rules governing commercial behavior. Such firms often devised private customs or institutions to define property rights and govern their transactions. With economic liberalization, these informal customs can supply a useful basis for establishing formal principles of law.[15]

A final reason for examining the operation of the pre-reform economy is to identify respects in which nascent market processes promise to protect consumer welfare without the

need for additional government intervention. In particular, the development of robust competition may obviate the need for expansive consumer protection measures. In Nepal, many commodities are sold by weight. Retail merchants typically measure and weigh products at the point of sale. Consumers frequently express the concern that merchants engage in short-weighing. In interviews conducted with Nepali business owners in February 1994, I saw evidence that competition is motivating merchants to take greater efforts to establish a reputation for honesty and accuracy in weighing products.

Himal Iron & Steel ("Himal") is one of Nepal's leading fabricators of iron and steel products. Like many other goods in Nepal, iron and steel products are priced by the kilogram, and buyers often complain that retailers use rigged scales to measure the weight of products, such as steel reinforcement rods, before sale. Retailer short-weighing poses a problem for Himal, because retailer misconduct casts Himal in a bad light. Retailers realize that they will not bear the full brunt of purchaser displeasure, as buyers will attribute at least some of the blame for short-weighing to Himal. To cope with this agency problem, Himal began weighing its products at the factory, wrapping the products in plastic at the factory, affixing a seal that states the weight as measured at the factory, and warning users that Himal cannot vouch for the weight if the seal has been broken.

Himal's practice of weighing iron and steel products at the factory is costly (in the time required to weigh products and in the cost of hiring laborers to do the weighing), but it has increased purchaser confidence in Himal. The approach has succeeded to the point that buyers often dispense with any weighing of Himal's products at the point of sale and instead trust the seal's representation of the products' weight. Himal also features this measurement

and certification technique in its advertisements. I asked Himal's chief executive if the firm had considered other techniques (such as purchasing and operating retail outlets) to deal with the agency problem. He said that Himal owns no retail stores, but that the company is beginning to identify approved Himal dealers who are permitted to place a Himal label in their shop windows.

B. The public institution context.

The success of market-oriented legal reforms depends heavily on the ability of the host country to develop public institutions necessary for the functioning of a new legal regime. Most efforts to establish antitrust and consumer protection legal systems in transitional economies pose extraordinary institutional challenges to the host country. Several constraints significantly affect the magnitude and rate of change.

1. Government agencies.

Several features of government agencies in transitional economies are important for the design and implementation of antitrust and consumer protection laws. One major constraint is a severely limited supply of expertise relevant to the implementation of an antitrust or consumer protection program. In the law drafting exercises in which I have participated, I have been very favorably impressed with the sophistication of host country experts assigned to the drafting group.[16] However, in transitional economies, attorneys or economists familiar with competition law principles or industrial organization economics are generally rare.[17] For example, in Mongolia, the government has delegated the drafting of procedures for implementing the country's antitrust law to engineers whose previous assignments had been to monitor the technical performance of Mongolian infrastructure

industries such as energy and telecommunications. In a meeting with the engineers to discuss the implementation procedures in June 1994, it was clear to me that the procedures working group was very capable and had absorbed a great deal of antitrust learning in a short time, despite little relief from their regular duties. It was also apparent that the procedures group would benefit from continuing participation by an attorney and an economist.

A second significant feature is that government agencies enjoy sweeping discretion and abide by few, if any, due process-oriented controls.[18] Government ministries usually operate under open-ended grants of authority with no requirement that they give affected parties the right to oppose or appeal government decisions, or offer a public explanation for their acts. Regulatory decrees are subject to frequent, unannounced adjustment and often are not published.

A third condition is that, in absence of antitrust or consumer protection institutions, there may be no government institution with a clear mandate or strong incentive to promote competition and the development of markets. Other government bodies, such as a privatization commission, sometimes can be counted on to support market-oriented reforms. The creation of an antitrust agency can supply a major institutional counterweight to the many organizations of government whose interest often lie in opposing or retarding the emergence of private ownership and business rivalry.

2. The courts.

Market-oriented law reforms, including antitrust and consumer protection legislation, often entail some judicial participation, either in hearing disputes at the trial level or reviewing the decisions of an administrative commission. Two basic conditions affect the

skill of the judiciary's participation in the enforcement of antitrust or consumer protection commands.

The first constraint is that, like many government ministries, the judiciary often has little familiarity with economic or legal concepts relevant to business law, including antitrust or consumer protection. The courts in most transitional economies will be building essentially from scratch in developing analytical principles for interpreting antitrust or consumer protection.

Important exceptions to this general condition will appear in a careful study of each country's laws and jurisprudence. For example, Zimbabwe's legal system has several features that would facilitate the implementation of an antitrust law. Derived from Roman-Dutch common law, Zimbabwean contract doctrine bars certain agreements deemed to be in "restraint of trade." In Zimbabwean jurisprudence, agreements in restraint of trade generally consist of unreasonable non-competition covenants contained in employment agreements or in contracts for the sale of a business.[19] Such restrictions are invalid if they are unreasonable in geographic scope or duration. In dealing with non-competition covenants, Zimbabwe's courts have become familiar with analytical principles that would be important in applying an antitrust statute that prohibited the formation of cartels and other output-restricting schemes by direct competitors. In distinguishing between "naked" and "ancillary" restrictions in non-competition agreements, Zimbabwe's courts have devised a methodology for assessing the pro-competitive and anti-competitive features of such agreements.[20] This experience will facilitate the operation of a ban on certain restrictive business practices.

Relevant commercial adjudicatory expertise and a source of post-reform rules might be

found in ministries that formerly controlled industry activity. Even planned economies engaged in a form of contracting to govern relationships among input suppliers, fabricators, and distributors. For example, during the planning era in Mongolia, a government ministry established schedules by which herders would deliver their animals to state-owned meat packing facilities. The ministry's central orchestration of this process, which involved coordinating the movement of herds over vast distances to ensure a steady supply of animals to the processing plants, did not eliminate the possibility for disputes between the herders and the meat packers.

Suppose a herder demanded a higher payment and a relaxation of the delivery schedule, claiming that unusually harsh weather conditions had increased the herder's costs and slowed the progress of the herd. If the meat packer and the herder could not agree to an adjustment of the original price and schedule, the government ministry would be called upon to settle the dispute. Through the rough equivalent of an arbitration process, ministry arbiters would focus on some of the same criteria that common law courts in capitalist economies use to decide cases involving the attempted re-negotiation of contract terms, such as the foreseeability of the contingency that prompted the demand for renegotiation, and the relative capability of each party to cope with the contingency at the lowest cost. The government officials who gained experience in resolving disagreements, and the rules they devised to decide such disputes, could be useful in developing post-reform commercial dispute resolution forums.[21]

A second formative condition is that courts in transitional economies usually operate with an austere administrative infrastructure that severely limits the dissemination of

information about the result or logic of judicial decisions. At the local and regional levels in Nepal and Mongolia, courts seldom publish opinions. Judges in these tribunals rely mainly on an oral tradition to decide cases. The highest court in the country may have the use of research tools such as personal computers or communications equipment such as a fax, but most courts do not. Even where judicial opinions and the statutes they interpret are published, it is unlikely that distribution of these materials throughout the nation's legal community will be widespread, current, or complete.[22]

3. Multiplicity of law reform measures.

The agenda or law reforms needed to build a market economy is especially long in transitional countries. Antitrust and consumer protection are only two elements of the effort to establish a market system. To establish the legal infrastructure for a market economy, a formerly socialist or communist country may need to adopt a wide array of new laws, including measures governing administrative practice and procedure, banking, bankruptcy, business associations, contracts, customs, environmental protection, insurance, intellectual property, judicial reform, labor, privatization, product liability, property, securities, taxation, and trade. The energies of the national legislature, key ministries, and indigenous experts knowledgeable about market processes will be stretched very thin.

4. History of nonenforcement of nominal legal commands.

Citizens in many formerly communist or socialist countries are accustomed to nonenforcement, or highly selective application, of laws and regulations. The lack of commitment and institutions to enforce nominal requirements engenders cynicism about the rule of law and the usefulness of enacting new legal commands. If implementation is not

forthcoming, the efforts of transitional economies to adopt new laws to satisfy conditions of loan agreements or structural adjustment programs may exacerbate public doubts about the efficacy of the legal system. Many countries have passed market-oriented laws, but have failed to establish mechanisms for implementing them. Creating new legal commands without effective institutions to implementation them may be worse than passing no new laws, given the tendency of hollow rules to undermine confidence in the law.

C. The political context: enduring suspicion of capitalism and market processes and impulses to reimpose controls.

In a number of transitional economies, the political consensus favoring economic and political liberalization is fragile. To many citizens and public officials, the shift to a market economy imposes unacceptable economic, social, and political costs. Former communists who are candidates for elective office have skillfully exploited popular discontent with the costs of the transition process to regain control of the national legislature and positions of responsibility in key government ministries. Pressure from external donors provides the principal impetus for transitional economies to sustain at least the outward commitment to reform.

Amid broad political and social resistance to economic liberalization, the development of competition and consumer protection policy can supply an important bridge to a market system. The availability of antitrust scrutiny of dominant firm conduct, mergers to monopoly, and cartels can help deflect pressures for the maintenance or reimposition of price controls. Notwithstanding legitimate fears about excessively aggressive antitrust oversight, an anti monopoly system may well be a superior alternative to government efforts to regulate prices

and other business decisions. Indeed, the realistic political alternative to creating an antitrust system may not be doing nothing at all, but instead more intrusive forms of government control of the economy. The establishment of basic commands against deception and fraud also can provide some degree of assurance to the public that they will not be victimized by market failures.

III. Implications for the Design and Execution of Law Reforms

The implementation context has a number of implications for how one designs competition and consumer protection laws and the institutions to execute them.

A. Studying existing economic and institutional conditions.

The design of market-oriented law reforms should flow from careful advance study of the host country's economy and existing institutions relevant to the operation or a market system.[23] Such study should include case studies of specific industries and interviews with academics, consumers, government officials, legal practitioners, and business managers. The case studies serve to identify problems on which antitrust and consumer protect on reforms should focus, to assess the institutional capabilities of the host country, and evaluate needed adjustments in institutions.

Pre-reform study should involve a collaboration between indigenous specialists and external technical advisors. A cooperative effort to perform case studies and interviews gives indigenous experts the benefit of experience and theoretical insights from external advisors, and ensures that external advisors are alert to distinctive circumstances of the host country. Such collaboration is an excellent opportunity for foreign advisors to help indigenous experts

to develop analytical techniques for understanding market processes.[24] As described below in this section, the participation by external advisors in pre-reform analysis, law drafting, and implementation will be most constructive when technical advisory bodies have a continuing, long-term presence in country.

B. Tailoring the law to reflect national conditions.

The pre-reform analysis should generate useful insights about the appropriate design of a competition or consumer protection system. As with the pre-reform analysis, the law drafting process should involve a collaboration between indigenous experts and external technical advisors.[25] The draft law that has the strongest prospects for adoption and implementation is one that emerges, in its principal elements, from the recommendations of the indigenous experts and commands their enthusiastic support. In this model, foreign technical advisors do not dictate terms.[26] Instead, they identify alternatives, discuss the strengths and weaknesses of different approaches to solving problems, illuminate the experience of other countries with different systems, and ensure that important issues of substance and implementation are addressed.[27]

In terms of substance, the object of the law drafting process should be to correct serious market failures identified in case studies and interviews and designing an implementation mechanism to ensure that the law's nominal substantive commands are executed. Perhaps the most important contribution of external technical advisors in the drafting process is to focus the drafting group's attention on implementation issues. Here the goal is to ensure that the law's substantive requirements do not outrun the nation's ability to execute them, either through existing institutions or through the formation of new institutions

whose timely establishment reasonably can be anticipated.

To the greatest extent possible, the law's substantive commands and implementation mechanism should build upon existing legal commands and institutions. To minimize transitional difficulties that accompany the absorption of new legal concepts, the law drafters should seek to engraft the new law onto existing institutions and practices. As the following examples indicate, the ideal design of the law may vary considerably from country to country, depending on existing institutions and legal practice.

One issue in law design is whether the law should provide for enforcement by private plaintiffs (either before a court or a regulatory commission), or should limit standing to a public officials who investigate complaints of private parties and initiate their own inquiries. In some transitional countries, such as Mongolia, the idea of private enforcement is largely alien and would require greater effort to establish as part of an anti-monopoly system. By contrast, Zimbabwe permits private enforcement of a number of legal commands, including criminal statutes. Thus, a private right of action to attack certain antitrust violations might be much easier to implement in Zimbabwe than in Mongolia.[28]

A second example concerns the capability of the country's judicial system. Where the courts have minimal experience with commercial law issues, it may be best to commit enforcement authority to an administrative commission with power to adjudicate complaints internally, with its decisions subject to review by the country's appellate courts. To enhance the legitimacy of commission enforcement and administrative adjudication, the reform law should incorporate procedural safeguards to ensure fairness to affected parties and to promote transparent decision making.

C. Simplicity.

Few transitional economies have a large reservoir of human capital or a well-established institutional infrastructure for implementing new market-oriented legal commands, including antitrust and consumer protection laws. This dictates that law drafters place a premium on achieving simplicity in the new legal regime. Achieving simplicity requires rigorous efforts to focus new substantive commands on the most serious market failures, and to ensure that legal commands do not overpower the ability of existing or contemplated institutions to execute them. The aim is to avoid a serious mismatch between the law's requirements and the capabilities of the institutions to satisfy them.

Even seemingly simple legal commands may involve complexities that may not be apparent at first glance. Many legal concepts that strike external observers as relatively straightforward are not easily transplanted to a transitional economy settings. One of the clearest and simplest rules in antitrust jurisprudence is the per se prohibition against agreements by direct competitors to fix prices. Key operative elements of the per se ban on horizontal price fixing are the definition and proof of agreement.[29] In some countries, evidentiary standards may require the introduction of a writing to establish the fact of an agreement, placing spoken understandings outside the reach of a ban upon collusion. Thus, efforts to condemn cartels orchestrated through a spoken exchange of assurances may require a major change in the host country's evidentiary standards.

An additional reason for simplicity is that it facilitates self-execution. Donor entities sometimes have funded technical assistance programs to help transitional economy governments to implement new laws,[30] but the host country cannot count on donors for

extensive commitment or follow through once the new legislation is enacted. Thus, it is best to design law reform measures on the assumption that no great amount of follow-on assistance will be forthcoming.

D. Durable commitment by advisors before, during, and after the adoption of new laws.

External technical assistance is a major ingredient of law reform programs in transitional economies. The effectiveness of technical assistance depends heavily on the establishment by external technical advisors of a long-term in-country presence. Having one or more persons resident in-country is essential to analyzing indigenous economic and political conditions, identifying reform priorities, participating in the drafting and enactment of legislation, and assisting in implementation. Maintaining a long-term in-country presence helps to develop constructive relationships between foreign advisors and indigenous officials and to overcome the host country's justifiable suspicion toward expert outsiders who dispense wisdom for a few days, collect souvenirs and colorful stories, and journey homeward in the knowledge that they will not have to live with the results of their advice. The in-country advisor can draw upon foreign specialists for short-term visits, but a program consisting mainly of "parachute" visits by external advisors is prone to misapprehend national needs, to design laws that are ill-suited to national conditions, and to slight critical implementation issues.[31] The last issue -- implementation -- deserves special emphasis. Few technical assistance programs give implementation the attention it deserves.[32] The presence of external advisors in the period following enactment of a new law can be critical for two principal reasons. First, in countries such as Mongolia and Nepal, statutes tend to cast important

provisions in general terms and delegate the preparation of operational rules or procedural guidelines to a government agency. The impact and efficacy of a statute can hinge crucially on how these rules and guidelines are drafted, and foreign advisors can provide a useful perspective on what such documents might say. Second, the first years of the life of the new enforcement apparatus may have an enormous effect on its prospects for long term success. The new agency faces difficult choices about organizing its operating units, designing an enforcement strategy, educating affected parties about the new legal regime, publicizing its activities, and educating its professional staff. Foreign advisors can be a valuable resource to agency managers as these matters are addressed.[33]

The creation of a long-term, in-country presence depends heavily on the preferences and choices of donor institutions such as the World Bank, the United Nations Development Program, and individual national assistance entities such as the Agency for International Development. Technical advisors will not take a long-term view, and cannot invest in a sustained in-country presence, unless the funding agencies adopt a long-term perspective and commit resources over a period of years to accomplish pre-reform analytical tasks, law drafting, and implementation. Government managers have weak incentives to look beyond the relatively short-term -- the two-year term of a posting in a transitional economy, the one-year assignment as head of a bureau, or the preoccupation of the donor country's legislature in the immediate year's budget cycle. A project that arouses great enthusiasm today may lose funding in next year's budget as the donor organization shifts its attention to the crisis or policy demand of the moment.

The short-term focus of decision making places a premium on investing in activities

that show swift, measurable returns. The donor might emphasize assistance in adopting a new statute (a measurable event), but commit few resources to pre-reform economic and legal analysis or post-reform implementation (activities whose impact is not readily calculated). In the fields of antitrust and consumer protection, sustained technical assistance helps the host country establish effective enforcement institutions may yield few immediate, tangible returns, but such assistance is valuable in raising the probability that new legal commands will be applied sensibly. Reform efforts must cope with not only the fragile commitment of the host country to a market system, but also with the short attention span of donor institutions in seeing any single reform initiative through to the end. As noted above, the possibility that donor organization support for a specific reform program may be short-lived suggests the importance of devising relatively simple legal commands and implementing institutions whose success does not depend heavily on long-term external technical assistance.

E. Emphasis on education and publicity.

Major ingredients of the program for implementing antitrust and consumer protection reforms should be publicizing the existence of the new legal regime and educating consumers, business managers, and government officials about its contents and rationale. Carried out through booklets, public service announcements, speeches, and workshops, the education and publicity program can help educate the nation about the functioning of a market economy and the specific protections of the new legislation.[34] Enforcement authorities also can help educational institutions develop market-based courses, such as basic microeconomics for undergraduates and courses in antitrust and consumer protection for law

schools.

Another dimension of the education process is building the analytical capability of the antitrust and consumer protection agencies. Foreign technical advisors can play a valuable role in this effort, particularly in conducting workshops in which advisors engage the host country participants in problem solving exercises .[35] Workshops enable participants to analyze competition and consumer protection problems and to evaluate alternative solutions. The foreign advisor can design problems based on experience in other countries and contribute observations about analytical techniques and enforcement methods that have succeeded in other settings.

The education and publicity program also can serve to reinforce positive indigenous trends in the pre-reform era. The enforcement institutions can teach consumers about their ability to shape producer behavior through changes in purchasing behavior. By teaching consumers how competition can protect their interests, the enforcement authority can encourage efforts by producers to attract consumers on the basis of superior price and quality attributes. Efforts to demonstrate the value of advertising can reinforce efforts by producers, such as Himal Iron & Steel, to devise methods for signaling high quality and truthfulness in dealer with consumers.

F. Emphasis on advocacy of market institutions.

Among the most important contributions of an antitrust or consumer protection system is to discourage attempts by other government institutions to stifle competition and otherwise restrict consumer sovereignty.[36] In many transitional economies the state remains a potent threat to the market process. Government agencies at the national, regional, and local

levels retain formidable power to frustrate economic liberalization by imposing new restrictions or interpreting existing legal commands. Sustained efforts by antitrust and consumer protection authorities to remove state impediments to market rivalry deserve at least as much attention as the scrutiny of conduct by private economic actors.

G. Development of a law enforcement program.

The investigation and prosecution of private misconduct should follow an initial period of education and publicity. The raw material for individual cases should emerge from several sources, including industrial organization studies performed in the pre-reform period, investigations conducted by the new enforcement agency, and complaints from consumers or business managers generated by the education and publicity effort. To establish the credibility of the new enforcement institutions, emphasis should be placed on the prosecution of a small number of especially egregious offenses, such as a bid-rigging cartel or fraudulent advertising of over-the-counter drugs. Enforcement actions should be widely publicized to establish business and public awareness of the new antitrust and consumer protection regime.

H. Ex Post evaluation.

Successful implementation requires continuing efforts evaluate the impact of completed enforcement initiatives. Ex post assessments can inform the judgment of enforcement officials about the future choice of initiatives and can illuminate, for the host country and external donor organizations the strengths and weaknesses of specific law reform measures. Academics and other commentators have begun to perform informative assessments of the results of competition policy initiatives and other market-oriented law

reforms in transitional economies.[37] To be effective, such assessments require the cooperation of government agencies in providing access to data and internal decision making processes. Donor organizations are in a strong position to elicit such evaluative efforts by making additional assistance contingent upon the host country's willingness to examine past activities, both through internal agency self-assessments and by facilitating analysis by external observers. Of course, a commitment to encourage ex post evaluations assumes a long-term perspective that donor organizations have not always exhibited in the past.

Conclusion

In principle, antitrust and consumer protection laws can play a positive role in facilitating the transition from planning to markets. Whether such measures do so in practice depends vitally on the process by which the laws are drafted and implemented. Successful drafting demands careful evaluation of existing economic and legal customs, practices, and institutions to identify serious problems and devise solutions that are likely to take root in the host country. Effective implementation requires matching the law's commands to the institutional capabilities of the host country, and sustained efforts following enactment to assist antitrust and consumer protection authorities to execute their responsibilities. The tasks of law design and implementation cannot be accomplished skillfully from a distance, nor through short-term interventions by outsiders. To do either effectively requires a sustained in-country presence by technical advisors, close collaboration with indigenous experts, and a willingness to provide assistance through the critical period in which the host country's institutions are applying the new law.

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Endnotes

1. When speaking through a translator to an audience having little familiarity with market economics, it is important to articulate one's thoughts clearly and deliberately. In another seminar in Mongolia, I hastily mentioned that "law and economics" had greatly influenced judicial thinking about antitrust policy in the United States. From my rushed presentation, the interpreter thought I had spoken of "lawn economics." At the seminar's end, one participant said that only a wealthy capitalist nation such as the United States could develop a sub-specialty of economics devoted to the study of residential landscaping.

2. See, e.g., William E. Kovacic & Robert S. Thorpe, Antitrust and the Evolution of a Market Economy in Mongolia,in COMPETITION POLICY AND DEMONOPOLIZATION IN THE POST-COMMUNIST ECONOMIES (Ben Slay, ed.) (forthcoming) (describing Mongolia's adoption of a new anti-monopoly law); Clive S. Gray & Anthony A. Davis, Competition Policy in Developing Countries Undergoing Structural Adjustment, 38 ANTITRUST BULLETIN. 425 (1993) (describing adopting of anti-monopoly legislation as an element of structural adjustment in developing countries); Sergio Garcia-Rodriguez, [Paper in this volume], 43 DEPAUL L. REV. (1995) (discussing the content of Mexico's new antitrust law); Robert G. Vaughn, Consumer Protection Laws in South America, 17 HASTINGS INT'L & COMPARATIVE L. REV. 275 (1994) (examining origins and content of new consumer protection laws in South American); Ana Julia Jatar, "Competition Policy in Latin America: The Promotion of a Social Change" (Jan. 1995) (describing adoption of competition laws in Latin American and European countries undergoing economic liberalization).

3. See, e.g., William E. Kovacic, Competition Policy, Economic Development, and the transition to Free Markets in the Third World: The Case of Zimbabwe, 61 ANTITRUST L.J. 253 (1992) (discussing Zimbabwe's consideration of a new antitrust system). 4. See Armando E. Rodriguez & Mark D. Williams, The Effectiveness of Proposed Antitrust Programs for Developing Countries, 19 N. CAROLINA J . INT'L L. & COMMERCIAL REG . 209 (1994); Paul H. Rubin, Growing a Legal System in Post-Communist Economies, 27 CORNELL INT'L L . J . 1, 45-46 (1994)

5. See Annette W. Brown, Barry W. Ickes & Randi Ryterman, "The Myth of Monopoly: A New View of Industrial Structure in Russia" 38-39 (World Bank Policy Research Working Paper No. 1331: 1993).

6. Paul Godek makes the point as follows: East Europeans have limited resources and much more important things to worry about at this precarious stage of their development. Worrying about antitrust issues shows an unhealthy state of anxiety about the imagined ills of capitalism. Exporting antitrust to Eastern Europe is like giving a silk tie to a starving man. It is superfluous: a starving man has much more immediate needs. And if the tie is knotted too tightly, he will not be able to eat what little there is available to him. Paul E. Godek, One U.S Export Eastern Europe Does Not Need, REGULATION 20, 21 (Winter 1992).

7. For more sanguine assessments of the value of antitrust and consumer protection programs in transitional economies, see James Langenfeld & Marsha W. Blitzer, Is Competition Policy the Last Thing that Central and Eastern Europe Need?, 6 AM. U. J. INT'L L. & POLICY 347 (1991); Spencer Weber Waller & Rafael Muente, Competition Law for Developing Countries: A Proposal for an Antitrust Regime in Peru, 21 CASE W . RES . J. INT'L L . 159 (1989);

Robert D. Willis, Anti-Monopoly Policies and Institutions, in THE EMERGENCE OF MARKET ECONOMIES IN EASTERN EUROPE 187 (Christopher Clague & Gordon C. Rausser, eds. 1992).

8. See Jeffrey Sachs, In Defense of Russia's Reformers, WALL ST. J., Dec. 30, 1993, at A8 (describing "hand-to-hand combat" between economic reforms and the "communist old guard" in Russian.)

9. See Irina Starodubrovskaya, The Nature of Monopoly and Barriers to Entry in Russia, 6 COMMUNIST ECONOMIES & ECON. TRANSFORMATION 3, 13 (1994) recounting role or local authorities in obstructing competition); Peter Murrell, Karen Dunn & Georges Korsun, "The Culture of Policy-making in the Transition from Socialism: Price Policy in Mongolia" (IRIS Working Paper No. 32: 1992) (describing how local government officials in Mongolia seek to control prices despite the elimination of price controls as a matter of national policy).

10. See Janusz A. Ordover & Russell Pittman, "Competition Policies for Natural Monopolies in a Developing Market Economy" (U.S. Department of Justice, Antitrust Division, Discussion Paper EAG 92-9: 1992).

11. See W. Kovacic, supra note 3, at 260 & n.24.

12. See Hernando de Soto, THE OTHER PATH 17-127 (1989) (documenting the substantial role of the "informal" sector in Peru's economy).

13. See, e.g., Douglas Faran, Farmers' Markets Help Ease Cuba's Pain, WASHINGTON POST, Jan. 23, 1995, at A1 (describing how Cuban President Fidel Castro has begun to permit farmers to sell produce directly to Cuban consumers at prices set by the supply and

demand for food).

14. See Robert D. Cooter, "Avoiding Tragedy in the World's Largest Commons" (October 1994) (describing how nomadic herders in Mongolia developed customary land use rights to ensure efficient use of scarce winter pasture land).

15. One would need to be wary of customs that serve mainly to cartelize individual industry segments. See note 11 supra and accompanying text.

16. The Mongolian attorneys, economists, and other experts with whom IRIS worked in drafting an anti-monopoly law for that country were strikingly well-versed in policy considerations relevant to the design of antitrust prohibitions. See William E. Kovacic & Robert S. Thorpe, Antitrust Law for a Transition Economy, LEGAL TIMES, Aug. 2, 1993, at 41.

17. See, e.g., Jim Leitzel, Russian Economic Reform: Is Economics helpful?, 19 EASTERN ECON. J. 365, 366 (1993) (discussing the lack of experience among Russian economists with the analysis of markets).

18. See Mancur Olson, the Hidden Path to a Successful Economy, in THE EMERGENCE OF MARKET ECONOMIES IN EASTERN EUROPE 55, 67-68 (Christopher Clague & Gorden C. Rausser, eds. 1992).

19. See Pearson Nherere, No Requiem for the Restraint Doctrine--Yet, 6 ZIMB. L. REV. 1 (1988).

20. On the importance in antitrust analysis of agreements among competitors of the distinction between naked and ancillary restraints, see Ernest Gellhorn & William E. Kovacic, ANTITRUST LAW AND ECONOMICS IN A NUTSHELL 179-96 (4th ed. 1994).

21. In the Ukraine, the post-reform commercial law courts are antecedents of the "arbitrage" offices that resolved supplier-fabricator disputes under communism.

22. In Zimbabwe, I interviewed one of the country's leading corporate law specialists. At one point in our conversation, the attorney pulled from the shelf in his office a well-thumbed copy of a volume containing Zimbabwean statutes dealing with business associations. The volume contained numerous handwritten annotations, and on many pages the attorney had affixed typed or printed inserts to the printed text. As new statutes were passed and existing statutes were amended, the government did not published complete, revised texts of the law. Thus, it fell to practitioners to annotate the official published texts of the original laws.

23. For example, the drafting of an anti-monopoly law in Mongolia in 1992 and 1993 built extensively upon research by IRIS in-country representatives, project members, and consultants. See, e.g., Peter Murrell, "Reform Issues in Mongolia" 'IRIS Country Report No. 1: 1991) (identifying priorities for economic and legal reform in Mongolia); Peter Murrell, Georges Korsun & Karen Dunn, "Price Policy in Mongolia: A Chronology of Developments" (IRIS Country Report No. 5: 1992) (describing modern evolution of price controls in Mongolia).

24. Cf. Robert Klitgaard, TROPICAL GANGSTERS 102 (1990) ("The only justification for foreign experts was as teachers of analytical techniques.").

25. For a description of the collaborative process through which Mongolia's antitrust law was drafted, see W. Kovacic & R. Thorpe, supra note 16.

26. This may not always be the case. In some instances the government of the host country may refuse to take an active hand in devising politically unpalatable reforms. In such cases it

may be necessary for donor organizations to "cram down" specific reforms to establish needed elements of a market-based legal infrastructure and to enable leadership of the host country to deflect political opposition by characterizing the adoption of a reform as an inescapable concession to external financiers.

27. Robert Klitgaard makes the case for technical assistance that encourages full-fledged "participation" by host country officials:

It had been my experience that decisions are improved by collegial efforts to lay out issues, clarify choices, and separate the value judgments and the ,factual questions. Foreigners like me can help in this, and if one is lucky, in the process the locals learn how to do it themselves. R. Klitgaard, TROPICAL GANGSTERS, at 79.

28. See W. Kovacic, supra note 3, at 264.

29. See William E. Kovacic, The Identification and Proof of Horizontal Agreements Under the Antitrust Laws, 38 ANTITRUST BULLETIN. 5 (1993).

30. See Kathleen E. McDermott, U.S. Agencies Provide Competition Counseling to Eastern Europe, 6 ANTITRUST 4 (Fall/Winter 1991) (describing placement of antitrust specialists from the Department of Justice and the Federal Trade Commission in anti monopoly bodies in Eastern Europe).

31. Cf. Glenn R. Lawrence, Are We Exporting Our Legal System?, 41 FED. BAR NEWS & J. 672, 679 (Dec. 1994) (questioning the value of short-term exchange visits to support rule of law projects in formerly communist and Socialist countries).

32. See R. Klitgaard, TROPICAL GANGSTERS, at 185: In the usual brand [of technical assistance] an expert comes and carries out a task, the classic case being writing a report and

then leaving. Much rarer was an expert who worried about implementation, how the report would be used in practice. And rarer still, at least in Equatorial Guinea, was the expert who worked with the Guineans and trained them.

33. An informative test of this assertion is unfolding in Ukraine, where IRIS holds an AID contract to supply technical assistance to Ukraine's Anti-monopoly Committee (AMC) . IRIS has placed a team of three American professionals in the AMC headquarters in Kiev. Two are economists (Linda Boner and Roger Boner) who combine extensive experience in the Federal Energy Regulatory Commission and the Federal Trade Commission. Both have made numerous presentations to foreign antitrust officials. Roger Boner has performed a number of in-country competition policy consultancies and has written widely on the subject of competition policy in transitional economies. See Roger Boner & James Langenfeld, Liberal Trade and Antitrust in Developing Nations, REGULATION 5 (Spring 1992) (discussing the roles of trade liberalization and antitrust in promoting competition). The third professional (George Gamota) is an attorney who speaks Ukranian. This team is especially well-suited to assist the AMC in training its professional staff, in developing programs to educate various Ukranian constituencies on Ukraine's anti monopoly law, in developing a competition advocacy program before other government bodies, and in formulating an enforcement strategy.

34. See James Langenfeld & Dennis A. Yao, Competition Policy and Privatization: An Organizational Perspective, in GOVERNMENTS AND MARKETS 195, 214 (H.J. Blommestein & R. Stuenenberg, eds. 1994) (describing value of educational outreach activities by competition authorities in transitional economies).

35. See R. Klitgaard, TROPICAL GANGSTERS, at 137, 149 (describing value of workshops as instructional tools).

36. See Craig W. Conrath & Barry T. Freeman, The Effectiveness of Proposed Antitrust Programs for Developing Countries -- A Comment, 19 N. CAROLINA J. INT'L L. & COMMERCIAL REG. 233, 243-45 (1994) (competition policy advocacy seen as valuable element of anti monopoly program in transitional economies); Imrich Flassik, Priorities of the Czechoslovak Anti-Trust Office, in THE ROLE OF COMPETITION IN ECONOMIC TRANSITION _ , 74-75 (Christopher T. Saunders, ed. 1993) (discussing efforts of Czechoslovak Federal Competition Office to reduce customs tariffs for imported automobiles); Paul J. Joskow, Richard Schmalensee & Natalia Tsukanova, Competition Policy in Russia during and after Privatization, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY 301, 359-60 (Martin Neil Baily, Peter C. Weiss & Clifford Winston, eds. 1994) (recommending that regional anti monopoly authorities in Russia advocate pro-competition policies in sectors such as energy, telecommunications, and transportation).

37. See Carolyn Brzezinski, Competition and Antitrust Law in Central Europe: Poland, the Czech Republic, Slovakia, and Hungary, 15 MICH. J. INT'L L. 1129 (1994) (assessing experience with antitrust laws in Central and Eastern Europe); Georges Korsun & Peter Murrell, "The Effects of History, Ownership and Pre-Privatization Restructuring on Post-Privatization Governance" (IRIS Working Paper No. 147: 1995) (studying determinants of post-privatization corporate governance structures in Mongolia); Ben Slay, "Industrial De-monopolization and Competition Policy in Poland and Hungary" (Middlebury College Working Paper No. 94-9: 1994) (evaluating impact of structural competition policies on

economic transition in Hungary and Poland).

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Predatory Versus Productive Government: The Case of U.S. Agricultural Policies

Gordon C. Rausser

Agricultural policy is a complex web of interventions covering output markets, input markets, trade, public good investments, renewable and exhaustible natural resources, regulation of externalities, education, and the marketing and distribution of food products. At the level of the federal government, these interventions have resulted in enormous budgetary costs; huge surpluses of farm products; major disputes with other countries; distorted international markets; and benefits to special interests that are often highly concentrated. The same programs, however, have been part of an agricultural sector whose productivity over much of the last century has been spectacular.

Do these massive governmental interventions correct for market imperfections, lower transaction costs, effectively regulate externalities, and enhance productivity? Or are these programs the result of manipulation by powerful commodity or agricultural interest groups actively engaged in rent-seeking or directly unproductive activities (Buchanan and Tullock 1962; Krueger 1974; Bhagwati 1982)? In this latter perspective, agricultural interest groups are presumed to behave much like the proverbial 800-pound gorilla—they walk where they want; they sit where they want; and they take what they want.

In the design and implementation of governmental policy in agriculture conflicts naturally emerge between public and special interests. A conceptual formulation that attempts to explain or prescribe public policy emphasizing only one of these interests is doomed to fail. Frameworks that neglect political forces and the role of special interest groups will have little explanatory power.

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Models that presume the government has no autonomy nor any interest in the size of the economic pie will also face serious limitations as explanatory, predictive, or prescriptive frameworks.

This essay will argue that agricultural policy in the United States has led to both the enhancement of efficiency through "productive policies" and the transfer of wealth and income to special interests through redistributive or "predatory policies." These two activities can be labelled as PESTs and PERTs. PEST policies, or political-economic-seeking transfers, are meant to redistribute wealth from one social group to another and are not explicitly concerned with efficiency. In contrast, PERTs, or political-economic resource transactions, are intended to correct market failures or to provide public goods; these policies have neutral distributional effects, at least in design (Rausser, 1982).

A review of the history of public policy in agriculture reveals not only tension between the PERT and PEST roles of the public sector, but also some coordination between these two types of activities. As different interest groups pressure the political process, the government trades off PESTs and PERTs in its attempts to acquire, balance, and secure political power. At times this has led to combinations of programs that appear incoherent. For example, conservation programs require the retirement of vulnerable acreage, while crop price supports penalize premature land retirement and create incentives for overutilization of vulnerable acreage. These apparent incoherencies, however, result from institutional arrangements that generate a government portfolio of productive and predatory policies. In such a world, the challenge for economists is to design and advocate policies that are both economically productive and politically sustainable.

Early Development of U.S. Agricultural Policies

Federal programs to assist the agricultural sector began in the second half of the 19th century. The period from 1850 through the early 1900s witnessed the emergence of important institutions aimed at lowering costs in the private sector. The Morrill Act of 1862 offered federal land grants to each state to establish free, public, higher education through the Land Grant College system. The U.S. Department of Agriculture, created in 1862, initially focussed on research, regulation, and information generation. The Hatch Act of 1887 set up a system of Agricultural Experiment Stations by providing annual grants to each state for agricultural research. The Smith-Lever Act of 1914 set up the Cooperative Extension Service system of county agents.

The grassroots organization represented by the county agent extension system proved to be an effective mechanism for communicating new agricultural technologies and knowledge directly to farmers. This organization also became the conduit for communicating back to the U.S. Department of Agriculture (USDA) and the land-grant universities signals on farm problems

requiring research. These early federal policies can largely be characterized as long-run institutional development, where the government was supplying public goods whose associated benefits and costs were widely dispersed.

A major resource promoting agricultural productivity has been the knowledge generated by public sector investments in research. This knowledge generation has repeatedly been shown to have significant influence on agricultural growth. Even so, the striking feature of agricultural research policies has been the overwhelming evidence of underinvestment. As Ruttan (1982) has shown, the rates of return to public good investments in agricultural research justify much higher levels of public research support.

Following the emphasis on public research, education, and extension support, legislation turned to the undesirable levels of rural infrastructure and problems of limited information. This legislation covered rural delivery of mail, soil conservation, agricultural credit, rural electrification, rural road building, and many other investments in the physical infrastructure of agriculture. These investments have been extensive. Pavelis (1985) has estimated that the federal government, "through direct construction or indirect cost sharing, has created up to 1975 about 45 percent of the value of all irrigation, drainage, and soil and water conservation facilities in the United States." Problems of limited information were addressed by other legislation that had the purpose of lowering transaction costs; for example, fertilizer and seed standards, weights, animal health, and food safety.

In more recent years, the evolution of many U.S. agricultural policies has demonstrated a distinct pattern. Early in the 20th century, enabling legislation was often justified as a means of correcting market failures and enhancing productivity. But once in place, these policies evolved into programs whose benefits were concentrated but whose associated costs were widely shared. Unsurprisingly, much of this legislation became a vehicle for codifying rent-seeking behavior. Examples of such agriculture policy evolution briefly described here include western resource and water development, soil conservation, environmental pesticide policy, and farm credit.

Western Resource and Water Development

Initially, the development of western water resources was viewed as promoting economic growth by turning "wastelands" into productive agricultural soils. Because of the potential concentration of transfers resulting from these policies, the Federal Reclamation Act of 1902 limited the size of those farms which could receive low-cost irrigation infrastructure and water to small-holder residents (160 acres per family member, or a maximum of 480 acres per household). The intent was to ensure that water projects benefited smaller farms rather than powerful land interests such as railroads, oil companies, or land speculators. These water resource projects were designed to be self-financed; project beneficiaries were expected to repay construction costs

over a 10-year period (Howitt, Mann and Vaux, Jr., 1982; Holmes, 1979; Worster, 1985).

However, as a result of one farm crisis following another from 1915 through 1930, the self-financing features were eliminated and reclamation construction funds were appropriated from the U.S. Treasury. Moreover, through a series of congressional enactments during the 1930s, the scope of reclamation policy was expanded to include activities such as fish and wildlife habitat development, flood control, navigation, and hydroelectric power generation and distribution. By the 1940s, the original intent of the 1902 legislation —to promote small-scale farmer settlement of the arid West—was all but forgotten. The acreage limitation provisions of the original legislation were never enforced. Once the court system was called upon to examine this lack of enforcement, the acreage limits were legislatively increased to 960 acres.[1]

The result of this history is that high water subsidies are available to selected farmers. For example, in the Westlands Water District, a part of the Central Valley Project in California, the difference between the actual cost and what farmers are currently paying translates into an average subsidy of approximately $500,000 per farm in the District (Reisner, 1986). California State Water Project officials are pursuing projects that will cost $212 per acre-foot and above, while some Central Valley Project farmers pay as little as $3.50 per acre-foot (Wahl, 1989). In Arizona, Scottsdale and Mesa have purchased water at total costs ranging from $200 to $300 per acre-foot, while recent desalting plant investments are expected to supply water at a cost of more than $1,000 per acre-foot.

Soil Conservation

A striking example of masking special interests by references to the public interest emerged with the passage of the Soil Conservation and Domestic Allotment Act of 1936. The dust bowl of the 1930s, dramatized by John Steinbeck's *The Grapes of Wrath*, provided the basis for a public perception that soil conservation was a serious social problem. The 1936 legislation marked the beginning of a long history of policies aimed both at commodity supply management and soil conservation. Specifically, the 1936 Act enabled farmers to receive soil conservation payments for reducing "soil-depleting" crops such as corn and cotton which, unsurprisingly, were also surplus crops. The focus on conservation emanated from concern about preserving and sustaining agricultural lands for future generations; "soil mining," erosion and "soil runoff" externalities were viewed as contrary to the public interest.[2]

[1]The major implementing agency for western water resource development has been the Federal Bureau of Reclamation. The water supplied by this Bureau at heavily subsidized rates to agriculture helps explain why the irrigation of just two California crops, alfalfa and cotton, takes as much water as is annually allocated to the state's entire population of 30 million.

[2]The U.S. Department of Agriculture has estimated that some 2 to 3 billion tons of soil are lost to erosion in the United States each year. Contrary to many popular press reports, this level of

The Agricultural Act of 1956 continued linking commodity supply management with soil conservation policy. The program was divided into two parts: a conservation reserve and an acreage reserve. The acreage reserve was to reduce the amount of land planted to the so-called program crops: wheat, cotton, corn, tobacco, peanuts, and rice. All farmers were eligible to participate in the conservation reserve, which allowed conversions of whole farms from cropland to soil-conserving uses. This program eventually enrolled nearly 30 million acres in the 1960s, moving marginal cropland into permanent pasture, timber, or recreational uses under contracts for a maximum of 10 years. It served the objectives of encouraging long-term adjustment of land and labor to nonfarm uses, soil conservation, and, to some degree, output management. However, almost all of the land in this conservation reserve returned to production during the 1973–1975 boom. In 1985, conditions were once again ripe for combining conservation and supply management. Farm production was generating enormous surpluses, and the environmental lobby was increasingly more effective. Accordingly, as of 1990, approximately 34 million acres have been enrolled in the conservation reserve program introduced by the 1985 Food Security Act.

A number of important lessons emerge from the evolution of commodity and soil conservation policies since the 1930s. In times of high agricultural supply and low prices, political opposition to supply-control policies can be countered when these policies are masked by conservation policies. When markets are expanding and prices are high, however, the public will not compensate farmers sufficiently to hold land out of production. Also, combining commodity and resource policies is far more difficult if institutional investments are not undertaken to establish an organization to sustain political support for these policies, a role effectively played by the soil conservation districts and/or the county agricultural adjustment committees.

Environmental Pesticide Policy

The origins of environmental pesticide policy began with the Federal Insecticide Act of 1910, initially developed to protect farmers from fraudulent claims of insecticide salesmen (Bosso, 1987). From these origins, the agricultural regulatory portfolio of the U.S. Environmental Protection Agency (EPA) can be traced. Today, this environmental and health hazard regulatory portfolio includes surface water pollution; groundwater pollution; air pollution;

erosion is not ruining American farmland. This is simply because topsoil is a renewable resource; it can be replaced by organic matter from crop residues. As a result, the rate of net loss of topsoil in the United States is, in fact, very small. The pollution effects of soil erosion are a different matter; these impacts arise as offsite effects of wind and water erosion.

worker exposure to agricultural chemical inputs; endangered species (exposure to the harmful effects of pesticides applied to the fields and crops in their habitat); and dietary risk (pesticide residues may remain in agricultural products that reach the consumer).

Like western resource development and soil conservation policies, the initial legislation regarding environmental pesticide policy was justified on the grounds of reducing costs, but the policy that it spawned reflected political influence and power. Pesticide environmental policy of the 1950s and 1960s was firmly controlled by an agricultural chemical coalition comprised of the chemical industry, the USDA, and the U.S. congressional committees (Bosso, 1987; Mitchell, 1979; Macintyre, 1987). In the political science literature, this coalition of business, regulators, and politicians has been referred to as an "iron triangle."

As public awareness began to increase, this coalition was challenged first by the Pesticide Control Amendment of 1954 that required any registered pesticide to have a tolerance level set by the U.S. Food and Drug Administration (FDA) for acceptable residues. In 1958, the "Delaney Amendment" was passed which states simply that no (food) additive shall be deemed safe if it is found to induce cancer when "ingested by man or animal." This Amendment was vigorously opposed by agricultural chemical interests but without success; it passed easily.

Until the publication of Carson's (1962) *Silent Spring*, most people knew the benefits of pesticides, but very few had any knowledge of the possible environmental and health risks of pesticide use (Perkins, 1982). But the thalidomide scare of 1962 gave increased credibility to the Carson message. Slowly, a new breed of environmental activists emerged and turned to the court system to enforce the pesticide control laws. In 1969, the Environmental Defense Fund won a case against the use of DDT in the state of Wisconsin. As Bosso (1987) reported, this first state-level ban of DDT "sent shock waves throughout the community, the chemical industry, and government at all levels." Accordingly, the chemical industry and the USDA slowly lost their grip. As Wilson (1980, pp. 391) has observed, most of these so-called "iron triangle" coalitions "appear to be made of metal far more malleable than iron." Shortly thereafter, the Nixon Administration announced its intent to phase out all nonessential uses of DDT within two years.

Since then a new political coalition has emerged aimed at regulating agriculture's effects on the environment. Comprised of the environmental interest group organizations, EPA, and members and committees of Congress without agricultural ties, this coalition's concerns have moved beyond the quality of the food supply to include the external effects of agriculture on water and wildlife as well. These groups helped to enact the National Environmental Policy Act of 1969, the Clean Air Act of 1970, and to establish the U.S. Environmental Protection Agency (EPA).

Farm Credit

Farm credit legislation set up a system of farmer-owned cooperative banks composed of federal land banks (long-term debt), production credit associations (short-term debt), and a bank for cooperatives. The economic justifications for government sponsorship of the Farm Credit Banking System (FCBS) were market failures which led to less than an optimal amount of credit being offered to the agricultural sector. In particular, federal banking laws prohibited the emergence of national banks, and state banks could not easily diversify the regional components of agricultural lending risk. Furthermore, adverse selection may exist in rural credit markets, due to heterogeneous endowments of farmers' abilities.

But since the federal farm credit system was restricted to the agricultural sector, it could not adequately address the problem of diversification. As the years unfolded, it also became clear that these institutions had an inherent conflict of interest. The banks of the FCBS were owned by the borrowers, who were either farmers or farmer-owned cooperatives. Stock equity in these institutions could not be freely traded; in fact, it could be redeemed only by paying off loans. Furthermore, since dividends were not paid, the most effective means for transferring any residual was by charging below-market rates of interest which led, in turn, to too much borrowing. Once interest rates rose dramatically in the early 1980s, the federal credit system faced many of the same problems that plagued the U.S. savings and loan industry. Accordingly, farm credit interest rates rose above market rates. More efficient farmers exited the system, terminating their stockholder interest as they paid off their loans. Farmers who could not secure credit from other sources remained in the system.

Due in large part to these structural problems, the farm credit banking system suffered losses of over $2 billion per year in 1985 and 1986. As the losses mounted, lobbyists representing the FCBS spent millions of dollars arguing for subsidies. The federal government bailed out the FCBS in 1988. Whether or not the FCBS had originally aimed at a market failure, it had developed its own political momentum for taxpayer transfers to the farm sector.

Legislated Redistributive Activities

To this point, the discussion has emphasized policies that were justified to some degree by market imperfections, even if they were often manipulated for purposes of redistributing income to the farm sector. However, the institutional structure which emerged from the efficiency-enhancing legislation of the 19th century and early 20th century—the Morrill Act, USDA, Hatch Act, Smith-Lever Act, and so on—composed of the extension system of county agents, the U.S. Department of Agriculture, and generic farm groups, formed the foundation

for one of the best organized economic interest groups in the country. The agricultural depression of the 1920s, which foreshadowed the Great Depression, provided the stimulus for this coalition to be more cohesive and effective in redistributing benefits to farmers. Also, during this period, farm interests were able to avoid a number of governmental regulations through legislative exemptions from antitrust, labor, and tax legislation.[3]

The long history of redistributive agricultural policies began in earnest with the passage of the Agricultural Adjustment Act of 1933, which continues to be revised every four years or so. Following the *Hoosac Mills* decision of the Supreme Court in January 1936, these redistributive programs required voluntary participation and offered nonneutral transfer schemes linking government support directly to the amount produced. Since these programs were tied to specific commodities, the generic farmer organizations began to lose influence. In effect, commodity-based groups became the primary vehicle for political expression of farmer interests (Lowi, 1965). At the same time, the USDA began a transformation from an organization that focused largely on research and education to a more conventional government agency, managing programs which provide direct economic benefits to specific interests.

Initially, the major policy instruments for redistributing income to the farm sector were price supports and public storage. Price supports were implemented through government loans to farmers, where farmers put up a certain amount of a commodity as collateral for the period of the loan. If market price fell below the loan rate (price support), the government took ownership of the collateral; if not, the farmer could be expected to pay off the government loan and redeem the commodity. Of course, since price supports were generally set well above market equilibrium prices and since farm productivity was increasing sharply (in part, from the public investment in research), storage of the huge surpluses was a necessary by-product.

With the commodity redistributive policies came losses for consumers and taxpayers, gains to farmers, and deadweight losses, whose range has been estimated for many commodities on numerous occasions. Table 1 reports the figures for a representative year over the period 1985–1988. It is worth noting that the effects captured in the table underestimate total social losses; for example, they neglect the waste generated from rent-seeking behavior and the deadweight losses associated with tax collections. Furthermore, with the passage of the 1985 Food Security Act, the distribution of burden across consumers and taxpayers shifted dramatically in the mid-1980s and the net losses computed here fell relative to earlier periods.

[3]The Capper-Volstead Act of 1922 specifically exempted agricultural cooperatives from some features of the Sherman antitrust legislation, allowing farmers to join together to purchase inputs, to market their products, and even to agree on the amount of joint sales. For much of this century, farmers were exempt from minimum wage legislation. After World War II, farmers were the major beneficiaries of the "bracero" program, which allowed temporary employment of Mexican aliens. Special provisions in the U.S. tax codes for agriculture included cash accounting and many tax shelter incentives for specific agricultural investments.

Table 1

Range of Annual Domestic Welfare Gains and Losses from Support Programs Under the 1985 Food Security Act, 1985–1988

Crop	Consumer Loss	Producer Gain	Taxpayer Cost[a]	Net Loss
	billions of dollars			
Wheat	0.24–0.30	2.62–3.22	3.67–4.27	0.69–1.95
Corn	0.68–0.76	7.23–7.62	7.30–8.10	0.36–1.63
Cotton	0.19–0.21	1.20–1.46	1.40–1.60	0.13–0.61
Peanuts	0.36–0.40	0.29–0.35	0[b]	0.01–0.11
Dairy	1.80–2.90	1.50–2.20	1.13–1.72	0.73–3.12
Sugar[c]				
Case I	1.90–2.40	1.50–1.70	0[b]	0.20–0.90
Case II	1.35–1.55	1.15–1.25	0[b]	0.10–0.40
Tobacco	0.20–0.22	0.34–0.38	0[b]	(0.12)–(0.18)[d]

[a]Includes Commodity Credit Corporation expenses after cost recovery.
[b]These programs are run at no-net cost to the government.
[c]Case I assumes U.S. policies do not affect world sugar prices. Case II takes into account the fact that U.S. policies reduce world sugar prices. The value of sugar import restrictions to those exporters who have access to the U.S. market (that is, value of quota rents) is $250 million.
[d]The tobacco program is estimated to have a positive net domestic welfare gain. This is because of the large value of U.S. exports allowing domestic producers to extract surplus from foreign consumers.
Source: Computed estimates from unpublished U.S. Department of Agriculture data.

The stylized facts emerging from Table 1 (not only for the United States but other countries as well) can be summarized as follows: the redistribution of income to agriculture is greater the richer or the more industrialized the country; the higher the cost of production; the fewer the number of farmers, absolutely and relative to the total population; the more price inelastic the supply or demand function; the lower the portion of total consumer budget spent on food; and the smaller on world markets the exporting country or the larger the importing country (Rausser and de Gorter, 1989). The efficiency of redistribution increases as either the demand or supply function becomes less elastic. Moreover, as Gardner (1983, p. 233) has shown, "The efficient method of intervention depends on which function is less elastic. Inelastic demand favors production controls, and inelastic supply a deficiency payment approach."

Policy Instruments

There are many margins for adjusting behavior. Since the 1930s, attempts to address these adjustments have resulted in a piecemeal proliferation of policy instruments. On the supply side, this includes the land controls and land conservation mentioned earlier, along with production quotas; and on the

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demand side, it includes export subsidies and enhancements, concessional foreign sales and food grants, and food stamps. Unfortunately, each additional policy instrument brought its own unanticipated side effects, requiring still additional mechanisms.

Sometimes the side effects seem so obvious that policy-makers can only have missed them through sheer myopia. For example, the initial voluntary acreage-reduction programs focused on compliance requirements *for a particular commodity*, neglecting the fact that farmers might substitute and grow other crops, like soybeans rather than corn. In fact, it was sometimes possible for the party that had demanded the original crop to substitute and use the new crop the farmer was growing (Brandow, 1977). Of course, if too many restrictions on substitution are placed on farmers, they will choose not to participate.

To understand how farmers can respond to voluntary programs, it is important to describe the mechanics of the income transfers. For some years, the major vehicle for these transfers has been "deficiency payments." The government sets a target price for certain commodities. The target price is set well above the market price, which encourages high program participation. The deficiency payment rate is computed as the difference between the target price (set by law) and the higher of the price support or the average market price received over the first five months of the marketing year. Each farmer participating in the program has a payment base, determined by the land base (essentially how much land they have dedicated to the crop in the past) and "program yield" (based on the individual's or counties' past yields). The deficiency payment rate times the payment base, adjusted for acreage set-aside requirements, determines the total deficiency payment.[4] Thus, the amount of deficiency payments to farmers is influenced through four different channels: target prices, price supports, the land resource base, and productivity.

To receive the deficiency payments, participating farmers must either allocate land to a crop in the program or to conservation uses dictated by the Department of Agriculture. Moreover, until 1990, the enabling legislation has generally required farmers to forego present and future program benefits if they harvest crops other than the program crop for which they have a "land base." This feature was intended to prevent a farmer from collecting federal subsidies for not growing one crop, while growing another. It also has the effect of coupling income transfers to the planting and harvesting of program crops. Historically, one of the major barriers to entry in program crop production has been land bases on which acreage restrictions are imposed (Becker, 1985).

[4]Specifically, for those who participate, the expected deficiency payment for a particular crop, c,

$$E(d_{ct}) = \left[P_{ct}^{T} - Max(P_{ct}^{S}, E(P_{ct}))\right](1 - \omega_{ct})L_{ct}Y_{ct}$$

where P_{ct}^{T} is the target price; P_{ct}^{S}, the support price; $E(P_{ct})$, the expected average price received by farmers; ω_{ct}, the percentage of land base required to be idled; L_{ct}, the land base in period t; and Y_{ct}, the program yield per unit of the land base.

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Over the years, more flexibility has slowly been introduced and the amount transferred has become increasingly less dependent on the actions, current and past, of farmers. For example, until the 1986 market year, the expected program yield was determined as a moving average of a farmer's past yields. One provision of legislation in 1985, however, was to assign unalterable program yields. Thus, a farmer could no longer strategically influence this variable.

The incentive to raise production caused by price supports was also dramatically reduced with the 1985 legislation. The Secretary of Agriculture was given discretion in the case of feedgrains and wheat to lower the price support up to 20 percent below the basic loan rate. For soybeans, the loan rate can be lowered no more than 5 percent. For cotton and rice, the effective loan rate is set at world market prices. As a result, cotton and rice farmers participating in government programs could first pledge their output as collateral for a loan at the basic rate and, at maturity, repay the loan at the prevailing world market price if it is lower than the basic rate.

In the case of land base, however, current actions can still influence how a farmer's base is computed.[5] A producer of a program crop has an assigned "base" acreage of that crop, which is derived from a five-year moving average of plantings of that crop on the farm. As a result, a forward-looking farmer may plant larger acreage in anticipation of future subsidies.

The trend toward lowering entry barriers to production of program crops and the degree of coupling at the margin was continued in the 1990 farm legislation. In comparison to previous legislation, the flexibility provisions allow market signals to play a more significant role in guiding production decisions. These provisions permit 15 percent of the land base to be planted to any program, any oil seed, any industrial, experimental, or any other nonprogram crop except for fruits and vegetables.[6] This 15 percent of the total base is not eligible for support payments, but program crops, other permitted crops, or conservation uses are allowed.

In addition to the above 15 percent "normal flex" provision, farmers are also allowed the option of an additional 10 percent flexibility. Subsidy payments are lost on these acres as well as the 15 percent "normal" flex acres; but for both the "normal flex" and "optional flex" acres, the land base is protected. Prior to 1990, the allocation of land to any nonprogram or other program

[5]The land base for each producer is established at the county office of the Agricultural Stabilization and Conservation Service (ASCS). The ASCS is the administrative agency within the U.S. Department of Agriculture that has responsibility for implementation of the deficiency payments. It has an office in each state and 3,000 county offices nationwide. In addition to several thousand employees, a local committee of three persons (usually producers) handles local appeals of decisions and other administrative matters. County offices assign each local producer a program yield as well as a land base.

[6]The latter barrier to entry is a reflection of the political influence of California fruit and vegetable growers.

crops would have reduced by an equivalent amount that acreage that would enter the 5-year moving average process for determining land base.

That portion of the actual land base that is idled can be decided by each producer, and each producer will rationally idle the least-productive land (whether the control comes through owner or renter status). This option, along with reconfigured variable inputs on the utilized land (plus the existence of nonparticipants) means that a program which seeks to reduce acreage by a given percent normally reduces output by a substantially smaller percentage. This phenomenon of increased per-acre yields associated with government acreage control programs has been referred to as "slippage."[7] Estimates of the amount of slippage range from 30 percent to as high as 60 percent (Norton, 1986; Love and Foster, 1990; Ericksen, 1986).

Given the possibilities for manipulating output patterns, it follows that predicting government agricultural spending is highly uncertain. Since the target price is set by the legislation, the major sources of uncertainty are the support price, the land base, and the number of farmers who choose to participate.[8] Indeed, the OMB and the USDA frequently generate point forecasts for government expenditures which are widely off the mark. However, it is notable that, compared to other budgetary predictions, predictions of agricultural expenditures have been systematically biased downward over the last few decades. One explanation is that there are strong incentives for underestimating expected Treasury costs in an area where the transfer recipients are distinctly more powerful and better informed than those who share the burden for the transfers (taxpayers and consumers).

In an attempt to control government spending, as well as to address goals of distributional equity, deficiency payments are limited to $50,000 per farm. Over the years, however, many loopholes have allowed these payment limitations to be exceeded. The loose definition of a "person" has fostered overlapping partnerships and other methods of farm ownership that qualify for multiple payment limits. Accordingly, the number of "farmers" in program-eligible commodities has increased over the last decade, while the number of farmers producing commodities ineligible for subsidies has declined.

Despite these attempted limitations, the distribution of program benefits continues to be viewed by many as inequitable. For the 1988 crop year, operating farms with sales above $100,000 received 57.6 percent of the direct government payments. As shown in Table 2, the cumulative distribution of government payments reveals concentration among the largest farming operations, with the average payment to all farmers having annual sales exceeding $500,000 per year at approximately $40,000. Since many large farms do not

[7]The slippage rate is defined by $s = -[(\Delta Y/Y)(\Pi/\Delta\Pi)]$ where Y is aggregate per-acre yield and Π is the ratio of land planted to total land, planted and diverted, for that crop.

[8]Prior to 1986, the level of productivity used in the computation of deficiency payments was also uncertain over the planning horizon following each revision in the basic Agricultural Adjustment Acts of the 1930s.

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Table 2
Distribution of All Government Payments by Farm Class, 1988
(all farms)

Farm Class (by annual sales)	*Number of Farms*	*Average Payment*	*Total Payments to Class*	*Total Payments*	*Total Farms in Class*
dollars	*thousands of farms*	*dollars*	*millions of dollars*	*percentage*	
< 10,000	1,051	559	588	4.1	47.8
10,000–19,999	270	2,368	640	4.4	12.3
20,000–39,999	253	5,821	1,472	10.2	11.5
40,000–99,999	300	11,461	3,444	23.8	13.7
100,000–249,999	220	21,452	4,714	32.6	10.0
250,000–499,999	67	32,484	2,188	15.1	3.1
500,000 >	35	40,874	1,435	9.9	1.6
Total	2,195	6,597	14,481	100.0	100.0

Source: U.S. Department of Agriculture. "Economic Indicators of the Farm Sector: National Financial Summary, 1989." ERS, ECIFS 902, Table 30, p. 46.

produce commodities eligible for government programs (approximately 25 percent of all farmland in the United States is eligible for government crop programs), participating farms receive considerably more than this figure. In fact, based upon sample surveys conducted by US Department of Agriculture, Economic Research Service, the estimates of payments to program-participating farms is $30,598 for the sales category of $100,000 to $249,000; $41,888 for the sales category $250,000 to $499,000; and $66,037 for the sales category above $500,000.

Implications of Coupled Transfers

Many of the inputs used in agricultural production are joint, producing valuable as well as undesirable outputs (Rausser, 1974; Rausser and Lapan, 1979). Encouraging agricultural production through coupled transfer schemes while requiring some land to be idled leads to excessive utilization of basic inputs. Residuals of excessive fertilizer and pesticide input applications combine with excess water and are transported into various water sources, an externality output. Toxic salts accumulate in agricultural land. Burning crop residues may result in air pollution. Wind erosion contributes to particulate air pollution and has been estimated to cost $4 billion or more in annual damages in the western United States, while erosion caused by water runoff has been a major contributor to water pollution resulting in damages estimated to range from $5 billion to $18 billion annually (Economic Report of the President, 1990).

The land that is allocated to production of program crops is combined with more pesticides and fertilizers than would otherwise be the case. Farmers receive subsidies only on that land that is part of the farmer's program crop base. Thus, a disincentive is created for rotating crops. Because crop rotation is a nonchemical technique for pest control, the coupled transfer programs aggravate pesticide pollution by encouraging the substitution of chemical for nonchemical pest control.[9]

In this respect, the experience of the United States is consistent with the rest of the world. Countries which tax their agricultural sectors (Argentina, Thailand) use less than one-twentieth the amount of chemical fertilizer per cultivated acre that highly subsidized countries such as Switzerland use. There is a similar direct correspondence between producer subsidies and the use of farm pesticides (Anderson, 1992).

Given the relationship between coupled transfers and the determined land base, acreage that is suitable for the program crops becomes more valuable. These subsidized land values encourage farmers to allocate available land to program commodity production. In some instances, this has included land that is steeply sloped and thus highly erodible, as well as wetlands that provide important wildlife habitat. Hence, coupled transfers based on land use have created incentives for farmers to use land in ways that increase adverse environmental impacts. These concerns helped motivate the conservation reserve program of the 1985 legislation and the planning flexibility provisions of the 1990 farm legislation. These recent farm bills have established a trend toward reducing the linkages between agricultural subsidies and farmers' production and land-use decisions. Accordingly, potential adverse environmental spillovers have been slowly reduced.

The inflexible settings of price supports and target prices in the early 1980s followed the favorable agricultural economic markets of the 1970s. The coupled transfer policies augmented the degree of overexpansion within the U.S. agricultural sector, making the sector especially vulnerable to the unanticipated interest rate, exchange rate, and growth rate patterns of the early 1980s (Rausser, Chalfont, Love, and Stamoulis, 1986). One adverse environmental result was the "mining of the soil" that many farmers engaged in during the 1980s in order to survive financial stress (Foster and Rausser, 1991).

Partly because of the nature of the coupled transfers, one production record after another was broken during normal weather years of the 1980s. These high levels of production led to pressure for change. For example, in 1983, commodity-specific certificates were offered in lieu of cash transfers; that is, farmers were offered subsidy in kind rather than cash. This became a means for releasing public stocks held in the farmer-owned reserve. In 1986, generic

[9]Due to the complex measurement problem that arises in the monitoring and estimating environmental bads, Pigovian taxes based on marginal damages are impractical (Rausser and Howitt, 1975). As a result, measurement or information policies must be put in place with environmental standards, taxes, or control policies (Hochman and Zilberman, 1978; Rausser and Lapan, 1979).

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commodity certificates were introduced in place of commodity-specific certificates up to the level of available stocks. Governmental expenditures skyrocketed in 1986 because governmental stocks moved on to market through the generic certificate program, driving real prices to record lows for many commodities and thus indirectly increased the level of deficiency payments. As noted above, the 1985 Food Security Act also dramatically lowered price supports, computing their levels as a moving average of past market prices with some bounded discretion on the part of the Secretary of Agriculture to set the actual price support at lower levels.

A number of general equilibrium analyses have been conducted to estimate the intersectoral effects of coupled transfer policies on the balance of the U.S. economy. One study concluded that the misallocation of resources and capital to agriculture depressed the productivity of other sectors of the U.S. economy and reduced American manufacturing exports by $7.5 billion and service exports by $3.4 billion (Hertel, Thompson and Tsigas, 1989). Another study estimated that the removal of all programs which distort agricultural production or constrain input use would increase 1991 GNP by $9.6 billion (Robinson, Kilkenney and Adelman, 1989).

U.S. Agricultural Policies and the Rest of the World

Since the United States is a large producer of some commodities on the world market, its price supports and accumulation of stocks can conceivably result in short-run favorable consequences for all exporters of the commodity in question. Specifically, if the internal price supports are so high as to effectively eliminate the export market as a relevant alternative, all the benefits accrue to other exporting countries in the short run. Over much of the post-World War II period, the United States has behaved as a residual supplier on world markets of many major commodities, especially the food grains, cotton, and the feed grains.

To the extent that the price support programs and coupled subsidy transfers discussed above, as well as protection against import competition (such as quotas in the United States and variable levies in Europe) all induce greater production, however, world prices will be depressed. This is particularly evident when the U.S. government sells unwanted stocks on the world market at less than the domestic price (through the Export Enhancement Program), makes concessional sales, or simply donates the food as aid (through PL 480). These potential effects have been examined in a number of empirical analyses (Tyers and Anderson, 1986; Roningen and Dixit, 1989; Zietz and Valdez, 1986). For example, Roningen and Dixit estimate that eliminating U.S. agricultural policies would increase world dairy product prices by 23.5 percent, sugar by 22.8 percent, coarse grain by 11.6 percent, wheat by 10.6 percent, rice by 2.9 percent, ruminant meats by 3.8 percent, and nonruminant meats by 3

percent. This would lead to corresponding costs for consumers and benefits for producers in the rest of the world.

Anderson and Tyers (1990) estimate that multilateral liberalization of agricultural policy by all OECD countries would increase the world prices of dairy products by 90 percent, sugar by 22 percent, coarse grain by 3 percent, wheat by 25 percent, rice by 18 percent, ruminant meats by 43 percent, and nonruminant meats by 10 percent. While these price changes would result in costs for consumers and benefits for producers in the developing world, Anderson and Tyers estimate that the net welfare of developing countries would increase by 1 percent. Simultaneous policy liberalization by developing countries, however, would result in a net increase in developing country welfare of up to 64 percent.

One justification often expressed in support of price floors and public storage programs in the United States and in other industrialized countries is that they stabilize what would otherwise be an unacceptable domestic volatility in basic commodity prices, at least over the very short run.[10] Ironically, these same policies amplify rather than dampen commodity price fluctuations on international markets. One glaring example of this phenomenon is the world sugar market. The European Community (EC) and the United States both protect their domestic sugar producers—for example, in the United States through price supports, tariffs, and import quotas. These policies have been estimated to have increased price instability in the residual world market for sugar by approximately 25 percent (World Bank, 1986). Moreover, because the United States has been dominant in the world sugar trade, the imposition of import quotas has lowered world sugar prices.

Not surprisingly, European and U.S. sugar policies have also placed significant burdens of adjustment on many developing countries. The 1986 *World Development Report* estimated that sugar policies of industrialized countries cost developing countries about $7.4 billion in lost export revenues during 1983 and reduced their real incomes by about $2.1 billion. Given the domestic supply response to sugar and other substitutable products, even those developing countries who currently benefit can expect their quote levels, and thus values, to slowly vanish. In the case of world wheat prices, Schiff (1985) has estimated that the variability could be reduced by 48 percent if all countries were to end their subsidization of wheat. Tyers and Anderson (1986), using a model simulating policy reform in more than a half dozen commodity markets, calculated that liberalization of agricultural policies of industrialized countries would substantially reduce the international price variability of major temperate-zone commodities: wheat by 33 percent, coarse grains by 10 percent, rice by 19 percent, sugar by 15 percent, and dairy products by 56 percent.

[10]Stabilizing prices is, of course, not equivalent to stabilizing incomes. As noted by Newbery and Stiglitz (1981), stabilizing prices may actually increase income variability.

Table 3
Productive Versus Predatory Policy Interventions in U.S. Agriculture, 1982–1986 Average (*percentage unit values*)

	Producer Subsidy Equivalents		
	Total	*Productive (PERT)*	*Predatory (PEST)*
Sugar	77.4	7.9	92.1
Milk	53.9	7.8	92.2
Rice	45.0	6.4	93.6
Wheat	36.5	13.5	86.5
Sorghum	31.5	14.5	85.5
Barley	28.8	20.9	79.1
Corn	27.1	17.7	82.3
Oats	7.6	61.6	38.4
Soybeans	8.5	74.3	25.7
Beef	8.7	55.5	44.5
Poultry	8.3	65.0	35.0
Pork	5.8	82.5	17.6
Average	24.6	35.6	64.4

Source: U.S. Department of Agriculture, "Estimates of Producer and Consumer Equivalents: Government Intervention in Agriculture." Economic Research Service, ATAD Staff Report No. AGES 880127, April 1988.

Accounting for Predatory and Productive Policies

One measure of the degree of government intervention across commodity groups can be represented as a "producer subsidy equivalent" (PSE), the ratio of the total value of all public sector assistance to total farmer receipts. As shown in Table 3, the degree of government involvement is most dramatic for products where demand is inelastic, like sugar, milk, rice, and wheat. Feed grains have an intermediate level of support while sectors with more elastic demands, such as soybeans and red meats, have the lowest level of support.[11]

The decomposition of the public sector assistance into productive (PERT) and predatory (PEST) forms of government policy is also reported in Table 3. The productive category includes all expenditures by the public sector that are expected to lower transaction costs and enhance the rate of economic growth, namely public good expenditures, information and marketing services, grades

[11]For a survey of own-price elasticity estimates, see de Gorter, Nielson, and Rausser (1992). At the farm level, the most demand-inelastic commodities are sugar, milk, and rice; those commodities with intermediate degrees of demand-price inelasticity are wheat, sorghum, barley, corn, and oats; and finally, those that have the least degree of inelasticity and, in some instances, elastic demand functions, include soybeans, beef, poultry, and pork.

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and standards inspections, crop insurance, public research, extension services, and so on. For the PEST category, all redistributive transfers from other segments of the economy to agricultural producers are incorporated, including deficiency payments, price supports, trade barriers, storage subsidies, input subsidies, subsidized credit, and so on.

Note that the products with inelastic demands (sugar, milk, and rice) receive a lower proportion of their public support in the form of productive policies, while the products with elastic demand (soybeans and meats) receive a higher proportion of their support in the form of productive policies. The data is consistent with the view that coupled predatory policies are higher in sectors where demand is inelastic and where supply is very responsive to policies and lower in sectors with highly elastic demand and low supply elasticities. As noted earlier, redistribution efficiency would argue for low supply elasticities but here the joint determination of PESTs and PERTs places more weight on policy-induced supply expansion. For some products that do not appear in Table 3—for example, specialty perennial crops like oranges, lemons and grapes—whose demand is highly elastic, but whose productivity and supply response is low, coupled predatory policies do not generally exist. Instead, for these specialty crops, producer organizations tax their members to finance the provision of local public goods (de Gorter, Nielson, and Rausser, 1992).

For the case of public good investments and predatory coupled transfers, it has been shown that, if a productivity-enhancing policy harms producers because of highly inelastic demand and responsive supply, but producers have more political clout than other interest groups, the amount of public-good investment will be inadequate (de Gorter, Nielson, and Rausser, 1992). However, the political obstruction to public good investments can be countered with subsidies that are tied to production, thus leading to less underinvestment in public goods than would otherwise be the case. In effect, since productive policies may harm members of special interest groups, compensation through predatory subsidies may offer a means of making the pursuit of the public interest politically viable (Rausser and Foster, 1990). Transfers that seem only predatory at first glance may, in certain cases, actually be politically necessary if society is to approach the optimal configuration of productive policies.[12]

Even if demand is elastic and the "representative" producer benefits from the dissemination of an advance, producers are likely to be heterogeneous in their adoption of new technology. Those producers who make the greatest use

[12]Political influence also operates through the public sector by frequently slowing down the redistribution of income generated by changing market conditions. Accordingly, markets with highly inelastic demand and supply conditions as well as changing technologies are those markets which generate rapidly fluctuating incomes and thus a demand for public sector "stabilization." In a world of limited knowledge of how economic systems operate, producer-interest groups have successfully argued that "price stabilization" programs are in the public interest. In this instance, interests who share the burden of financing such programs are led to believe that such policies are PERTs.

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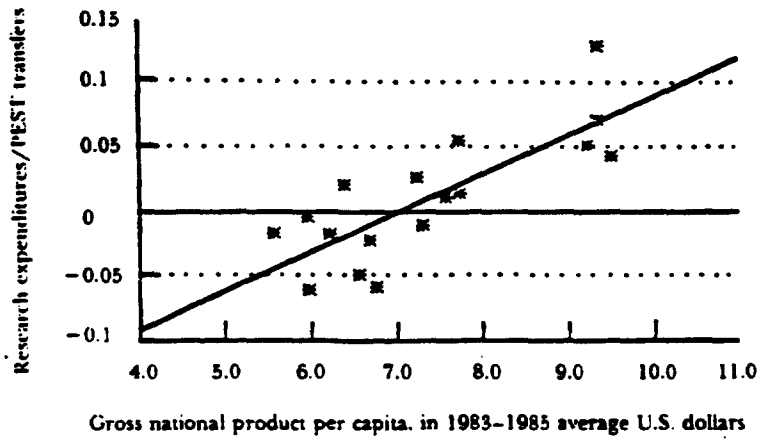
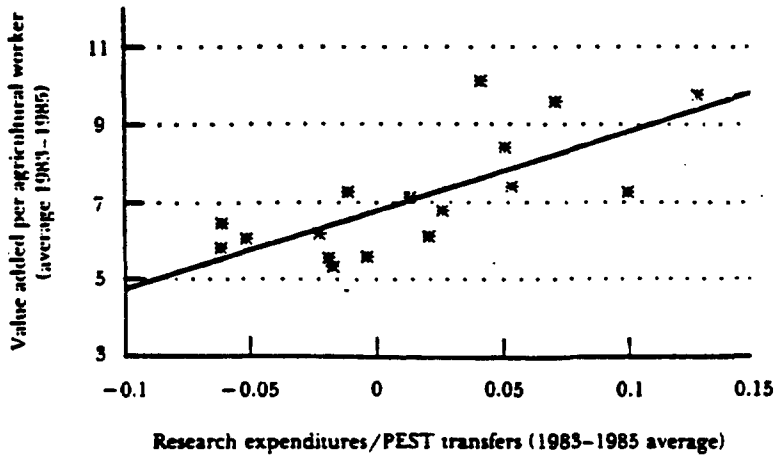
Figure 1
Research Expenditures / PEST Transfers Versus Per Capita Gross National Product



of the new technology will gain from its dissemination and the associated equilibrium price decrease, while others who make little or no use of the technology are likely to lose. Indeed, nonadopters always lose when the demand curve is anything less than perfectly elastic. In this setting, the key is not the elasticity of demand, but the heterogeneity of producers in their ability to take advantage of technical advances. If a sufficient number of these heterogeneous producers are harmed by the equilibrium effects of technological changes, then potential political impediments to future technical advances may arise. If so, some promise of wealth transfers from the winning consumers and taxpayers to the losing producers will be necessary to have any advance at all. As shown in Foster and Rausser (1992), wealth transfers tied to output may be a more effective means than per-firm lump-sum payments in inducing defection from the coalition of those producers least harmed by the technical change. Price-distorting payments target producers who, although harmed by the technology dissemination policy alone, expand their production the most.

A recent study supporting this perspective has examined PEST transfers and PERT investments in agricultural research for 23 countries. The evidence is revealed in Figure 1, which shows that the ratio of PERT to PEST transfers unambiguously increases with country income levels. In Figure 2, productivity measured by value added per agricultural worker is related to the mix of PEST and PERT expenditures. This suggests that one reason for the record of strong productivity growth in developed country agriculture is that, despite a strong tendency toward increased protection, there is a complementary tendency toward support for agricultural research. As Lee and Rausser (1991) note, complementary provision of PEST and PERT policies provides a consistent

Figure 2
Value Added Per Agricultural Worker Versus Research Expenditure / PEST Transfers



explanation for the distinctly different patterns found in developed versus developing countries. Developed countries typically protect their agricultural sectors while investing more in agricultural research and generating higher levels of agricultural productivity, while developing countries typically tax their agricultural sectors, invest little in agricultural research, and experience generally low levels of agricultural productivity.

The Search for Politically Robust Reform

Far too frequently, the economics profession has examined PEST policies as though they were separate from other policies, explaining their existence by the relative influence of interest groups or the opacity of the policy impacts. For the U.S. agricultural sector, however, one of the major messages is that policies can be packaged so vested interests may acquiesce to one policy in exchange for another. This observation applies not only to U.S. agricultural policy, but to all types of public-sector activities; for example, privatization with safeguards for some social groups in formerly command economies, urban planning and the granting of zoning variances in exchange for the supply of local public goods, and special worker adjustment compensation for industries facing increased international competition.

The challenge for economists in agricultural policy, as in other areas, is to identify policy reforms that make economic sense and are politically robust. In the past, the best the economic literature has been able to offer in the design of

democratic decision-making frameworks is to *separate* the processes for productive and predatory policies. Long ago, Wicksell (1896 [1967]) recognized the distinction between these types of policies and argued for organizing government so that the provision of the two types of policies would be decided by separate and qualitatively different processes. Mueller (1989), in his recent survey of the literature, outlines the conceptual and practical advantages of considering the two types of policies separately.

However, whatever the issues of analytical convenience, it is now being recognized that political and economic forces must be jointly considered in matters of both design and implementation of public policies (Rausser, 1982). Much recent investigation has been devoted to theoretical and empirical models of public sector decision-making in an attempt to accomplish this task. Readers interested in these issues from a general perspective might begin with Becker (1983, 1985); Peltzman (1976); and Zusman (1976). Those interested in applications to agricultural policy in particular might begin with Gardner (1987); Rausser and de Gorter (1989); Foster and Rausser (1992); and de Gorter, Nielson, and Rausser (1992). The purpose of the latter models is to explore ways in which PERT and PEST policies are jointly determined.

Economists have only begun to scratch the surface in the development of operational frameworks for blending productive and rent-seeking policies. In general, work in this area must recognize that these two types of policies go hand in hand; frequently, predatory policies are offered as compensation to those that are harmed as a result of the implementation of productive policies. Just as frequently, productive, or what may only appear to be PERT policies are structured to mask the redistributive mechanisms put in place by predatory or PEST policies, for example conservation and commodity subsidies, food security and self-sufficiency, instability and subsidized public storage, and so on. Furthermore, PERT policies with concentrated benefits but widely shared cost profiles naturally evolve into PEST policies, especially where the power of the few is alive and well and/or vested interests are relatively homogeneous. This means, of course, that the political-economic costs of removing policy distortions can be dramatically different from the cost of their original implementation. These asymmetric costs can result in policy irreversibilities, a consequence that is generally swept aside when the original policy intervention is evaluated. Finally, the special advantages offered to those groups seeking PEST transfers that face highly inelastic demand and supply relations must be tempered by the impact of PERTs on production possibility frontiers.

Operational prescription must recognize not only the economics of various policies, but also how the distribution of political power will affect the sequence of policy steps. The distribution of political power will often be critical in reforming policies to be more productive and less predatory (Rausser and Zusman, 1992). There will be situations where the political timing may be especially ripe, perhaps because of an economic crisis caused by outside factors, to change the institutional structure of agricultural programs. This was

certainly true in the mid-1980s when macroeconomic and international phenomena helped spawn a crisis in the U.S. agricultural sector. In the midst of this crisis, political entrepreneurship emerged which led to some governmental autonomy in the design of the 1985 Food Security Act as well as the subsequent 1990 Farm Act. The lowering of economic barriers and the enhanced planning flexibility introduced by these two pieces of legislation cannot be explained by the pure rent-seeking or predatory models of governmental intervention found in the literature.

Opportunities for restructuring the trade-off between the public and special interests have often appeared greatest during times of economic crises. However, the sustainability of the restructured tradeoffs and the new mix of productive and predatory policies has been shown time and time again to depend critically upon changes in the underlying institutional configuration. In the case of U.S. agricultural policy, an example of institutional changes that could alter the level and distribution of political power might arise from the current GATT negotiations. In the Uruguay round of the GATT negotiations, it was accepted early by all parties that distortionary trade policies in agriculture exist to rationalize internal country policies; thus, both sets of policies should be included in the negotiations. Accordingly, a number of proposals have been tabled in Geneva for reducing internal country coupled PEST policies and substituting PERT policies (Rausser, 1992). In the case of the U.S. government, this substitution process has been proposed to occur over a 10-year adjustment period. This means, of course, that the interest-group configuration after the completion of the GATT negotiations could be dramatically different than the political landscape that has existed over much of the prior 60 or so years. Agriculture will no longer be compartmentalized. Agricultural sector issues will be linked with other trade issues, thus widening the vested interests that will determine whether a GATT agricultural code is accepted or rejected. If the GATT agreement is accepted by the U.S. Congress, the executive branch will, no doubt, lean on the external code as a basis for credible commitments to achieving more PERTs in exchange for fewer PESTS.

In the grand scheme, the major policy issue is whether society can achieve more productive policies in exchange for fewer predatory ones. In the case of U.S. agriculture, even though the PERT/PEST balance over the last two centuries may be positive, as the years have unfolded it has become increasingly less so. Short of an external GATT agricultural code, the actual process of reversing this trend will depend upon those interests that have access to the policy-making process, the issues over which those interests can negotiate, the degree of consensus that is sufficient to complete negotiations, and the course if negotiations break down. For example, simply changing congressional seniority rules would significantly alter access power. Many of the commodities which enjoy the greatest amount of PEST transfers can be characterized as Southern crops. Changing the relative cost of organizing those who benefit from reforms

will increase their responsiveness to changes in their welfare. Creative packaging may also change the political technology by demonstrating the feasibility of alternative, more efficient programs of wealth transfer. Steps like these often require political entrepreneurship; leaders who become essential players by being part of any consensus or admissible coalition supporting reform. In the final analysis, designing mixes of agricultural policy to generate greater efficiency and improved equity will not be sustainable without altering the policy-making process.

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U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

September 1995

TO: Economic Growth Training Workshop Participants[1]

FROM: G/EG/EIR, Forest Duncan F.D.

SUBJECT: **Directory of LRJ Strategic Objectives**

The Research and Reference Services (R&RS) project of CDIE/DI prepared the attached directory of "Strategic Information and Indicators" relating to legal, regulatory, and judicial (LRJ) reform. You should find the directory to be helpful in identifying objectives and indicators for LRJ initiatives you may be planning.

R&RS queried the Program Performance Information for Strategic Management database to identify all strategic objectives and indicators with the key words "legal," "regulatory" or "judicial." Information sources included recent Mission Action Plans, Annual Performance Indicators, and Country Program Strategy Plans. The list was not narrowed further to identify only those objectives relating to private sector and agribusiness activities, as it was felt that the more comprehensive listing may be useful in suggesting alternative ways of defining LRJ objectives and indicators.

Comments or questions relating to the directory are welcome, and may be addressed to Ms. Laura Williams, PPC/CDIE/DI/RRS, Room 203, SA-18.

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Strategic Information and Indicators Related to Legal, Regulatory, and Judicial Reform
PRISM Database

Argentina Source: Action Plan FY95-96 2/95

PROGRAM OUTCOME NO. 2.1
Selected improvements in legal, regulatory and judicial environment for business in Argentina
Regulatory norms and procedures adopted
Unit:Norms Expressed As:Number

Bangladesh Source: CPSP 1995-1997 2/95

OTHER ACTIVITY NO. 3.1
Women's awareness of legal rights and access to legal services increased
Disputes in project areas successfully mediated through village councils
Unit:Disputes mediated Expressed As:Percent
Registered marriages in project areas (Annual Proxy)
Unit:Marriages Expressed As:Number

Burundi

PROGRAM OUTCOME NO. 2.3
Improved legal environment and support judicial reforms

Case turnover rate
Unit: Expressed As:
Courts in Bujumbura and outside
Unit:Courts Expressed As:Number
Evidence of the improvement of the legal environment
Unit: Expressed As:
Public law firms
Unit:Public Law Firms Expressed As:Number
Reform of legal codes relating to commerce
Unit: Expressed As:
Reform of legal codes relating to land tenure
Unit: Expressed As:
Reform of legal codes relating to women's rights
Unit: Expressed As:

Cambodia Source: Action Plan 1995-97 5/95

PROGRAM OUTCOME NO. 1.3
Increased access to legal, regulatory, and judicial organizations providing services that are perceived as more transparent, predictable, effective and fair

Backlog of prisoners detained without hearings
Unit:Prisoners Expressed As:Number
Civil cases brought by private citizens to formal justice system for resolution
Unit:Cases Expressed As:Number
Criminal trials and convictions of members of the police, the military and the wealthy
Unit:Trials/ConvictiExpressed As:Number
ons
Functioning, broadly-inclusive Bar Association established
Unit:Bar AssociationExpressed As:Yes/No
Legal documentation in comformity with existing laws being performed within ministries
Unit:Legal Expressed As:Yes/No
Documentation
Level of organization of case files
Unit: Expressed As:
Poor litigants and the accused receiving free legal assistance
Unit:Poor Expressed As:Number
Litigants/People Accused
Trained clerical staff in the provincial courts
Unit:Staff Members Expressed As:Number
Use of evidence other than witnesses in trials
Unit: Expressed As:
Waiting time required for both civil and criminal trials to be held
Unit: Expressed As:

Caribbean Regional Source: Action Plan FY95-96

PROGRAM OUTCOME NO. 1.2
Improved regulatory framework developed and implemented

Countries with customs regime streamlined and modernized per year
Unit:Countries Expressed As:Number
Court registries operations streamlined and modernized.
Unit:Countries per Expressed As:Number
year

Enabling business legislation developed
Unit:Legislation Expressed As:Number
Enabling business legislation enacted
Unit:Legislation Expressed As:Number

Dominican Republic Source: Action Plan FY96-97 4/95

PROGRAM OUTCOME NO. 4.1
Environmental component of the Sector Regulatory Framework in place

Firms complying with the standards and norms
Unit:Firms Expressed As:Percent of all firms
Standards and norms for energy regulation established
Unit:Standards/NormsExpressed As:Number
Standards and norms for energy regulation established - Internationally-accepted norms and standards identified
Unit:Standards/NormsExpressed As:Yes/No
Standards and norms for energy regulation established - Norms and standards in place
Unit:Standards/NormsExpressed As:Yes/No

Chile Source: Action Plan FY1996 7/94

PROGRAM OUTCOME 1.1
Judicial function and access to justice improved

Dispute resolution/legal aid centers functioning
Unit:Centers Expressed As:Number
Judges trained - male
Unit:judges Expressed As:number
Judges trained - female
Unit:judges Expressed As:number
Judicial employees trained:Employees/male
Unit:Male employees Expressed As:Number
Judicial employees trained-Employees/female
Unit:Female employees Expressed As:Number
Legal assistance backup center functioning
Unit:Center Expressed As:Yes/No
National automated case tracking system operational status
Unit:Courts incorporated Expressed As:Percent
Regional court administrators
Unit:Individuals Expressed As:Number

named

Colombia Source: Action Plan FY96-97 3/94

PROGRAM OUTPUT NO. 1.4
Improved access, fairness, and public perception of the judicial system

Cases addressed out of the total cases assigned to Public Defenders
Unit:cases Expressed As:percent
Cases assigned to Public Defenders
Unit:cases Expressed As:number
Conflicts resolved annually by the mediation mechanisms operating in conciliation centers, and municipal civil and criminal courts (For Bogata, Cali, Medillin, Barranquilla, and Bucaramanga)
Unit:Conflicts Expressed As:Number
Disiplinary actions by the Attorney General's Office (AGO) against justice sector personnel involved in human rights violations, which result in criminal cases
Unit:actions Expressed As:percent

Colombia Source: Action Plan FY96-97 3/94

Disiplinary actions by the Attorney General's Office (AGO) against justice sector personnel involved in bribery and illicit enrichment out of total disciplinary actions by the AGO against justice sector personnel
Unit:actions Expressed As:percent
Favorable sentences for the defendants assisted by public defenders in major crimes' indictments of total sentences for defendants assisted by public defenders
Unit:sentences Expressed As:percent
Popular perception of effectiveness of and accessibility to the criminal justice system
Unit:sentences Expressed As:percent

Costa Rica Source: Action Plan FY95-96 3/94

PROGRAM OUTCOME NO. 2.8
Establishment of a transparent set of rules, laws, and regulations that structure incentives to stimulate production and trade and provide the legal framework for growth

Costa Rica Source: Action Plan FY95-96 3/94

PROGRAM OUTCOME NO. 2.3
Strengthened legislative and judicial process

Adoption of delay reduction mechanisms in court system
Unit: Expressed As:
Alternative Dispute resolution(ADR) mechanisms introduced for civil/commercial court cases
Unit:Mechanisms Expressed As:Number
Fully-integrated Legislative information system installed and functioning
Unit:system Expressed As:
Internal capabilities developed in the legislature
Unit:Training activities Expressed As:Number

El Salvador Source: Action Plan 1996-97 1/95

PROGRAM OUTCOME NO. 3.2
Legal, market and price environment conducive to sustainable private forestry

Adoption of sustainable forest management practices
Unit:Plans Expressed As:Number
Stumpage value of standing timber
Unit:Index Expressed As:Index (1992=100)

El Salvador Source: Action Plan 1996-97 1/95

PROGRAM OUTCOME NO. 3.2
Improved legal and institutional framework for effective protection of human and citizen rights

Case backlog in criminal courts
Unit:Cases Expressed As:Percent of total
Case backlog in family courts
Unit:Cases Expressed As:Percent
Indigent detainees receiving legal counsel from the public defender's office

Unit:Indigent detainees Expressed As:Number
New cases resolved in criminal courts in under 1 year
Unit:New cases Expressed As:Percent of total
New cases resolved in family courts in under 1 year
Unit:New cases Expressed As:Percent of total

Gambia Source: API 1993 10/93

PROGRAM OUTCOME NO. 1.3
A more favorable legal and regulatory environment conducive to increased private sector investment

Company tax as % of total tax revenue
Unit:company Expressed As:percent
Firms of five or more employees paying into Social Security
Unit:Firms Expressed As:Number
Witnesses heard in court
Unit:witnesses Expressed As:number

PROGRAM OUTCOME NO. 2.2
A more favorable legal and regulatory environment conducive to the adoption of NRM practices

Approved community resource management agreements (CRMAs) in project areas
Unit:agreements Expressed As:number
Approved community resources management agreements in nonproject areas: Agricultural
Unit:agreements Expressed As:number
Crop land
Unit:Hectares Expressed As:Numbers
Forest land
Unit:Hectares Expressed As:numbers
Forest management
Unit:CRMAS Expressed As:Number

Gambia Source: API 1993 10/93

Forest/range agreements
Unit:agreements Expressed As:number
Forestry/range agreements
Unit:agreements Expressed As:number
Hectares managed per community resource management agreements(CRMAs)

in project targeted areas in the subsectors: crop land
Unit:CRMAS Expressed As:Number
Hectares under NRM practices outside ANR targeted areas
Unit:Hectares Expressed As:number
Range lands
Unit:Hectares Expressed As:number
Range management
Unit:CRMAS Expressed As:number

Gambia Source: API 1993 10/93

Selected legal and administrative reforms enacted and implemented
Unit:Reforms EnactedExpressed As:Number

PROGRAM OUTCOME NO. 5.1
Natural resource use policy/legal framework created and implemented

Level of resources provided for natural resource management (GOES, donors FONAES)
Unit:Current US Dollars Expressed As:Millions
Selected Policies/Laws established: Forestry Law/Gen Envt Law/Law for SEMA/Env Ed Policy
Unit:Law or Policy passed Expressed As:

Guinea-Bissau Source: API 1994 3/95

PROGRAM OUTCOME NO. 1.1
Technical/analytical base for planning T & I policy, legal and regulatory reform and for providing direct T & I support to the private sector improved in the critical growth sub-sectors

Status of research/analysis/knowledge regarding economic potential and policy, legal, regulatory, judicial and other constraints to the realization of private sector activity in the CGS - Rice
Unit:Scale Expressed As:1 (worst) to 7 (best)
Status of research/analysis/knowledge regarding economic potential and policy, legal, regulatory, judicial, and other constraints to realization of private sector activity in the CGS - Cashews
Unit:Scale Expressed As:1 (worst) to 7 (best)
Status of research/analysis/knowledge regarding economic potential and policy, legal, regulatory, judicial, and other constraints to realization of private sector activity in the CGS - Fruits

Unit:Scale Expressed As:1 (worst) to 7 (best)
Status of research/analysis/knowledge regarding economic potential and policy, legal, regulatory, judicial, and other constraints to realization of private sector activity in the CGS - Vegetables
Unit:Scale Expressed As:1 (worst) to 7 (best)
Status of research/analysis/knowledge regarding economic potential and policy, legal, regulatory, judicial, and other constraints to realization of private sector activity in the CGS - Forest products
Unit:Scale Expressed As:1 (worst) to 7 (best)
Status of research/analysis/knowledge regarding economic potential and policy, legal, regulatory, judicial, and other constraints to realization of private sector activity in the CGS - Fisheries
Unit:Scale Expressed As:1 (worst) to 7 (best)
Status of research/analysis/knowledge regarding economic potential and policy, legal, regulatory, judicial and other constraints to the realization of private sector activity in the CGS - General commerce and general services to the private sector
Unit:Scale Expressed As:1 (worst) to 7 (best)

PROGRAM OUTCOME NO. 1.2
Policy, legal and regulatory environments for increased private T & I in the critical growth sub-sectors improved

Improvement in the legal and regulatory environment for increased private T & I in the critical growth sub-sectors
Unit: Expressed As:Yes/No
Improvement in the policy environment for increased private T & I in the critical growth sub-sectors
Unit: Expressed As:Yes/No

PROGRAM OUTCOME NO. 1.3
Adjudication of T&I legal and regulatory conflict improved

Improvement in adjudication of T & I legal and regulatory conflict
Unit: Expressed As:Yes/No

PROGRAM OUTCOME No. 1.4
Ability of entrepreneurs to respond to improved policy, legal, and regulatory environment improved

Haiti Source: Action Plan 1996-97 5/95

PROGRAM OUTCOME NO. 1.1

More effective, self-sustaining judicial system and improved legal advocacy

Clients represented through Civil Society advocacy
Unit:Clients Expressed As:Number
Control structure for police is defined and working
Unit:Event Expressed As:Yes/No
Permanent police force deployed nationwide
Unit:Police Expressed As:Cumulative Number
Trials successfully completed
Unit:Trials Expressed As:Number

Haiti Source: Action Plan 1996-97 5/95
Improvement in the ability of entrepreneurs to respond to improved policy, legal and regulatory environment
Unit: Expressed As:yes/no

Honduras Source: Action Plan 1996-97 3/95

PROGRAM OUTCOME NO. 4.1
More ethical and effective prosecutorial and judicial systems

Cases prosecuted by the Public Ministry on corruption
Unit:Cases Expressed As:Number
Cases prosecuted by the Public Ministry on crimes against women and ethnic minorities
Unit:Cases Expressed As:Number
Cases prosecuted by the Public Ministry on environmental liability
Unit:Cases Expressed As:Number

Honduras Source: Action Plan 1996-97 3/95

Cases prosecuted by the Public Ministry on others
Unit:Cases Expressed As:Number
Court officers investigated [and sanctioned] by the Court's Inspector General of Tribunal's Office and sanctioned by the Court - Complaints received by the Court
Unit:Court Officers Expressed As:Number
Court officers investigated [and sanctioned] by the Court's Inspector

General of Tribunal's Office and sanctioned by the Court - Complaints investigated by the Court Inspector General
Unit:Court Officers Expressed As:Number
Court officers investigated [and sanctioned] by the Court's Inspector General of Tribunal's Office and sanctioned by the Court - Complaints sanctioned
Unit:Court Officers Expressed As:Number
Court officers prosecuted by the Public Ministry - Cases sucessfully prosecuted - Referred by the IG
Unit:Cases Expressed As:Number
Court officers prosecuted by the Public Ministry - Cases sucessfully prosecuted - Referred by others
Unit:Cases Expressed As:Number
Public Ministry cases on corruption adjudicated by the court
Unit:Cases Expressed As:Number
Public Ministry cases on crimes against women and ethnic minorities adjudicated by the court
Unit:Cases Expressed As:Number
Public Ministry cases on environmental liability adjudicated by the court
Unit:Cases Expressed As:Number
Public Ministry cases on others adjudicated by the court
Unit:Cases Expressed As:Number

India Source: Action Plan 1995-97 2/95

PROGRAM OUTCOME NO. 1.2
Improved policy and regulatory environment conducive to market efficiency in selected areas

Average tariff rates
Unit: Expressed As:Percent
Investment in agribusiness by private firms
Unit: Expressed As:
Jobs created in factories per year
Unit:Jobs Expressed As:Millions
Maximum tariff rates
Unit: Expressed As:Percent
Municipal and local governments with authority to issue bonds
Unit: Expressed As:Number
National clearance settlement and depository systems established for securities industry
Unit: Expressed As:
Private sector capacity addition as a percentage of total capacity

addition in power (utilities)
Unit: Expressed As:Percent

Madagascar Source: API 1994 2/95

PROGRAM OUTCOME NO. 1.1
More effective, self-sustaining judicial system and improved legal advocacy

Clients represented through Civil Society advocacy
Unit:Clients Expressed As:Number
Control structure for police is defined and working
Unit:Event Expressed As:Yes/No
Permanent police force deployed nationwide
Unit:Police Expressed As:Cumulative Number
Trials successfully completed
Unit:Trials Expressed As:Number

Madagascar Source: API 1994 2/95

PROGRAM OUTCOME NO. 1.1
Fair and swift treatment of entrepreneurs by the legal and judicial system

Commercial adjudications - Civil court backlog
Unit: Expressed As:
Commercial adjudications - Adjudications via non-governmental proceedings
Unit: Expressed As:
Economic laws enacted after an advocacy process of private sector groups
Unit:Laws Expressed As:Number
Investment Code applications approved by the GRM
Unit: Expressed As:

Mali Source: API 1994 3/95

PROGRAM OUTCOME 1.1
Improve regulatory policies and practices

Allowing the private sector to provide agricultural transport services - Haute Vallee cotton privately transported
Unit:Haute Vallee cotton Expressed As:percent

Commercial & Administrative courts in Bamako, Kayes and Mopti become fully operational successfully handling business and industrial litigations
Unit:cases Expressed As:number
Price controls on internal transport
Unit:controls Expressed As:

Mexico Source: Action Plan FY96-97 5/95

STRATEGIC OBJECTIVE NO. 1
Improved performance of target institutions in selected legal/regulatory areas to the NAFTA

Patent applications still pending after 8-11 years
Unit: Expressed As:Percent
SEDESOL inspections that follow newly developed norms for industrial pollution control
Unit: Expressed As:Percent
Shrimp boats in compliance with required use of turtle excluder devices in the Gulf of Mexico and the Carribean
Unit: Expressed As:Percent

Morocco Source: CPSP 1995-2000 3/95

PROGRAM OUTCOME NO. 2.1
Improved policy, regulatory, and institutional framework

Local capacity to assess and respond to urban/municipal environmental issues
Unit:USAIDTarget Expressed As:Number
Cities
National capacity to assess environmental issues
Unit: Expressed As:Number
National capacity to respond to environmental issues
Unit: Expressed As:Qualitative
Policies and regulations adopted for - Water quality norms and standards
Unit: Expressed As:Qualitative
Policies and regulations adopted for - Water pricing
Unit: Expressed As:Qualitative
Policies and regulations adopted for - Fuelwood use for industrial and commercial enterprises
Unit: Expressed As:Qualitative
Policies and regulations adopted for - Urban environmental assessments

Unit: Expressed As:Qualitative
Policies and regulations adopted for - Industrial and domestic effluent norms and standards
Unit: Expressed As:Qualitative

Nepal Source: Action Plan 1995-97 5/95

PROGRAM OUTCOME NO. 3.2
Improved legal enviroment for women

Law which prohibits women inheriting property
Unit: Expressed As:Qualitative

Nepal Source: Action Plan 1995-97 5/95

Women seeking legal redress from legal aid offices
Unit:Women Expressed As:Number
Women-advocacy NGOs
Unit:NGO's Expressed As:Number

Paraguay Source: Action Plan FY96-97 4/95

PROGRAM OUTCOME NO. 1.2
Strengthened judicial systems to support timely and impartial prosecution of cases

Established case tracking system throughout Asuncion courts
Unit:Courts Expressed As:type

Paraguay Source: Action Plan FY96-97 4/95

Pre-trial release for those entitled to prison exemption while they await trial within Asuncion court system
Unit:Persons Expressed As:Number
System established for merit-based selection and promotion of professionals
Unit:judges Expressed As:number

Peru Source: Action Plan FY96-97 5/95

PROGRAM OUTCOME NO. 1.1
Strengthened, more independent judicial and legislative systems that sustain the rule of law and protection of human rights

"Disappearances" and extrajudicial killings by forces of order
Unit:Disappearances Expressed As:Number
Bills passed by legislature and approved by executive without executive changes or vetoes
Unit:Bills Expressed As:Percent
Demonstrable autonomy of judiciary and legislature from executive interference
Unit:Qualitative Expressed As:
Formal judicial accusation and ruling in civilian courts
Unit:Time Expressed As:Average # of Months
Legislation enacted to implement constitutionally-mandated decentralization of government
Unit:Qualitative Expressed As:Yes/No
Narco-traffickers tried and convicted
Unit:Traffickers Expressed As:Number
New national policy statements and/or laws promulgated on drug production and trafficking
Unit:Policy Expressed As:Number

Peru Source: Action Plan FY96-97 5/95

PROGRAM OUTCOME NO. 5.1
Improved regulatory framework for the environment and natural resource base

CONAM operational
Unit:Qualitative Expressed As:
Civil society participation in ENRM policy process
Unit:groups Expressed As:number
Existance of national environmental plan
Unit:Qualitative Expressed As:
Timley implementation of policy agenda
Unit:Policy matrix Expressed As:

South Africa Source: API FY1994 2/95

PROGRAM OUTCOME NO. 1.2
Increased majority access to the legal system and awareness of rights and responsibilities

Functioning legal advice centers
Unit:Advice Centers Expressed As:Number
Legal and human rights cases filed
Unit:Cases Expressed As:Number

South Africa Source: API FY1994 2/95

PROGRAM OUTCOME NO. 3.2
Improved policy and regulatory environment for full participation in the economy

Housing policies changed and implemented
Unit:Policies Expressed As:Number
Private sector policies changed and implemented
Unit:Policies Expressed As:Number

Sri Lanka Source: CPSP 1996-2000 3/95

PROGRAM OUTCOME NO. 3.3
Increased effectiveness of judicial systems

Backlog cases in Courts of Appeal
Unit:Cases Expressed As:Number
Mediation Board cases resolved
Unit:Resolved cases Expressed As:Percent
People using Mediation boards
Unit:People Expressed As:Number

Uruguay Source: Action Plan FY96-97 2/95

PROGRAM OUTCOME NO. 1.2
Private business executives, Congress and the public better informed about legal, regulatory and judicial (LRJ) issues

Change in attitude and knowledge regarding LRJ reforms in sample of firms participating in USAID activities
Unit: Expressed As:percentage
Individuals participating in AID activities regarding LRJ issues
Unit:Individuals Expressed As:Number
LRJ impediment topics raised for discussion by grantee business groups involved in AID activities
Unit:Topics Expressed As:Number

Uruguay Source: Action Plan FY96-97 2/95

STRATEGIC OBJECTIVE NO. 2
Improved efficiency and quality in judicial decision making

Median number of months required to obtain first-level decision in

civil cases
Unit:Months Expressed As:Number(average)
PROGRAM OUTCOME NO. 2.1
Court administration and other judicial reforms implemented

Judicial planning and budgetary capability instituted
Unit:Reports Expressed As:yes/no
Reforms (administraitve and judicial) implemented
Unit:reforms Expressed As:number
Supreme Court sessions devoted to administrative matters
Unit:Sessions Expressed As:Percent

Zambia Source: API FY1994 3/95

PROGRAM OUTCOME NO. 2.2
Improved regulatory and credit environment

Share of crop marketing conducted by private sector
Unit: Expressed As:percent

Zimbabwe Source: API FY1994 3/95

PROGRAM OUTCOME NO. 2.2
Improved policy and regulatory environment

Average real cost of a minimum unit (newly constructed)
Unit:Zimbabwean dollars Expressed As:Number
Construction/building materials on the free import list
Unit:Materials Expressed As:Number
Policies in place to facilitatedecontroled private grain marketing and trading
Unit:Policies Expressed As:yes/no
Policies in place to facilitate black private sector ownership/provision of railway services
Unit:policies Expressed As:yes/no

HOW TO OBTAIN USAID DOCUMENTS

Development Information Services Clearinghouse
1500 Wilson Blvd., Suite 1010
Arlington, VA 22209-2404

Telephone: (703) 351-4006
Fax: (703) 351-4039
E-Mail: DOCORDER (USAID E-mail address)
docorder@disc.mhs.compuserve (Internet address)

HOW

Items are ordered by the document identification number (DOCID) found in the top left hand
corner of the citation.

Example: PN-AAY-486 or PD-ABC-123

PN - USAID supported studies; XN designates an annex to a PN document of the same number.

PD - USAID project documentation; XD designates an annex to a PD document of the same number.

COST

Documents are free of charge to USAID employees.

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U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

September 1995

TO: Economic Growth Training Workshop Participants[1]

FROM: G/EG/EIR, Forest Duncan

SUBJECT: **Directory of USAID Projects Engaged in LRJ Activities**

The Research and Reference Services (R&RS) project of CDIE/DI prepared the attached directories of USAID projects engaged in legal, regulatory, and judicial (LRJ) activities relating to private sector and agribusiness development. Mission participants interested in exploring the feasibility of LRJ activities with their host countries should find the directories to be useful in identifying and learning from other Missions pursuing similar initiatives.

The directories identify projects by geographic region and provide an abstract of the project purpose and outputs. Related project documentation such as the project paper, evaluations, and project technical reports follow the abstract. The CDIE document identification number is noted, and directions for requesting the documents are included at the end of each directory.

The projects were selected on the basis of the Activity Code Special Interest (ACSI) system that the Agency uses in its budget planning process. After identifying projects with a "Legal, Regulatory, and Judicial Development" code, the list was narrowed to only those projects linked with private sector and agribusiness development. The directories contain data results only for the LRJ activity components found in the original abstracts provided by the Projects database of CDIE's Development Information System.

As some projects may have been missed in this initial document search, R&RS welcomes recommendations for projects that should be added to this working directory. Please e-mail your recommendations to Ms. Laura Williams, PPC/CDIE/DI/RRS, Room 203, SA-18.

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[1]Prepared for the Economic Growth Training Workshop sponsored by USAID's Bureau for Global Programs, Field Support and Research held September 17-21, 1995 at Leesburg, Virginia.

Private Sector Projects with LRJ Components

Africa

Mozambique: Private Sector Support Program Technical Assistance 6560218

Mozambique: Private Sector Development Support 6560208

Zaire: Private Sector Support 6600120

Asia/Near East

Morocco: Private Sector Support and Export Promotion 6080189

Europe/NIS

New Independent States: Private Sector Initiatives 1100005

Global

Private Enterprise 9400026

Private Enterprise: Private Enterprise Development Strategy and Support 9402028

Latin America

Latin America Regional: Instituto Libertad y Democracia 5980772

Regional Office Central America & Panama (ROCAP): Federation of Private Sector Entities in Central America and Panama 5960149

Peru: Private Sector Policy Planning and Institutional Development 5270298

Caribbean Regional: Investment Promotion and Export Development 5380119

Latin America Regional: Private Sector Initiatives 5980619

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6560218 Mozambique
Private Sector Support Program Technical Assistance
FY 90 - 95 Status: A

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Project to provide TA needed to implement the A.I.D. Private Sector Support Program (PSSP, 6560208), a commodity import program (CIP) which is aimed at strengthening private sector agriculture in Mozambique via price liberalization and improved agricultural marketing.

Amendment of 3/18/91 authorizes longer-term, more collaborative TA, which is needed to increase Mozambique's policy analysis and implementation capacities. Institutional linkages will be developed between three units in the Government and three U.S. universities.

- Michigan State University will help the Ministry of Agriculture (MOA) to conduct research on national and household-level food security. Activities will include establishment of an agricultural market information system in selected areas, surveys on rural household food security, and information bulletins, issues papers, and policy seminars.
- The University of Wisconsin Land Tenure Center will help the Survey Unit of the MOA Center for Agricultural Training to examine land tenure security issues, particularly those related to state farm divestitures. Activities will include case studies of actual divestitures, a data base to track divestitures, exposure of Mozambican staff to lessons learned from similar experiences in neighboring countries, and policy seminars, issue papers, etc.
- Cornell University will help the Food Security Department of the Ministry of Commerce to implement a household income and expenditure survey in Maputo and possibly Beira, to improve eligibility criteria in safety net programs, and will also assist in the design of better safety net measures. (PD-BCA-340)

PD-ABE-009 17-Special Evaluation Mar 1992
Mozambique : private sector support program (656-0208 / 0218) -- evaluation

PN-ABR-402 62-AID Supported Study Apr 1993
Land tenure issues in post - war Mozambique : constraints and conflicts

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6560208 Mozambique
Private Sector Development Support
FY 89 - 92 Status: I

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Commodity import program (CIP) to support private agriculture in Mozambique through liberalization of agricultural prices and marketing.

Specifically, the CIP will support the following Government of Mozambique (GOM) reforms:

- Increased liberalization of the producer pricing system for agricultural commodities,
- Divestiture of state farms to commercial and family farmers
- The development of private sales and service networks for agricultural inputs
- The institutionalization of open general licensing as a mechanism to increase private sector access to foreign exchange and to allow the market to play a greater role in determining the uses of scarce foreign exchange.

USAID/M and the GOM will also develop a plan to privatize state enterprises and mixed companies in the agricultural input, implement, tractor, and related sectors.

Amendment of 7/19/90 increases program funding and adds, as a fifth area of policy reform, a reduction of restrictions on competitive private sector trade and transportation serving agricultural producers in Cabo Delgado, Nampula, and Zambezia provinces. (PD-ABI-958).

Amendment of 5/15/91 incorporates pricing and marketing reforms for these products into the program's policy objectives. The reforms will increase the availability of these products and will help to lay the foundation for private participation in their importation and distribution. (PD-ABH-026)

PD-ABE-009 17-Special Evaluation Mar 1992
Mozambique : private sector support program (656-0208 / 0218)
-- evaluation

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6600120 Zaire
Private Sector Support
FY 87 - 89 Status: I

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Project to support the development of Zaire's private sector by

- Providing funds to address the immediate credit needs of small and medium-scale private enterprises (SME's)
- Promoting Government of Zaire (GOZ) policy changes necessary for long-term private sector growth.

The program, which will be developed in close collaboration with the

Bank of Zaire within the framework of the World Bank's Financial Sector Adjustment Credit Program, will consist of:

- Basic covenants concerning GOZ continuation of stabilization and liberalization measures, especially regarding control of the deficit and liberalization of prices, interest rates, and exchange rates
- Conditions precedent to the initial release of funds stipulating GOZ commitments to long-term financial sector development and to U.S. participation in the reform program
- Conditions precedent to subsequent releases of funds stipulating specific measures promoting domestic resource mobilization and allocation to the private sector by commercial banks. (SOURCE: PD-BBM-418)

XD-ABI-244-A 42-Project Paper (PP) 23 May 1989
Private sector support program, [TA]

Private Sector & Asia/Near East

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6080189 Morocco
Private Sector Support and Export Promotion
FY 86 - 90 Status: I

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Project to help Morocco increase private sector exports by expanding credit insurance, increasing the availability of prefinancing credit for smaller firms, and providing TA to beneficiary firms and the Moroccan Center for Export Promotion (CMPE). The Ministry of Finance, the Banque du Maroc, and the International Executive Service Corps (IESC) will implement the three project components.

Significant changes will be made regarding credit rates, credit ceilings, eligibility, and the approval process.

Amendment of 7/28/89 adds a trade and investment services (TIS) program to be implemented by IESC. The TIS will stimulate both Moroccan-U.S. joint ventures and Moroccan exports to the United States by

- Identifying firms that are good candidates for joint ventures and providing a range of services to facilitate such ventures
- Identifying exportable Moroccan products, helping to ensure the quality and reliable production of these products, and hiring subcontractors to arrange sales to U.S. buyers. (PD-AAZ-935)

PD-ABG-096 68-Final Report 28 May 1993
Final report : final impact evaluation of the export credit insurance component of the private sector export promotion project

Private Sector & Europe/NIS

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1100005 New Independent States [see also 164]
Private Sector Initiatives
FY 92 - 97 Status: A

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Project to facilitate the economic transformation of the New Independent States (NIS) of the former Soviet Union by supporting U.S. investment in and trade with the NIS and fostering privatization. The project will focus primarily on reorienting NIS economies from defense to civilian needs. The advisors will work with local political and business leaders to recommend legal and regulatory reforms, and they will also channel information on business opportunities to U.S. companies. A Trade and Investment Service (TIS) will be established in key locations (Moscow, St. Petersburg, and a far eastern city in Russia; Kiev, Ukraine; and Alma Ata, Kazakhstan) to help NIS governments create a legal and regulatory framework for bilateral trade and investment, privatization, and defense conversion. (SOURCE: PD-ABD-956)

Various documents for the following countries related to this project's activities are availble: Armenia, Belarus, Kazakhstan, NIS, Kyrgyz, Moldova, Ukraine, Uzbekistan, Russia, Georgia, Tajikistan, and Turkmenistan

Private Sector & Global

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9400026 Private Enterprise
FY 93 - Cont Status: A

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Under this project, the Global Bureau's economic growth office is assisting the following countries with private enterprise initiatives: Gaza and the West Bank, Swaziland, Cape Verde, Zimbabwe, Jordan, Egypt, Bangladesh, and Costa Rica. Documentation including

LRJ activities include:

PN-ABU-775 62-AID Supported Study Dec 1994
Jordan : recommendations for reforms in the application of fines for infractions of customs law and in the incentive system for customs officers -- final report

PN-ABW-420 62-AID Supported Study Jun 1995
IDLI [International Development Law Institute] in transition : strategies for sustainable development - final report

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9402028 Private Enterprise
Private Enterprise Development Strategy and Support
FY 85 - 95 Status: A

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Project to support the development of private enterprises in LDC's. In FY 1987, the project will be revised to focus on improving USAID private enterprise strategy and reforming host country policy and institutions in the direction of privately-led economic growth. The revised project will also develop innovative, highly-leveraged approaches aimed at redirecting A.I.D.'s traditional programming processes to address constraints to private enterprise development. (CP88, Annex IV, p. 147-148)

PN-ABJ-782 17-Special Evaluation Aug 1989
Final evaluation of the ninth presentation of the course : 'the role of the private sector in development'

PD-ABE-497 98-Program Document May 1992
A.I.D. / Washington private sector project handbook

PD-ABE-787 17-Special Evaluation Dec 1989
Evaluation of the private enterprise development support project

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5980772 Latin American Regional
Instituto Libertad y Democracia
FY 89 - 94 Status: A

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Grant to <<Instituto Libertad y Democracia>> (ILD), a Peruvian PVO, to strengthen its institutional capability and develop an expanded international research and training program in conjunction with its conversion into an international organization. The main emphasis of ILD to date has been on the working of the informal sector in Peru.

- ILD will conduct a major multifaceted research program, the results of which will be used to formulate policy changes or reforms in Peru, especially in areas where the informal sector plays a large role (e.g., housing and manufacturing).
- Outreach and dissemination activities will be carried out, including the promotion of the ILD thesis and methodology, dissemination of legislative proposals proceeding from ILD research, dissemination of information on the informal sector outside of Peru, etc. (SOURCE: PD-AAZ-117)

PD-ABE-159 15-Proj Eval Summary(PES)/Eval Summary(ES) 3 Jun 1992
Private sector institutional reform project

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5960149 Reg Office Cen America & Panama-ROCAP
Federation of Private Sector Entities in Central America and Panama
FY 89 - 93 Status: C

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Grant to the Federation of Private Sector Entities in Central America and Panama (FEDEPRICAP) to strengthen the role of the private sector in Central America's economic development. FEDEPRICAP will provide its members with policy analysis, negotiation, representation, and information and referral services in the areas of transportation, capital mobilization, and trade.

The transportation component will focus on problems such as excessive delays at border crossings, regulations prohibiting foreign truckers from picking up freight, and the lack of a regional brokerage system for truck shipments.

In the area of policy development and reform, FEDEPRICAP will take the lead in promoting region-wide policies and regulations to stimulate foreign and domestic investment and stem capital flight. Efforts will include formulating options for

policy reform and monitoring existing and proposed policies.

Amendment of 9/27/89 funds activities improving cargo transportation by helping to modernize port tariff systems.

Amendment of 4/11/90 strengthens activities in work with government authorities and businesspeople to counter the negative impact of illicit drug trade on legitimate businesses, and seek TA/training from the U.S. Drug Enforcement Agency

PD-ABI-198 68-Final Report [1994]
Project assistance completion report : private sector initiatives project

PD-ABI-947 15-Proj Eval Summary(PES)/Eval Summary(ES) 13 Jun 1994
Private sector initiatives (PSI)

XD-ABI-947-A 68-Final Report [7 Nov 1993]
Final evaluation of FEDEPRICAP with respect to ROCAP project no. 596-0149

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5270298 Peru
Private Sector Policy Planning and Institutional Development
FY 85 - 89 Status: I

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Project to promote policy reform and dialogue among and between private and public sector institutions involved in the policy formulation process in Peru. The project will include activities with formal private sector groups, the informal private sector, and public sector organizations.

A grant to the << Instituto Libertad y Democracia >> (ILD, the foremost authority on the informal sector in Peru) will finance continued ILD research and analysis on the informal sector and ILD advocacy of legal and regulatory reforms to create a policy framework more conducive to investment and integration into the formal economy.

PD-ABE-159 15-Proj Eval Summary(PES)/Eval Summary(ES) 3 Jun 1992
Private sector institutional reform project

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5380119 Caribbean Regional
Investment Promotion and Export Development
FY 84 - 92 Status: I

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Project to promote private investment in productive, export-oriented businesses in Eastern Caribbean LDC's, with a stress on institutionalizing the investment promotion (IP) process.

The IP efforts of PDAP II will/may include

- St. Kitts-Nevis: assistance to the public sector in formulating IP policies, promotion of overseas investments, and training for garment and electronic firms undertaking joint ventures with foreign manufacturers
- St. Lucia, promotion agro-industrial investments
- St.Vincent, promotion of agribusiness and of light manufacturing, development of linkages between local firms and foreign businesses

PD-ABD-495 17-Special Evaluation Feb 1988
Evaluation of the portfolio of RDO/C's private sector office
: second program report

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5980619 Latin American Regional
Private Sector Initiatives
FY 82 - 90 Status: I

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Project to help the Latin American private and public sectors to generate more effective private sector participation in development. Project funds will be used to undertake surveys and assessments of constraints to and opportunities for greater private investment and to examine the impact of various governmental policy and regulatory measures on private incentives.

Documents concerning this project's activities within the following countries are available: El Salvador, Bolivia, Belize, Domincan Republic, Honduras, Ecuador, Argentina, Peru, Guatemala, Chile, and Paraguay.

Agribusiness Projects with LRJ Components

Africa

Zambia: Agricultural Sector Liberalization Project (ASLP) 6110231

Chad: Agricultural Trade Policy Reform Program 6770068 and 6770069

Cameroon: Support to the Program of Reform in Agricultural Marketing Sector 6310083

Niger: Economic Policy Reform Program 6830259

Madagascar: Madagascar Agricultural Export Liberalization Program 6870102

Asia/Near East

Bangladesh: Private Sector Agriculture Inputs 3880087

Indonesia: Agribusiness Development 4970368

Nepal: Agroenterprise and Technology Systems 3670160

Indonesia: Agriculture and Rural Sector Support Program 4970357

Tunisia: Agricultural Policy Implementation 6640343

Europe/NIS

East European Regional: Restructuring Agriculture and Agribusiness 1800024

Latin America

El Salvador: Modernization of the Agriculture Sector 5190397

Nicaragua: Private Agricultural Services 5240315

Caribbean Regional: High Impact Agricultural Marketing Promotion 5380140

Bolivia: Private Agricultural Producer Organizations 5110589

Ecuador: Non-Traditional Agricultural Exports 5180019

Dominican Republic: Agribusiness Promotion 5170186

Ecuador: Agricultural Sector Reorientation 5180051

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6110231 Zambia
Agricultural Sector Liberalization Project (ASLP)
FY 94 - 01 Status: P

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Program/project to help the Government of Zambia (GRZ) to liberalize the country's agricultural sector. Program assistance will consist policy reforms to increase the production and marketing of selected food crops. Conditions precedent will require the GRZ to:

- Consolidate existing land-related legislation
- Raise revenues from State-owned lands for use in financing rural infrastructure
- Develop market-oriented maize marketing and agricultural credit policies.

Project assistance will comprise two components. A Policy Management and Implementation component will provide advisors to monitor and inform Zambian policymakers about agricultural sector activity and constraints; train personnel of the Ministry of Agriculture, Food, and Fisheries in market liberalization and private sector promotion; and, possibly, develop legislation for privatizing agricultural marketing enterprises and services. A Small Farmer Access to Resources component will rehabilitate feeder roads; develop legislation to improve land access and tenure security; and increase the access of small farmers to agricultural credit. (SOURCE: PD-ABI-955)

PD-ABI-955 01-Project Identification Document (PID) 19 Jul 1994
Agricultural sector liberalization

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6770069 Chad
Agricultural Trade Policy Reform Program
FY 92 - 94 Status: A

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Project to provide TA and training in support of the Agricultural Trade Policy Reform Program in Chad. See the abstract of 6770068.

PD-ABK-662 62-AID Supported Study Jan 1994
Legal and regulatory aspects of export of agropastoral products : Republic of Chad -- contract no. 677-0069-C-00-3554-00 : final report

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6770068 Chad

Agricultural Trade Policy Reform Program

FY 92 - 97 Status: A

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A program to support policy reform by the Government of Chad (GOC) to encourage increased imports of agricultural inputs, including marketing-related inputs such as trucks, and increased exports of agricultural products.

The program will result in lower import taxes on agricultural inputs and simplified procedures for export. The cash transfer could offset the GOC's immediate revenue loss from lower import taxes. The steps needed to bring about this policy reform will be formulated during the design of the program, with emphasis on selecting the option that will result in the quickest response by the private sector.

The program aims to institutionalize the reforms necessary to expand agricultural production and private sector trade, which is mainly in agricultural products. (Abstract taken from FY 1992 CP, PN-ABH-202, p. 252)

PD-ABK-925 68-Final Report Jan 1995

Projet de reformes des politiques agro-commerciales (NPA/ATPRP no. 677-0068 et 677-0069) : evaluation finale

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6310083 Cameroon

Support to the Program of Reform in the Agricultural Marketing Sector

FY 90 - 92 Status: I

****

Project to support the Program of Reform in the Agricultural Marketing Sector, Phase 1 (PRAMS I, Project No. 6310068) in Cameroon. The program aims at liberalizing and privatizing markets for arabica coffee in the North West and West Provinces.

PN-ABR-908 56-Case Studies Mar 1994

Paths of policy reform : case studies of PRAMS I and cooperative law reforms -- final report

****

6310068 Cameroon

Program for the Reform of the Agricultural Marketing Sector (PRAMS) I

FY 90 - 92 Status: C

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Program to liberalize the internal and external marketing of arabica coffee in Cameroon.

Major reforms include the following:

- Establishment of a graduated tax structure for arabica coffee
- Elimination of the cooperative marketing monopolies in the North West and West provinces
- Modification of NWCA's institutional arrangements to restructure its operational and organizational components
- Government of Cameroon (GRC) interim policy statement outlining objectives regarding cooperatives in the North West province in lieu of revised cooperative law
- Promulgation and implementation of a liberalized cooperative law that reduces GRC involvement in the formation, management, and dissolution of cooperatives nationwide. (SOURCE: PD-BBW-695)

PN-ABR-903 62-AID Supported Study Mar 1994

Organizational approaches to policy reform : a comparison of donor approaches with special reference to Cameroon

PN-ABR-904 62-AID Supported Study Mar 1994

Institutionalism and policy reform

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6830259 Niger

Economic Policy Reform Program

FY 88 - 94 Status: A

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Program to promote policy and institutional reforms in Niger fostering increased exports of agro-pastoral products, particularly through official channels.

Conditions precedent require the GON to ease regulations and controls that impede exporting and to strengthen regional trade relations, especially with Nigeria. By the end of the program the following measures will have been taken:

- export regulations for livestock trade simplified and made uniform
- requirements for licensing in skins and hides export trade relaxed to promote competition and GON personnel trained in new licensing procedures

- investment environment improved via a "businessperson's bill of rights" defining private sector rights and responsibilities and a system of judicial arbiters between the private sector and the GON
- action plan issued and actions underway for implementing recommendations of a recent GON study on livestock exporting policy
- no new trade monopolies sanctioned
- marketing and price reporting system for the consulate in Kano and a regular system for announcing foreign exchange rates established

Amendment of 9/29/92 adds two additional tranches. Conditions precedent for the first tranche include:

- issuance and promulgation of legal/regulatory sanctions against public officials requesting or receiving illegal payments from those who produce, trade in, or transport agro-pastoral products
- public information campaigns concerning this anti-corruption legislation, the elimination of export tax and license requirements, and current prices of agro-pastoral products and transportation costs
- scopes of work for policy analyses of trucking/trading regulations and trucking tariffs and monopolies.

Conditionality for the second tranche includes evidence of reduced illegal payments to public officials, new laws/regulations regarding trucking and trading enterprises, and radio information campaigns in three local languages on the topics mentioned above.
(PD-ABF-193)

PD-ABE-357 17-Special Evaluation 20 Jul 1992
Niger economic policy reform program (683-0259 and 683-0263)
: evaluative assessment

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6870102 Madagascar
Madagascar Agricultural Export Liberalization Program
FY 88 - 92 Status: I

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Program to remove policy and procedural impediments to liberalized agricultural export markets in Madagascar through a policy reform-conditioned program grant.

The program grant will be disbursed in two tranches. Conditions precedent (CP's) to the first tranche relate to:

- Eliminating government monopolies on exports of the traditional crops (cloves, coffee,vanilla, and pepper) that account for 80% of all agricultural exports
- Ensuring private operators free access to these markets and to the continued allocation of foreign exchange through an open and market-clearing system.

The Government of Madagascar (GDRM) will also be required to submit a schedule for

meeting the CP's to the second tranche, namely: the implementation of policies and procedures to liberalize agricultural export market operations and the continued allocation of foreign exchange through an open system.

The project grant will finance activities to consolidate program reforms and to identify additional reforms needed for agricultural liberalization.

PAAD Amendment of 8/17/89 provides an additional program grant. The FY89 program will focus on outstanding policy and administrative issues affecting agricultural exports, and on continuing support for the Open General Licensing system for the distribution of foreign exchange for imports.

A constraints identification component will undertake special studies and development work on policy and regulatory, institutional, and private subsector-specific constraints to increased agribusiness exports. (SOURCE: PD-BBM-576)

PD-ABB-314 17-Special Evaluation Mar 1989
Madagascar agricultural export liberalization program : performance assessment

Agribusiness and Asia/Near East

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3880087 Bangladesh
Private Sector Agriculture Inputs
FY 92 - 97 Status: C

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The project's policy initiatives will include efforts to:

- Remove impediments to private sector entry into vital agri-service areas
- Provide the private sector with monitoring and advice on government rules and procedures
- Deal with new policy issues in areas such as irrigation requirements, equipment uses, mechanization, and seed restrictions.

Further, the project will improve the private sector's capabilities through transfer of appropriate technologies, TA, provision of market intelligence, and access to U.S. commodities. (Abstract taken from FY 1992 CP, PN-ABH-202, p. 482)

(No documents available for this project.)

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4970368 Indonesia
Agribusiness Development
FY 91 - 97 Status: A

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Project to promote agribusiness development in Indonesia by (1) enhancing public sector support for agribusiness and (2) strengthening private agribusiness organizations. The Ministry of Agriculture (MOA) will implement the project with assistance from a U.S. TA contractor.

The MOA and the Ministry of Industry (MOI) will develop at least two new services for the private sector in the areas of policies, grades, or standards.

- The project will help the MOA and the MOI to address both macro-level policy issues and micro-level (subsectoral) regulations that affect production, harvest, transport, processing, packaging, and marketing of particular crops.
- Private agribusiness organizations will be given the opportunity in various fora to recommend and advise on policy changes.
- The project will help private not-for-profit agribusiness producer and trade organizations to provide services to their members and to provide policy input to the government. (SOURCE: PD-ABD-365)

PD-ABD-365 42-Project Paper (PP) 27 Sep 1991
Agribusiness development project

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3670160 Nepal
Agroenterprise and Technology Systems
FY 90 - 95 Status: A

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Project to strengthen the role of Nepal's private sector to expand agricultural markets and to accelerate the adoption of new farming technologies and value-added services. The project will provide support to the private Federation of Nepal Chambers of Commerce and Industry (FNCCI) and the public National Agricultural Research Center (NARC), and will consist of threecomponents: (1) agroenterprises, (2) agricultural research, and (3) research outreach.

First, FNCCI will establish a private sector support facility -- the Agroenterprise Center (AEC) -- to provide or broker information and services to agroenterprises (e.g., producer groups, commodity associations, farmer enterprises and firms). Types of services will include TA, information (e.g., marketing, prices, regulatory), feasibility studies, training, and study trips. The AEC will ensure that businesswomen and managers receive adequate assistance. (SOURCE: PD-ABC-039)

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4970357 Indonesia
Agriculture and Rural Sector Support Program
FY 87 - 96 Status: A

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Program to support policy changes in Indonesia aimed at increasing rural employment and incomes during a serious fiscal crisis precipitated by a drastic decline in the price of oil, Indonesia's major export.

The program's specific policy objectives are to expand and diversify the agricultural sector and to improve the efficiency of domestic financial markets. Program funds will be used to provide budgetary support to the Ministries of Agriculture and Finance for the implementation of policy and related institutional reforms.

Disbursements will be conditioned on progress in policy reform. Agricultural sector benchmarks are to:

- Initially reduce pesticide subsidies by 30% in order to encourage efficient utilization rates
- Expand trade reforms to include agricultural inputs needed to produce food and agricultural exports
- Reduce transportation and licensing costs associated with secondary crop processing and trade by eliminating the copra tax and by conducting analyses of trade and processing licensing procedures
- Introduce institutional reforms in agricultural research and planning with a view to agricultural diversification.
- Establish a legal framework and a regulatory system that will encourage development of the insurance and pension industries (SOURCE: PD-CAW-409)

PD-ABA-075 15-Proj Eval Summary(PES)/Eval Summary(ES) 17 Oct 1989
Agriculture and rural sector support

PD-ABK-690 15-Proj Eval Summary(PES)/Eval Summary(ES) 2 Mar 1995
Agriculture and rural sector support program

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6640343 Tunisia
Agricultural Policy Implementation
FY 87 - 90 Status: I

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Project to strengthen the Government of Tunisia's (GOT) capacity to conduct economic analyses, especially those needed to support the GOT/World Bank Agricultural Structural Adjustment Program (ASAP). The GOT Directorate for Planning, Statistics and Economic Analysis (DPSAE) will be the lead implementing agency for the project, which will support: (1) specific ASAP-related studies; and (2) capacity building for DPSAE and other agencies.

The majority of project funds will be used to conduct the economic analyses needed to support ASAP policy reforms. These reforms have three aims:

- Efficient resource allocation (analyses will predict input demand, assess the potential effects of removing subsidies, calculate the costs and coefficients of effective protection in crop production and processing, evaluate fertilizer distribution and use, and simulate policy impacts on specific agricultural subsectors)
- Price deregulation (analyses/modeling of price impacts on consumer demand, agricultural supplies, and the competitiveness of agricultural products)
- Privatization (case studies of the relative efficiencies of private firms and parastatals and of their likely reactions to policy changes, and analyses of potential export markets and of the potential role of the private banking system).

DPSAE's capacity to conduct these analyses and to monitor the effects of ASAP policy changes will be strengthened. (SOURCE: PD-AAV-773)

PD-AAW-508 70-Discussion Paper 15 Oct 1986
Issues paper : agriculture policy implementation project (664-0343)

PN-ABH-091 21-Conference Proceedings/Paper May 1989
Agricultural policy reform in Tunisia : structural adjustment and challenges for the 1990s -- seminar proceedings

PN-ABI-682 62-AID Supported Study Jul 1991
Agricultural policy analysis : a summary report

PD-ABE-038 68-Final Report Jul 1991
Agricultural policy implementation project, APIP : final report

Agribusiness & Europe/NIS

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1800024 East European Regional
Restructuring Agriculture and Agribusiness
FY 91 - 97 Status: A

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Project to restructure the agricultural and agribusiness sectors of Eastern and Central Europe in the direction of a market economy.

There are many documents relating to this project. Identify your geographic or sector interest to a PPC/CDIE/DI/R&RS employee in order to obtain copies.

PD-CBI-759 49-Not Elsewhere Classified Design Document 22 Apr 1991
Restructuring agriculture and agribusiness : cooperative training

PD-CBI-760 49-Not Elsewhere Classified Design Document 28 May 1991
Restructuring agriculture and agribusiness (180-0024) : technical assistance to Coop-Bank in Poland

PD-ABJ-433 53-Progress/Interim Report 28 July 1994
Restructuring agriculture and agribusiness : private sector program for Poland USAID grant, EUR-0024-A-00-2042-00 -- quarterly report on activities from April 1 to June 30, 1994

Agribusiness & Latin America

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5190397 El Salvador
Modernization of the Agricultural Sector

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Project to develop sectoral policies and supporting project activities to modernize El Salvador's agricultural sector. The project will provide TA, training, institutional support, and studies to support the implementation of market-based agricultural reforms that will be included in the FY 94 and subsequent ESF policy programs.

Specifically, the project will support Government of El Salvador reforms to:

- Divest itself of agricultural enterprises which rightly belong in the private sector and

develop efficient farmer-owned cooperatives,

- Address growing labor constraints in agriculture
- Analyze tax policy effects on agriculture and implement tax reforms which encourage sustainable land use

(Abstract based on New Project Description, USAID/El Salvador Program Objectives Document, FY 1993-97, and Action Plan, FY 1993-94, PD-ABD-067).

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5240315 Nicaragua
Private Agricultural Services
FY 91 - 96 Status: A

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Project to strengthen private agricultural producer organizations (PAOs) in Nicaragua. The project consists of two cooperative agreements: one with the Union of Agricultural Producers of Nicaragua (UPANIC) to fund agricultural services for PAOs, the other with the Nicaraguan Association of Producers of Nontraditional Exports (APENN) to promote the production of nontraditional agricultural exports (NTAEs).

The agreement with APENN will support four activities:

- Strengthening of APENN's ability to provide its members the services needed to increase NTAE production and to voice policy concerns with the government
- A market information center serving APENN members, to comprise a computerized, international market price database and a reference library, to include information on regulations and inspection procedures governing agricultural imports into the United States, Europe, and Asia
- Provision by APENN of extension and marketing services for specific export crops such as melons, asparagus, ornamentals, etc., along with efforts to address transportation and infrastructural constraints
- A variety of training events on key export crops and themes such as market analysis, pesticide regulations and use, and produce handling, packaging, and processing. (SOURCE: PD-ABH-246)

PD-ABH-246 42-Project Paper (PP) 26 Jun 1991
Private agricultural services

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5380140 Caribbean Regional
High Impact Agricultural Marketing and Production
FY 86 - 93 Status: I

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Project to encourage investment in export-oriented agriculture in the Eastern Caribbean by providing TA and funding to commercially viable enterprises. The Caribbean Financial Services Corporation (CFSC) and a U.S. contractor will implement the project, which will include Quick Response Activities (QRA's), major subprojects (SP's), and a core contract.

To stimulate smaller-scale private enterprises to fill market niches and to reduce commercial banks' reluctance to lend to small agricultural enterprises, the CFSC will finance QRA's. (SOURCE: PD-AAU-068)

PD-AAZ-511 42-Project Paper (PP) 30 Jun 1988
High impact agricultural marketing and production : amendment no. 2

PD-ABJ-885 68-Final Report 2 Nov 1994
PACR [project assistance completion report] : Agricultural Venture Trust

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5110589 Bolivia
Private Agricultural Producer Organizations
FY 86 - 92 Status: I

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Project to strengthen and expand the capacity of private agricultural producer organizations (PAPO's) in Bolivia to provide member services by upgrading their internal structures and their ability to influence policy issues. The Ministry of Planning and Coordination will implement the project.

Grant amendment of 8/30/90 extends PACD 2 years to 12/92 and increases funding. The revised project, which will be implemented by the Ministry of Agriculture and Campesino Affairs with assistance from Ronco (long-term TA) and Volunteers in Overseas Cooperative Assistance (short-term TA) (SOURCE: PD-AAU-342)

XD-ABG-400-A 68-Final Report Dec 1992
Private agricultural producers organizations project (project number 511-0589) : final evaluation

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5180019 Ecuador
Non-Traditional Agricultural Exports
FY 84 - 94 Status: A

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Project to promote nontraditional agricultural exports by private companies in Ecuador. The project, to be implemented by the Federation of Ecuadorean Exporters (FEDEXPOR) and the Ecuador National Association of Businessmen (ANDE) and other entities noted below, will provide information/support and policy/planning services and establish agribusiness finance facilities and an Agribusiness Advisory Board (AAB).

In the area of policy and planning, short-term, in-country training in policy analysis techniques will enable FEDEXPOR staff to conduct limited policy analyses and to supervise analyses contracted out to other firms (A.I.D. and FEDEXPOR will co-finance three such analyses during the project). Short-term TA will help FEDEXPOR expand dissemination of export information to political leaders and opinion makers.

Finally, a private sector AAB will facilitate communication among sectoral leaders, the Government of Ecuador, and A.I.D., while a contracted advisor will help ensure that the project focuses on sound agribusiness activities. (SOURCE: PD-AAP-570)

PD-AAX-824 17-Special Evaluation May 1988
Evaluation of the non-traditional agricultural exports project

PD-ABC-106 17-Special Evaluation Nov 1987
Report on the findings, conclusions and recommendations on assistance for the non-traditional agricultural exports project, (proj. no. 518-0019)

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5170186 Dominican Republic
Agribusiness Promotion
FY 85 - 90 Status: I

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Project to provide credit and TA to new and expanding agribusinesses in the Dominican Republic and to improve the mechanisms and policy framework for promoting and financing agribusinesses. The project will be implemented mainly by the Central Bank (FIDE) and the Dominican chapter of the private-sector Joint Agricultural Consultative Corporation (JACC/DR).

TA and training will be provided to Secretariat of Agriculture's Plant Health Division to support preclearance and certification of nontraditional agricultural exports to the United States.

Amendment of 9/22/89 extends the PACD to 12/31/92 and puts increased emphasis on expanding JACC's institutional and service delivery capabilities. In the area of services, the project will fund TA to develop or expand: pre-inspection of exports; laboratory services (e.g., testing soils, pesticide residue, and water quality); commercial information services; and TA and training for members. (PD-ABC-754)
(SOURCE: PD-AAS-094)

PD-ABF-534 68-Final Report Dec 1992
Final report : agribusiness promotion project

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5180051 Ecuador
Agricultural Sector Reorientation
FY 85 - 94 Status: A

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Project to strengthen the ability of Ecuador's Ministry of Agriculture (MOA) to develop policies aimed at reliance on market forces and promotion of private sector initiatives. The project, to be implemented mainly by a new MOA Policy Analysis Unit (PAU), will also strengthen private sector policy capabilities and upgrade agricultural information systems.

- An immediate agricultural policy agenda will be developed, based on pre-project and project-financed studies (particularly on commodity pricing, marketing, and divestiture of parastatals). Also, TA will be provided to help the PAU analyze

recommendations of a U.S. Presidential Agricultural Task Force which visited Ecuador in 10/84.

- To institutionalize policy analysis within the MOA, the newly created PAU, staffed by 5 MOA and 5 private sector professionals, will receive extensive TA and in-country training. PAU will function primarily as a fast-turnaround, problem-oriented analysis unit, providing policy advice to the MOA, identifying priority areas for study, etc.
- To upgrade private sector policy capabilities, an Agricultural Policy Institute will be created within an existing private organization, Fundacion Ciencia, and will sponsor policy studies (on, e.g., terms of trade, research priorities), publicize policy issues (through publications, workshops, etc.), and expand private sector policy and research capacities through, inter alia, a reference center, small research grants, and 4 Ph.D. and 2 M.S. U.S. scholarships in agricultural economics.

To provide the information needed for policy analysis and private sector investment decisions, an agricultural information system will be developed. (SOURCE: PD-AAS-883)

PN-ABM-577 17-Special Evaluation Jun 1992
Assessment of the agricultural sector reorientation project

HOW TO OBTAIN USAID DOCUMENTS

Development Information Services Clearinghouse
1500 Wilson Blvd., Suite 1010
Arlington, VA 22209-2404

Telephone: (703) 351-4006
Fax: (703) 351-4039
E-Mail: DOCORDER (USAID E-mail address)
docorder@disc.mhs.compuserve (Internet address)

HOW

Items are ordered by the document identification number (DOCID) found in the top left hand corner of the citation.

Example: PN-AAY-486 or PD-ABC-123

PN - USAID supported studies; XN designates an annex to a PN document of the same number.

PD - USAID project documentation; XD designates an annex to a PD document of the same number.

COST

Documents are free of charge to USAID employees.

Illustrative Statement of Work

for an LRJ Assessment

UNITED STATES OF AMERICA
AGENCY FOR INTERNATIONAL DEVELOPMENT

Madagascar Official Papers

Advisory and Assistance: YES( ) NO(X)

1. Country of Performance: Madagascar

2. Indefinite Quantity Contract: ANE-0015-B-00-1019-00 , Del. Order No. 16

NEGOTIATED PURSUANT TO THE FOREIGN ASSISTANCE ACT OF 1961, AS AMENDED, AND EXECUTIVE ORDER 11223

3. CONTRACTOR:
University Research Corp., Intl.
The IRIS Center
2105 Morrill Hall
University of Maryland
College Park, MD 20742

TIN NO. 52-1752957
DUNS NO. 00-325-6088

4a. ISSUING OFFICE:
Agency for International Development
AID/FA/OP/B/PCE, Rm 1508, SA-14
Washington, D.C. 20523

4b. ADMINISTRATION OFFICE:
Agency for International Development
AID/FA/OP/B/PCE
Washington, D.C. 20523

5. PROJECT OFFICE
Forest Duncan, PRE/SMIE

6. SUBMIT VOUCHERS TO:
Office of Financial Management
Room 700, SA-2, Washington, DC 20523

7. EFFECTIVE DATE
August 20, 1993

8. ESTIMATED COMPLETION DATE
December 31, 1993

9. ACCOUNTING AND APPROPRIATION DATA
Amount obligated: $ 157,257
Ceiling Price: $ 157,257
Appropriation No. 72-112/31014

PIO/T No. 687-0510.03-3-20086
Budget Plan Code: GSS2-92-21687-KG63

10. The United States of America, represented by the Contracting Officer signing this Order, and the Contractor agree that: (a) this Order is issued pursuant to the Contract or Agreement specified in Block 2 above and (b) the entire Contract between the parties hereto consist of this Delivery Order and the Contract or Agreement specified in Block 2 above.

11a. NAME OF CONTRACTOR
University Research Corporation, Int'l

BY: (Signature of authorized official)

TYPED OR PRINTED NAME:
Nancur Olson

TITLE:
Vice President, URCI

DATE:
August 31, 1993

11b. UNITED STATES OF AMERICA
AGENCY FOR INTERNATIONAL DEVELOPMENT

BY: (Signature of Contracting Officer)

TYPED OR PRINTED NAME:
Gary V. Kinney (kak)

TITLE:
Contracting Officer

DATE:
SEP 7 1993

ARTICLE I - TITLE

Institutional Reform and the Informal Sector - 940-0015 - Madagascar: Support for Environment for Investment in Madagascar: Institutional Reforms for a Market Economy - Alternative Dispute Resolutions

ARTICLE II - OBJECTIVE

There are three separate objectives under this order, each defined by a separate scope of work. The contractor shall: 1) examine the Malagasy judicial system as it interrelates with the executive and legislative branches of the government, and recommend methods to foster its independence, 2) coordinate an IRIS roundtable discussion on Malagasy investment reform issues, and 3) assess the legal/regulatory problems currently hampering financial sector development in Madagascar and provide the mission with specific recommendations.

ARTICLE III - STATEMENT OF WORK

See Attachment 1.

ARTICLE IV - REPORTS AND DELIVERABLES

See Attachment 1.

ARTICLE V - RELATIONSHIPS AND RESPONSIBILITIES

Technical directions during the performance of this delivery order will be provided by PRE/SMIE, Forest Duncan.

ARTICLE VI - TERM OF PERFORMANCE

A. The effective date of this delivery order is reflected on block 7. of the cover page and the estimated completion date is reflected on block 8 of the cover page.

B. Subject to the ceiling price established in this delivery order and with prior written approval of the Project Officer (see block 5 of the cover page), the contractor is authorized to extend the estimated completion date, provided that such extension does not cause the elapsed time for completion of the work, including furnishing of all deliverables, to extend beyond 60 calendar days from the original estimated completion date. The contractor shall attach a copy of the Project Manager's approval for any extension of the term of this delivery order to the final voucher submitted for payment.

C. It is the contractor's responsibility to ensure that Project Manager-approved adjustments to the original estimated completion date do not result in costs incurred which exceed the

REVISED SCOPES OF WORK

ENVIRONMENT FOR INVESTMENT IN MADAGASCAR: INSTITUTIONAL REFORMS FOR A MARKET ECONOMY

This PIO/T provides three separate scopes of work for separate but related activities under the general theme of investment environment in Madagascar.

JUDICIAL INDEPENDENCE

I. BACKGROUND

At the request of USAID/Madagascar, the Center for Institutional Reform and the Informal Sector (IRIS) has undertaken a study to examine how the legal, regulatory, and judicial (LRJ) environment and the investment process affect the prospects for market reform in Madagascar, and to determine further which institutional reforms would most encourage the growth of a market economy. This report was delivered to the government in April 1993.

II. OBJECTIVE

The objective of this consultancy is to further develop and promote the recommendations of this study, examining in particular the independence of the judicial system from the legislative and executive branches of government.

III. TASKS

1. General Tasks

The consultant will further develop the ideas presented in the final report of the study mentioned above to promote recommendations on the following:

a) The legal basis of judiciary independence;

b) The budgetary resources needed to establish and maintain independence of the judiciary;

c) The rules and practices required for the creation of an independent judiciary and the rule of law; and

d) The training in commercial law of judges and lawyers.

2. Specific Tasks

a) Working with IRIS core staff, Malagasy legal officials, private business employees and lawyers in private practice, the consultant will deepen the

recommendations of the IRIS report regarding independence of the judiciary. Particular attention will be given to the budgetary and organizational changes that are necessary to make the de jure judicial independence a reality.

b) With the assistance of the United States Information Service (USIS), the consultant will explain and promote concrete ideas for the independence of the judiciary in Madagascar.

c) The consultant will prepare a detailed program for promoting such independence of the judicial system. The action plan will include the necessary legal changes, organizational and budgetary requirements, and training requirements to promote judiciary independence. Training recommendations should take into consideration the services available from the International Development Law Institute (IDLI) in Rome.

IV. REPORTS AND DELIVERABLES

A draft action plan in English will be submitted to USAID/Madagascar prior to the consultant's departure from Madagascar.

A final revised action plan (ten English and thirty French copies, plus the English and French versions on diskette in WordPerfect 5.1) will be mailed to USAID/Madagascar no later than one week after receipt of the Mission's comments.

V. PERSONNEL

The consultant will be a lawyer with broad international experience in the analysis of legal, regulatory, and judicial systems; will be familiar with French-based LRJ systems; and will have French language capability at the FSI 3/3 level. In addition, IRIS will provide substantive technical support to the consultant from the home office. This support will include pre-trip consultations with respect to IRIS experience in other countries, collection of legal and economic materials and information on the activity of other donors and experts in similar projects, and communication and oversight over the course of the consultancy. IRIS will also provide logistics support for the consultant.

VI. LOGISTICS

The consultant will be fully responsible for all logistical arrangements for the implementation of the contract, including office space. The consultant will also be

responsible for arranging international travel to and from Madagascar.

VII. LEVEL OF EFFORT

The consultant will spend twenty-one work days in Madagascar and five work days in the home office for revising the final action plan and having it translated into French. The consultant will schedule one work day in Rome at the International Development Law Institute (IDLI) on his/her way to Madagascar to determine the feasibility of using IDLI resources for legal training in Madagascar. USAID/Madagascar will inform IDLI of the reason for the visit. The consultant will contact IDLI directly to arrange the visit. The work should begin no later than August 8, 1993. In addition IRIS will provide five days of substantive technical support from the home office, as well as logistics support.

PLANNING THE INVESTMENT ENVIRONMENT ROUNDTABLE

I. BACKGROUND

At the request of USAID/Madagascar, the Center for Institutional Reform and the Informal Sector (IRIS) has undertaken a study to examine how the legal, regulatory, and judicial (LRJ) environment and the investment process affect the prospects for market reform in Madagascar, and to determine further which institutional reforms would most encourage the growth of a market economy. This report was delivered to the government in April 1993.

II. OBJECTIVE

The objective of this consultancy is to follow-up on this study, in particular to prepare the groundwork for a public/private roundtable to discuss the recommendations contained in the IRIS report.

III. TASKS

1. General Task

There are a series of institutions in successful market economies which do not exist in Madagascar. Building those institutions is neither an automatic nor an easy process. The IRIS report describes some of these institutions and proposes ways to facilitate their development in Madagascar. The scope of this consultancy will be to determine the interest of a broad range of Malagasy for a roundtable discussion of the IRIS recommendations.

2. Specific Tasks

The two person team, including at least one core staff member of IRIS, will conduct further individual interviews with people contacted during the first IRIS visit, and interview other people, in order to collect specific and updated information which will be used at the roundtable and in further work. The team will propose a plan for a roundtable discussion of legal and regulatory issues and the investment approval process.

IV. REPORTS AND DELIVERABLES

A draft proposed plan in English for a roundtable discussion will be submitted to USAID/Madagascar prior to the team's departure from Madagascar.

The draft plan shall contain the following sections:

- Proposed Agenda
- Speakers
- Sponsorship
- Timing
- Participants
- Expected Outcome

A final revised plan (twenty English and twenty French copies, plus the English and French versions on diskette in WordPerfect 5.1) will be mailed to USAID/Madagascar no later than one week after receipt of the Mission's comments.

V. PERSONNEL

The in-country team will be comprised of two persons plus the support of the expert on the legal framework for financial institutions for seven days in Madagascar; at least one shall be a core staff member of IRIS. The consultants will be lawyers, economists or private sector experts with broad international experience in the analysis of legal, regulatory, and judicial systems; will be familiar with French-based LRJ systems; at least one will have French language capability at the FSI 3/3 level. In addition, IRIS will provide technical support to the consultants from the home office. This support will include pre-trip consultations with respect to IRIS experience in other countries, collection of materials and information on the activity of other donors and experts in similar projects, and communication and oversight over the course of the consultancy. IRIS will also provide logistics support for the consultants.

VI. LOGISTICS

The consultants will be fully responsible for all logistical arrangements for the implementation of the contract, including office space. The consultants will also be responsible for arranging international travel to and from Madagascar.

VII. LEVEL OF EFFORT

One consultant will spend eighteen work days in Madagascar and five work days in the home office for revising the final plan. The work should begin no later than August 24, 1993. The second consultant will spend not less than ten work days in Madagascar and five work days in the home office for revising the final plan. The work should begin no later than September 2, 1993. The expert who will be already responsible for assessing the legal framework for financial system development will devote seven days in country to this effort.

This third team member will devote at least seven work days in Madagascar and two work days in the home office to this task. In addition, IRIS will provide four days of legal and economic issue support from the home office, as well as logistics support.

ASSESSMENT OF LEGAL FRAMEWORK FOR FINANCIAL SYSTEM DEVELOPMENT

I. BACKGROUND

The structural changes that have opened Madagascar's economy to market forces are a necessary first step, but this change alone does not lead to economic growth. The emerging shift towards a market economy requires abrogation of previous legal provisions based on a state-controlled economy. In Madagascar many laws have been inherited from the French system and have become outdated. Also, successive changes in policy have on occasion resulted in measures inconsistent with the traditional and constitutional hierarchy of the sources of law. Modernization of the legal framework pertaining to economic activities, in particular updating existing laws, creating new legal instruments and repealing inadequate or obsolete ones, is an essential precondition for economic development.

II. OBJECTIVE

The purpose of this PIO/T is to cover the costs of one financial economist and one legal expert to assess the existing laws and regulations, and practices affecting the financial sector (banking operations, financial contracts and mortgages, debt recovery, bankruptcy and liquidation) and recommend measures allowing to put these laws, regulations, and practices in conformity with the government's economic liberalization program and to reinforce the infrastructure for financial system development.

III. TASKS

A. Analysis

An adequate financial infrastructure is necessary to enable the financial system to effectively play its two key functions of financial intermediation and provision of payments services. The consultants will assess the problems currently hampering financial sector development and provide USAID/Madagascar with specific recommendations.

Specifically, the consultants will analyze the following issues:

1. Legal issues in banking operations. Whereas mortgage (hypothèque) is now little used in France, this is still the most common form of security required by banks in Madagascar.

One of the most common complaints against banks is that securities required by banks for granting loans and other facilities to businesses are difficult to provide. Banks also complain of the difficulties in obtaining repayment even of secured loans because of the present system of administration of justice, the precarious nature of ownership deeds, the cost of recovery in remote areas, and the traditional and cultural factors which impede the execution of judgments.

2. Legal changes for improving banking operations. Banks should be encouraged to adopt a wide range of securities and financing schemes available in other countries and in particular in countries whose legal systems are derived from French civil law. These include: (a) project financing; (b) a combination of "hypothèque" and "cautionnement" instead of exclusive reliance on hypothèques; (c) "délégation" to ensure that the number of creditors in relation to a particular project is as wide as possible; (d) greater use of shares and other title deeds as security; (e) title reservation clauses in contracts of sale financed by loans; (f) insurance cover for loans; and (g) securization. Many of these products could probably be developed solely through agreements between banks and their customers even before there is specific legislation covering them. Banks would thereby contribute to the establishment of a modern system of law. If the overall legal system and procedure for settlement of disputes and recovery of debts are improved, banks may be expected to adopt a more liberal approach to loans and securities.

3. Financial Contracts and Mortgages. Commercial law in Madagascar is based on the autonomy of the contracting parties' will and accordingly allows operators considerable freedom in agreeing on their reciprocal obligations. However, when a contract is concluded with a foreigner, Malagasy exchange regulations limit the freedom to transfer funds, purchase foreign securities and export goods. Real and personal guarantees governed by law are not always possible or effective. Mortgages can only be constituted on registered properties and that, if the creditor or borrower is a foreigner, the transaction is subject to discretionary authorization. Banks most often use the private mortgage method to avoid the cost of notarized deed or because there is no notary near enough to the bank office. Often, too, a mortgage is only registered for its date, but not entered in the formal records to avoid costs that could lead the borrower to reject the loan. This situation warrants a reform that would limit the cost of mortgage registration to a reasonable fixed fee.

4. Alternatives to Mortgages. Various ways exist in which real property can be accepted as security without a mortgage

being taken out, such as promise or prohibition to mortgage or deposit of title with a bank. The "floating charge" used in English law makes it possible to guarantee a current account subject to appreciable variations against corporate capital, whereas a mortgage can only be taken out for a set amount. Pledging against equipment or merchandise is sometimes done by means of open warehousing, but the warehouses operated by the Chamber of Commerce in Madagascar do not appear sufficiently reliable for the warrant system. In rural areas the real problem is not guarantees but primarily the lack of funds for lending, which obliges farmers to turn to informal money-lenders who practice usury to the disadvantage of borrowers.

5. Debt Recovery. Improvement of the means of debt recovery can help lower the costs of banking transactions in Madagascar. When bad faith or risk of nonpayment is evident, banks resort to enforcement of their claims. If they hold notarized evidence of debt, such as mortgage or bond, they can institute proceedings for attachment of the goods or property mortgaged or given as security. If there is no executory deed, the bank must apply to the courts to obtain an injunction or order to pay. If the debtor challenges the injunction, the case is transferred to the ordinary commercial court, presided over by a judge of the court of first instance and including two businessmen appointed upon the proposal of the Chamber of Commerce.

6. Bankruptcy and Liquidation. The law in respect of collective procedures only admits bankruptcy and court-ordered liquidation in accordance with legislation inherited from the French. The time limit set by law should not exceed three months from the adjudication of bankruptcy. However, due to the legal system's inability to give decisions and produce the required documents within the time set, proceedings can drag on for years. Also, many managers and trustees lack qualifications. This situation calls for modernization of the relevant legislation and institution of collective prevention procedures which can be initiated by representatives of the staff, bankers and other creditors concerned, subcontractors in particular. This prevention procedure would have the effect of suspending proceedings. In the case of liquidation of assets, the debtor and a representative elected by the body of creditors should be able to supervise and facilitate the operations of the trustee to prevent any item from being sold off at bargain-basement prices. The law must be reviewed so as to minimize the impact of social imperatives, reduce bureaucratic procedures and promote reconstruction and administration.

B. Reform Recommendations

At the conclusion of the analysis, no later than week three, the consultants will present preliminary findings to USAID/Madagascar in a verbal report. This briefing will indicate the importance/urgency of dealing with the six issues. USAID/Madagascar and the consultants will agree on three issues for further work. During the second half of the consultancy the consultants will prepare a set of detailed recommendations to address the three issues identified as priority.

IV. DELIVERABLES

The consultants will submit a draft report in English prior to departure from Madagascar. The report will be in two sections: (1) Legal Issues in Financial Sector Development, and (2) Priority Reform Recommendations. The two sections will correspond to tasks A and B. Three weeks after receipt of written comments from USAID/Madagascar, the consultants will submit 20 French and 15 English final reports as well as each report on a 3 1/2 in diskette formatted on WordPerfect 5.1.

V. PERSONNEL

The team will be comprised of two persons, including a lawyer and an economist, both with experience in analysis of legal systems and financial sector development; will be familiar with French-based institutions; will have French language capability at the FSI 3/3 level. In addition, IRIS will provide substantive technical support to the consultants from the home office. This support will include pre-trip consultations with respect to IRIS experience in other countries, collection of materials and information on the activity of other donors and experts in similar projects, and communication and oversight over the course of the consultancy. IRIS will provide logistics support for the consultants.

VI. LOGISTICS

The consultants will be fully responsible for all logistical arrangements for the implementation of the task, including office space. The consultants will also be responsible for arranging international travel to and from Madagascar.

VII. LEVEL OF EFFORT

A total of thirty-five days of effort (twenty-six work days in Madagascar, five work days in the home office, and four international travel days) are envisaged for the above task. The consultation will begin on or about August 14, 1993. In addition, IRIS will provide five days of substantive technical support from the home office on legal and economic issues, as well as logistics support.

ECONOMIC GROWTH TRAINING WORKSHOP

Sponsored by USAID, Global Bureau.
Center for Economic Growth
Xerox Training and Conference Center
Leesburg, Virginia
September 17-21, 1995

Summary of Points for September 18, 1995

prepared by the
Center for Institutional Reform and the Informal Sector (IRIS),
University Research Corporation International,
University of Maryland

THEME: LEGAL, REGULATORY AND JUDICIAL ENVIRONMENT

SESSION ONE: Why Are LRJ Reforms Important to AID's Success?

1. Developing and Implementing Effective Legal and Regulatory Reform

Evidence is considerable and growing that economic development and democratic government depend on an arrangement of institutions or "rules of the game" many of which can be described as legal, regulatory or judicial institutions. These institutions, as well as less formal institutions that can be described as custom or culture, provide incentives for individuals both within and among organizations. This idea represents a change from earlier ideas that development depended most critically on increased financial, capital, human or natural resources. While all of these factors are relevant to growth, none explains the differences in development as completely as do differences in the arrangements or institutions, particularly those which are the subject of this week's program.

AID has an enormous variety of activity underway to help people in developing and transition societies understand and improve these institutions in ways that promote economic and democratic development. Many of those activities are conducted under the rubric of private sector or agribusiness projects, but many that are developed under other program headings are also very important to private sector and agribusiness development.

or a primer in the economic or other rationale for specific sector policies. [1] Instead the approach is to frame a way of thinking about LRJ issues which will assist in making decisions about even the narrowest examples.

Research to systematically test the hypotheses that LRJ institutions matters to growth has confirmed the idea that the collection of LRJ institutions, as well as sector-specific policies such as those facilitating credit markets, do play an essential role in determining income levels and growth rates.

Since 1993 a team at the University of Maryland's IRIS Center has been looking at growth in more than 100 developing countries over a period of several decades and measured the amount of property rights and contract enforcement. To capture the wide variety of institutions which give meaning to property rights and contract enforcement, the team developed as a measure of "contract intensive money" (CIM)--the ratio of financial assets which require that the parties depend on courts for their enforcement (such as savings accounts, commercial and financial company paper) relative to cash. The findings are that CIM is positively correlated with both income, investment and growth. While on-the-spot markets are self-enforcing and appear spontaneously in all societies, markets with transactions which require third-party enforcement often bring great economic gains, but emerge only in markets with appropriate institutions. [2]

Closely related work has explored the connections between democracy, dictatorship and development. Many of the same LRJ institutions which provide for economic development also provide for political rights. The conclusion of this work is perhaps surprising: that while long standing democracies tend to be more developed and have better LRJ institutions for private sector and agribusiness development, simply switching from a dictatorship does not assure growth. Many long-standing autocrats have provided sufficiently secure property rights and contract enforcement as to achieve, for a time, significant rates of growth. This research has examined the incentives of democrats and autocrats, and measured growth rates against several regime types.[3]

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[1] For a broad overview of several essential LRJ institutions see Clive Gray, "Reform of the Legal, Regulatory and Judicial Environment - What importance for Development Strategy?" CAER Discussion Paper No. 10 (HIID: Cambridge, MA), August 1991. For a country specific discussion see Hilton Root, "Environment for Investment in Madagascar: Institutional Reform for a Market Economy," Country Report No. 11 (IRIS: College Park, MD), February 1993.

[2] Christopher Clague, Philip Keefer, Stephen Knack and Mancur Olson, "Contract Intensive Money: Contract Enforcement, Property Rights and Economic Performance," IRIS Working Paper No 151 (IRIS: College Park, MD), February 1995.

[3] Christopher Clague, Philip Keefer, Stephen Knack and Mancur Olson, "Property and Contract Rights Under Democracy and Dictatorship," IRIS Working Paper No. 169 (IRIS: College Park, MD), July 1995.

2. Deciding where to start: Constitutions or contracts?

This phrase attempts to capture the trade-off between working on specific commercial rules or on the political rules which provide for their adoption and enforcement.[4]

For most of the societies in which we are working, the problem is not how to create LRJ institutions where none exist, but instead how to reform very poorly designed or operating institutions. Political institutions are important foundations for the LRJ environment. These include constitutions, the bodies which implement and interpret them and the procedures by which they are adopted and amended. We all have examples of lofty constitutions which play no role in promoting market activity because they are not implemented in ways which limit the ability of the state or others to interfere with property or enforcement of contracts.

In such societies it is legitimate to ask whether it makes sense to expend effort on development of sector specific policies or even on legislative or executive branch development of commercial rules. If an autocrat or a corrupt bureaucracy can change or ignore laws what value is assistance aimed at policies which can change with the whim of an individual? This dilemma suggests that sustainable LRJ reform ultimately includes reform of political institutions such that LRJ policy makers and implementers are constrained by the rule of law.

> Example: In Madagascar a new Constitution adopted in 1992 provided for an independent judiciary, badly needed in a society in which courts functioned slowly if at all and subject to political interference. Specific steps to increase the independence of the judicial system were developed with AID assistance and turned into legislative proposals. However, political deadlock with roots in both the new constitutional arrangements and with their implementation has prevented action on a very essential reform. Should AID have better spent the time on constitutional effort?

> Example: Development of bank secrecy legislation in Chad would have increased the confidence of private firms in the banking system. In an environment in which the same government which can adopt the rules can change them overnight, or ignore them, will effort on specific rules actually result in greater confidence on the part of private actors and thus lead to the economic impact hoped for?

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[4] There are many examples of LRJ institutions existing without specific or formal sanction by a national government of some sort. Well developed markets have existed since early history which operated across great distances and provided for extension of credit, sanction for breach of agreed-upon rules or contracts and so forth. There are important opportunities for alternative developments of this sort and we can learn about the functioning of markets by studying these historical markets which did not depend on the state for their rules. See Avner Grief, "Markets and Legal Systems: The Development of Markets in Late Medieval Europe and the Transition from Community Responsibility to an Individual Legal Doctrine," IRIS Working Paper No. 159 (IRIS: College Park, MD), April 1995.

There are districts in which the position of the rural population is that of a man standing permanently up to his neck in water, so that even a ripple is sufficient to drown him[5]. Economists are increasingly aware of the central role of risk and risk-avoiding behavior in poor agrarian economies. Specifically, research over the last two decades has lent support to the following propositions.

(a) Many apparently odd institutions which reduce incentives to supply effort or investment are actually sensible compromises; some efficiency is given up in the interest of reducing/sharing risk. Efforts to change such arrangements may simply force them to go underground.

Examples: Sharecropping, land fragmentation in rural India, "attached labor" in South Asia.

(b) Carefully designed LRJ reforms can lead to substantial gains by expanding markets and improving incentives.

Example: In poor agrarian economies full-fledged private property rights in land (which grant an individual the right to use, sell, or mortgage) may not exist. This can reduce the farmer's ability to raise loans, since she/he cannot then use the land as collateral. Moreover, the farmer will have less incentive to invest on a plot unless she/he is certain of obtaining long-term access. Consequently, international organizations have initiated programs of land titling. Gershon Feder of the World Bank has shown that in Thailand such programs have led to substantial productivity increases.[6]

(c) However, for several reasons, rural communities are often uneasy about reforms.

(1) Powerful vested interests can manipulate the reform process in their favor.

Example: Rich farmers may be able to manipulate records and obtain titles to more than their fair share of land[7].

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[5] Quoted in James C. Scott, The Moral Economy of the Peasant (New Haven: Yale University Press, 1976).

[6] "The Economics of Land and Titling in Thailand" in K. Hoff et al eds. The Economics of Rural Organization (New York: Oxford University Press, 1993).

[7] Gershon Feder and David Feeny, "The Theory of Land Tenure and Property Rights", in K. Hoff et al eds. The Economics of Rural Organization.

goods, the reality may not operate in that fashion.[8] One factor to consider in deciding what reform to support is the conclusion of the analysis described here.

Both theory and experience suggest that governments are not well suited to provide private goods, but can be efficient providers of public goods. In societies in which LRJ functions operate poorly, government power, often exercised through various LRJ institutions, becomes a mechanism for taking private goods for ruling elites, corrupt officials or other narrow interests.

What are public goods and how are they distinguished from private goods? The answer to this question will permit us to think about the nature of particular LRJ reforms more clearly.

- Private goods are often described as exhibiting the characteristics of rivalry and exclusion.
- Rivalry addresses the question: Does my use of a particular good preclude its use by others?
- Exclusion addresses the question: Is it possible to exclude others from enjoying the benefits of the good?

Several examples will illustrate what we mean when we say that **public goods** exhibit **non-rivalry** and **non-exclusivity**, while private goods exhibit both rivalry and exclusivity.

The most common examples of public goods are national defense or a highway. On the other hand, an apple is a private good because my consumption precludes anyone else from eating it. Further, it is easy for me to exclude others from eating my apple.

A constitution or a law are both normally public goods. A good constitution offers rights and rules which everyone can enjoy. The enjoyment by one does not reduce the enjoyment by another. Further it is difficult to exclude some people from the benefits of a good law or good constitution. It is assumed here that AID's mission, at least in the area of LRJ reform, is to create public goods, not LRJ institutions that have characteristics of private goods.

Aren't all laws or regulations essentially public goods? Whole volumes of special interest legislation in the United States reflect our own confused experience, revealing that this problem is not completely understood among US policy makers. There are dozens of examples of government regulating, controlling, diminishing the value of private property in some way. Using some public interest rationale, US legislators have given industries the power to fix prices, to

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[8] For a country-specific discussion of this topic see Charles Cadwell, "Protection of Property Rights and Regional Constitutions of the Russian Federation," prepared for a workshop on regional constitutions sponsored by the President's Analytical Center of the Russian Federation and IRIS on March 10-14, 1995.

Among more general legal or regulatory developments, the scope of intended beneficiaries may effect our thinking about how "public" are the benefits. The quality of the implementing bureaucracy may also be important. For example, legal reform to simplify licensing for foreign investment may deliver benefits to only a narrow group of firms; if the licensing bureaucracy is corrupt such reforms may simply focus the location of bribe taking. Should AID resources instead be used to eliminate or simplify licensing for all firms? For small firms? Would the simplification for foreign investors simply create private goods for officials (bribes) and a small number of firms (those seeking to avoid the taxes or other permitting requirements imposed on others)?

At the same time, there may be reforms which are narrow in terms of sector applicability (such as privatization of agricultural processing capacity). Is privatization such an LRJ reform? Individual privatization transactions are obviously not. The whole point is to create private ownership. However, privatization processes are. Does the process proposed (either as law or a decree of some sort) create a public or a private good? Assuming that the process is, at least formally, an open one, it is unlikely to be characterized by rivalry (use by one precludes use by another). On the other hand, the operation of the process may be such that it is possible for insiders or officials to exclude others from participation--turning a public good, the legal processes for privatizing state property, into a private one. If closed policy processes permit participation only by narrow interests (and are therefore more likely to create private goods--either exception from regulatory coverage or special access to an LRJ institution) should AID consider the characteristics of reform proponents in deciding what to work on?

This is not to suggest that development of sector-specific LRJ reforms are, by nature, less desirable. For example, it may be easier to establish less arbitrary commercial courts or special function courts to decide certain kinds of disputes than it would be to reform fundamental rules regarding the independence of the judiciary. Rather the framework of "public" or "private goods suggests that we examine the design and likely operation of the proposed reform in light of the ideas of rivalry and exclusion.

Beyond this, it may also be relevant to consider the nature of likely beneficiaries--how will poor people be affected, for example. This factor is not necessarily informed by consideration of public or private goods.

Thus the independence of the judiciary, the existence of working and capable courts and a shared understanding among all policy makers of the implications of ideas such as the relative appropriateness of government provision of private or public goods, are the foundations for effective protection of property, and the economic growth that comes with it.

The considerations which this discussion suggests for donors contemplating LRJ reforms are many. They include the following:

-- Prioritization of reforms is predominantly based on the most pressing needs of each country. Some policies will be important to implement first because of underlying economic conditions.

So, are there any general lessons on which particular policies are in which particular sequence? There are a few which are quite obvious:

- Getting inflation down to reasonable levels is pre-requisite for other reform actions in many situations.

- Liberalizing internal markets needs to be accomplished before external markets can be liberalized.

- Attacking the worst policies first (the simplest example of this is reducing the highest tariffs first while leaving lower tariffs to be dealt with later) is logical and most cost effective.

- Liberalizing the flow of goods in international trade needs to be accomplished before liberalizing financial flows.

Even though there are not really many definitive rules saying which policies must go together and in what order, there are general lessons on issues of process that can be offered. These are:

- Institutional push or institutional pull?

Institutions are supposed to be in the service of the economic actors in a country or policy situation. Thus the actual needs of economic actors are central to institutional development and implementation. What those actors actually need is highly contingent on the existing economic system and the configuration of institutions within it--i.e., the system that we are interested in reforming. It is seldom possible to determine this context--actors, needs, economic system, institutional configuration within it--a priori. That is, a detailed assessment of each specific situation is usually required to determine the needs of economic actors, the extent and functioning of existing institutions, and what institutional arrangements are most appropriate to address unmet needs.

Put another way, the creation of institutional arrangements is most appropriate when it is demand induced--when the needs of economic actors shape and guide the use of economic and related institutions. The state--legislation, regulations, enforcement--cannot get too far ahead of the market in creating and implementing institutional arrangements. Arrangements that actors are not ready to use (do not "need") will lie moribund.

SESSION THREE: How Should AID Do LRJ Reform Assistance?

1. Assessing the LRJ Environment and Potential Areas of Assistance

AID, in working with private sector and agribusiness activities, designs programs and projects to increase economic growth and firm and family incomes. In these specific, mostly sectoral program and project designs, cross-cutting issues and constraints--such as specific aspects of the legal, regulatory and judicial environment--are considered. However, they are seldom given a prominent place in the final design of AID's specific programs or projects. In fact, the sectoral administrative structure and project formats evolved by AID and many other donors diminishes the priority given to such issues which usually, by definition, transcend specific sectors.

However, AID does its job with respect to the LRJ environment in several ways. Its strategic work, at the country level, incorporates comprehensive aspects of the overall legal and institutional framework. Partial views of the same framework arise from AID's implementation of fundamental policy changes in specific areas. Sector specific LRJ analyses can be undertaken as part of sectoral strategy or program and project design efforts.

The starting place for LRJ consideration is the knowledge that donors--e.g., the World Bank, AID, and others--have found, through experience, that law plays a significant role in fostering economic development. Thus, as it launches efforts to foster private sector development and increase agribusiness growth, AID can productively determine how the existing legal framework will facilitate or impede such efforts and what actions may be needed to change the legal framework so that it effectively supports the development and growth objectives being sought.

Donors such as the World Bank have found that diagnostic reviews and studies of the LRJ environment in countries where legal reform is needed have been beneficial to those countries. Diagnostic reviews, especially those that fully involve host country officials and experts, help ensure that LRJ reforms are timely and responsive to the needs of the country.[9] These assessments may slow project initiation but they seem to make them more effective. They can be carried out for projects, sectors or the country as a whole.

Example: AID, in Cambodia, is currently undertaking a country-wide assessment aimed at determining the need for extensive reform in the democracy and governance, economic and LRJ areas. This broad scale approach to reform is important in Cambodia where

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[9]William E. Kovacic, "Designing and Implementing Competition and Consumer Protection Reforms in Transitional Economies: Perspectives from Mongolia, Nepal, Ukraine, and Zimbabwe." Paper prepared for the Depaul Law Review Symposium on "Cultural Conceptions of Competition: Antitrust in the 1990's", February 3, 1995, Chicago, IL.

However, since the LRJ environment is omnipresent it must be dealt with directly or by default in fashioning and undertaking development activities. Dealing with it effectively involves project and higher level considerations--Is some LRJ reform essential for development success? For project success? Can this reform be achieved within the envelope of a specific substantive--e.g., agribusiness--project alone? What is necessary to deal with needed reforms beyond the purview of the project? Is there need for a separate effort involving broader reform--either to benefit this single project or to enhance the LRJ environment for all development efforts? Must this broader activity precede desired project initiatives?

There is no single answer to whether LRJ issues should be dealt with as parts of other projects or as a separate endeavor.[11] Countries in which substantial political and economic changes have occurred require major transformation of their LJR environment too. LRJ reform in such cases usually requires its own specific project focus. Other countries which have large bodies of law and regulations set down in support of a market economy may require less wholesale LRJ reform. Their reform needs may be more specialized--e.g., competition policy, more cost effective alternative dispute resolution, improved regulations. The process aspects of these countries' legal systems also often need improvement. Some of these elements of LRJ reform can and should be considered as part of other programs or projects.

AID must consider interesting and substantial trade-offs in deciding on the importance and extent of LRJ environment and issues assessment efforts. Principal trade-offs in this portion of LRJ activity are:

- What significance should be given to LRJ as an area of focus unto itself vs. as a part of other activities?

- What is the importance of understanding the LRJ environment and LRJ issues vs. understanding other key issues? How far should this understanding extend--depth of analysis undertaken to understand what happens and why with LRJ behavior, linkages between LRJ arrangements and parameters of other development efforts?

- What impact does significant LRJ assessment have on the timeliness of AID's broader strategy and specific projects in areas other than LRJ?

- How does the interdisciplinary nature of LRJ assessment affect the identification, design and implementation of AID strategic, programmatic and project efforts?

- Do the anticipated and desired end results of LRJ assessment efforts at the strategic, program and project level justify the opportunity costs of such activities?

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[11] IBRD. The World Bank and Legal Technical Assistance. pp. 11-12.

content of reform in meetings, surveys, and news reports of various kinds helps garner opinions about the reforms, expands participation in them and shapes and builds support for the reforms finally put forward. Community support also increases via its specific participation in creating the reforms--thus more closely adjusting the reforms to the needs and desires of the community.

Broad community support for reforms is needed to achieve sustainable impact. Legal reform is not confined to the legal profession, to legislators or regulators alone. Sustainable reforms are likely only if a broad segment of the community impacted by them understand and accept them.

As with LRJ assessment, AID faces trade-offs in deciding how to deal with the participation aspects of LRJ reform. Principal trade-offs in this portion of LRJ activity are:

- What role should participation in LRJ reforms play in their design and implementation by AID?

- Broad participation in LRJ reforms contributes to some objectives of AID and others involved in them but detracts from others. For example, it extends the time needed to craft reforms and implement them directly or as part of other projects, thus slowing the development process. Broad participation can make the cost of defining and approving reforms greater. It can give those interested in maintaining the status quo a prominent place in the reform process. Participation may also enable opposition to planned or desired reforms to mobilize. In each LRJ reform situation, AID must weigh the pros and cons of particular participation forms and levels.

- There is substantial linkage between participation and the substance of LRJ reforms. Expert participation only, for example, may lead to an optimum technical reform package. Broad scale public participation may dramatically water down the reform substance generated and accepted. AID must trade off its desired substantive reform result and the potential sustainability of that result in selecting participation modes for specific LRJ reform efforts.

- Well planned and funded education for reform is often a step child of the reform process. AID must determine its importance for long-term reform sustainability and incorporate educational activities into reform efforts at an appropriate level.

- Once the AID- or other donor-supported technical assistance departs, who understands and carries forward the implementation?

3. Measuring Success

To achieve as well as measure LRJ success, specific goals for LRJ interventions need to be chosen. What are appropriate goals? Identifying and selecting high order goals for a society

the same as outputs by definition--when carefully specified are not within the control of the project or program itself. Rather, they are actions, activities or events (not fostered by AID's efforts) motivated and powered volitionally by specified individuals or organizations. These EOPS--basically behavioral changes by individuals or organizations that do not depend upon the project per se--deserve the closest attention of AID program and project designers and evaluators. When properly formulated and achieved, EOPS provide clear indication of LRJ success--measurable, sustainable, and adequate to achieve the desired purpose of the effort undertaken. This behavioral change is the "development" we seek and what we want most to evaluate.

AID itself has designed and implemented many strategies and projects that involve an improved LRJ environment or which address specific LRJ issues. Typical program outcomes in these efforts are:

- "A more favorable legal and regulatory environment conducive to increased private sector investment";
- "Improve regulatory policies and practices";
- "Improved policy and regulatory environment conducive to market efficiency in selected areas".

These program outcomes are not always companioned by performance indicators that illustrate what development practitioners want to know--namely, the behavioral changes that can be documented to illustrate outcome achievement and the sustainability of the endeavor. Many indicators are in the form of: "Enabling business legislation enacted" or "Improvement in the ability of the tax authority to enforce tax regulations." Indicators must be sharpened to illustrate specific actions measurable in terms of economic (or other) effects. These economic effects require certain things to be implemented--e.g., improved LRJ practices must be in use and shown to contribute to desired economic outcomes. Whether these indicators are specifically behavioral or physical (e.g., documentation of human actions or of yield increases, expanded loans, or other factors illustrating the desired behavioral change) they must be caused by or linked directly to the changes in incentives from the LRJ reforms being implemented.

LRJ activities, whether undertaken as stand alone efforts or as part of other projects, benefit from interim goals and measures. Monitoring progress, for example, is important in every donor assisted effort. Monitoring is especially important for LRJ projects because they so frequently cross-cut sectors and require cooperation across public and private sector entities. Close monitoring, using agreed upon indicators, facilitates coordination and support from the different entities involved in such efforts. While indicators can be established for various aspects of LRJ activities--e.g., input, output or purpose related indicators--the most important ones are those that shed light on purpose level progress. Indicators to monitor are:

- Are relevant actors participating in activities aimed at producing the desired EOPS--e.g., business persons attending joint venture formation sessions, private

frequently involves more time, cost and interdisciplinary involvement that AID makes available for evaluation, especially at the project level. AID must trade off financial and administrative costs and their associated substantive and procedural changes against its proven evaluation procedures.

- Evaluation of LRJ interventions assumes knowledge by those involved of the linkages between LRJ issues and other substantive objectives sought. To achieve a satisfactory state of knowledge about these linkages at the working level will require a long-term commitment by AID to education and training of its own staff, a commitment that will reduce resources and time of field staff to absorb or work with other concerns.

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BIOGRAPHICAL DATA
FINANCIAL SECTOR DEVELOPMENT

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COMPENDIUM OF EVALUATION FINDINGS
C D I E

EXIT CHEAP CREDIT

Subsidized and (essentially the same) directed credit have long been favored as a way to achieve economic efficie and redistribute income to the poor. But in practice cheap credit rarely, if ever, achieves those ends. Instead, it o worsens the conditions it seeks to improve. A better course is to move toward financial liberalization, letting cred markets reach their own equilibrium without government intervention.

Background

From the 1950s until recent years, developing-country governments and international donors channeled cheap credit toward sectors or activities thought to promote development—generally, agriculture and small enterprises. Governments and donors justified the subsidized credit on grounds of economic efficiency and more equitable income distribution.

Credit markets, the argument went, invariably favor large, well-established concerns. That shuts out the small borrower and reinforces the concentration of power and wealth—a symptom of market failure. Informal financial institutions—pawnbrokers, for example—do exist, but their volume of lending is too small and costly. Accordingly, existing financial systems are inadequate, and government intervention is needed.

Thus, to modernize agriculture and spur industrial growth, governments undertook to make cheap credit available to small farmers and microentrepreneurs. To effect the subsidization, they used three main tools. One was the imposition of *lending requirements* on banks. Such requirements obligate lending institutions to allocate given proportions of their loan portfolios (or even absolute amounts) to specific sectors.

Another mechanism, frequently supported by international donors, was *refinance schemes*. Through these schemes banks borrow funds from central banks for specific uses at significantly lower rates than the banks would ordinarily charge. The third, *interest rate subsidies* were probably the most common tool. Such subsidies mean that governments specify below-market interest rates for specific lines of credit.

The Record

The goals of intervention were well intentioned, bu subsidies, for the most part, have not worked. One fai has been lack of sustainability. Lending institutions se to provide capital to the target group could not sur without the concessional aid provided by donors. Inte subsidies for money *borrowed* pushed down rates money *deposited*. Savers had little incentive to put t money into low-yield accounts. The flow of funds credit purposes turned into a trickle.

More fundamentally, subsidized credit often misse mark. Despite their reason for being, subsidized len institutions naturally sought to lower their risk. T continued to gravitate toward larger, ostensibly r creditworthy borrowers. Income *was* redistributed—regressively. A study of subsidies to Costa Rican far illustrates. The study found that some 80 percen subsidized agricultural loans in 1974 went to large far who thereby captured most of the subsidy.

Even when small farmers did actually receive cheap cre the outcome was rarely as beneficial as expected. The i was that subsidized credit would allow farmers to bec more productive through investment in new technol Often they did not. Other factors not anticipated thwa success. Such factors included lack of supporting serv (such as maintenance and effective marketing) inadequate fertilizer and storage.

Another important point was that good farmers were to increase their output profitably while paying ma rates of interest. Many such farmers were already pa high market rates to local moneylenders. The s observations applied to microentrepreneurs. Conclus

ıe technology could not cover the cost of capital, the estment in such technology was not justified.

what about the contention that targeted and subsidized dit has been used to good avail elsewhere—most spicuously, the United States and the high-performance nomies of East Asia? True, these countries have at es provided limited amounts of cheap credit. A growing sensus, however, suggests that these policies have been levant or tangential to sustained economic growth. In United States, subsidization (for example, to farms ıugh the Department of Agriculture and to small inesses through the Small Business Administration) is ı as regressive; its costs are deemed too high. As for the t Asian countries, their success probably owes more to r stability, their development of human capital, and r reliance on competitive markets than to government rvention.

ıort, the predominant record with subsidized or targeted lit has been equivocal at best. Many developing-country ernments and their international donors have been ting their credit policies away from cheap credit and ard more market-driven determinants. To be sure, a ;ipitate plunge from concessional credit into the rough- -tumble of fully competitive money markets can cause ɔwn dislocations (as witness Argentina, Chile, and guay in the mid-1970s). The issue seems to be how to sit from one to the other without exacerbating financial ability and giving way to uncertainty.

ssons and Implications

rojects that lend funds at free-market rates and pay ·ket rates to savers can be financially viable and ɔessful. By contrast, lenders that provide cheap capital neither. They can continue operations only so long as ɔrs continue to provide concessional aid. Projects that ɔort such lenders have little development impact because do not contribute to the creation of sustainable tutions needed by farmers, microentrepreneurs, and ɔoor.

y and large, the poor do not benefit the most from ɔessional credit projects. Targeted credit does not h its intended beneficiaries and tends to redistribute me regressively.

• **Farmers can increase their output profitably while paying market rates of interest.** Credit has not been the major constraint to development it was often presumed to be. Moreover, few borrowers who benefited from subsidized credit have been later able to become clients of commercial banks. The important element is *access* to credit institutions rather than *price* of credit.

• **Subsidizing interest rates hinders mobilization of savings.** Artificially low interest rates on savings discourage potential savers and thus depress the amount of funds available for borrowers.

• **The best approach to correcting market failure is to address it head-on through reforming economic policy and institutions.** Likewise, direct transfers are the best way to redistribute income. A strong government role in financial markets is appropriate, but that role should not be in the provision of cheap credit. Rather, the government's role is to help markets work better by redressing information imperfections, developing a legal framework, and providing proper regulation, supervision, and enforcement.

• **Nongovernmental organizations and private voluntary organizations can have advantages in lending to small enterprises.** To succeed, though, they must act as lending institutions rather than as philanthropic agencies. That is, they need to use risk-reducing technologies, charge cost-covering interest rates on loans, keep loan defaults and arrears low, and be able to mobilize voluntary savings for the funds they need. They should aim at financial self-sustainability within a relatively short time.

• **Donors can complement their efforts at the macroeconomic level with programs to help develop financial services that reach efficient small entrepreneurs and the poor.** Priority should go to supporting development of commercially viable, nontargeted financial institutions that can meet the liquidity demands of small entrepreneurs. Such programs should proceed cautiously, however, expanding only as successes warrant. They should aim at having the supported institutions eventually offer both credit and deposit services on a commercial basis. Programs should become financially self-sustainable in the short term.

For further information, please contact CDIE's information clearinghouse by phone at (703)351-4006 or by fax at (703)351-4039. PN-ABS-526

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COMPENDIUM OF EVALUATION FINDINGS

MAXIMIZING THE OUTREACH OF MICROENTERPRISE FINANCE

Providing financial services to the very poor not only makes development sense, it can be profitable. A review of 1 of the most effective microenterprise finance programs in 9 developing countries revealed that the formula for success is charging interest rates high enough to cover costs and keeping salaries low. Donor dollars stretch furth if they're invested in institutions with the potential and commitment to become self-sufficient and reach large numbers of poor people.

Background

Microenterprise development is a prominent part of USAID's economic strategy for reaching the poor. During FY1995, USAID has allocated $140 million for microenterprise funding. Conventional wisdom holds that microenterprise finance is desirable because it helps poor people, but is too costly to be profitable. USAID's Center for Development Information and Evaluation (CDIE) recently completed an evaluation of successful microenterprise finance programs that found this view wrong.

From rural Bangladesh to urban Bolivia, with a range of clientele and average outstanding loans as low as $32, microfinance institutions were able to cover day-to-day costs and reach large numbers of poor people. Five of the 11 institutions studied were fully profitable, generating inflation-adjusted positive returns on assets. Five others covered their operating costs without outside assistance.

Past efforts using subsidized directed credit often failed because lending institutions became decapitalized, funds didn't reach intended groups, and programs distorted financial markets. The programs studied learned from past mistakes. They are charging interest rates and fees that cover the costs of delivering financial services, and they are embracing financial self-sufficiency as a primary goal.

The purpose of the CDIE study was to identify elements critical to the success of microenterprise finance programs and to determine performance standards. It assessed performance from two perspectives: *outreach*, or access by the very poor, and *financial sustainability*.

The study used the criteria of loan size (a rough proxy for client income level), number of borrowers (a proxy for scale), and reputation for financial strength. Instituti studied were the Unit Desa System of the Bank Rak Indonesia (BRI), Lembagan Perkreditan Desas of Indone Badan Kredit Desa of Indonesia (BKD), La Asociac Dominicana para el Desarrollo de la Mujer of the Domini Republic (ADOPEM), Actuar Bogotá of Colomb Fundación Integral Campesina of Costa Rica (FINC Banco Solidário S.A. of Bolivia (BancoSol), Kenya Ru Enterprise Programme (K-REP), Agence de Credit p l'Entreprise Privée of Senegal (ACEP), Bankin Ra Karkara (BRK) of CARE in Niger, and the Grameen Ba of Bangladesh.

Findings

Significant outreach to the poor, including the ve poor, can be achieved. Clients of these institutions w typically very small businesses without access to forr financial services, and many borrowers were wom Average loans outstanding were $200—$400. Scale, ratl than exclusive focus on the poor, determines whether very poor are reached. Mixed programs that serve a rar of clients have successfully reached large numbers of very poor.

Operational efficiency can be achieved consistently a range of geographic settings. Ten of the 11 institutic were operationally efficient, covering the cost of day-day operations, including salaries and other administrati costs, from interest and fees. Five were fully profitable program revenues covered both operating costs and financial costs of obtaining funds on a commercial ba

Programs are reaching large numbers of poor peop Institutions in Indonesia and Bangladesh have achiev

:rage on a national scale. The Grameen Bank covers ɔst half the villages in Bangladesh, and the BRI's Unit a system has more than 2 million borrowers and 12 ion savers.

grams are rapidly increasing their client base. Clients increasing by 25 percent to 100 percent a year in grams assessed. Actuar Bogotá in Colombia, for ınce, increased from 7,000 clients in 1990 to 54,000 in 3. Programs have achieved this by maintaining financial ›ility—controlling bad loans, holding down inistrative costs, and developing a rapidly growing of financial resources.

nt demand for these programs is strong. That is ent in the growth in the number of borrowers, the loan folio and, in some cases, savings. In addition, these rams experience low delinquency on loans, although :are charging interest rates significantly above inflation.

effective real rate of interest charged is a key factor ·lf-sufficiency. In 1994, Actuar Bogotá, for instance, ged 71 percent interest on loans, which, with inflation ' percent, was the highest real effective interest rate of group. It achieved a 4.9 percent real return on total ts. In contrast, K-REP in Kenya, where inflation was ercent, charged 38 percent interest, which translated a real interest rate of negative 9 percent. K-REP also the lowest average return on assets—negative 18.5 ent, although it did cover operational costs.

relationship of the average salary of microfinance gram employees to the gross national product per ta is also a significant factor in financial success. rams that hired community staff at modest salaries a significant cost advantage and greater likelihood of eving profitability than those that arose from donor ects that stressed outreach and ignored financial ility. Those institutions tended to hire highly educated, ively expensive employees.

grams can achieve substantial outreach to the poor be financially viable. These "frontier" programs, :h made a decision to be self-sufficient, brought their structures in line with spreads available in local :ets and adapted credit methodologies to market ands to achieve self-sufficiency.

commendations

ess organizations' commitment to achieving ational efficiency and ultimately full self-sufficiency within a reasonable period. Management commitment should be visible in concrete targets and credible plans. Indicators of effective performance include

- *Operational efficiency.* The organization should be working to develop an efficient, low-cost credit methodology; to control delinquency; and to rationalize its cost structure, particularly salaries.

- *Interest rate and fee policy.* Costs of services should be adjusted for inflation and priced to support financial viability.

- *Reporting standards.* Financial reporting should meet private sector standards and management should use the information effectively.

Invest in institutions with the potential to reach full self-sufficiency and significant outreach. Provide support that fosters financial self-sufficiency, keeping in mind that it may require 5 to 10 years and substantial support. To determine whether an organization needs support, and if so, what type, find out what hurdles the program has to overcome to reach self-sufficiency:

- *Programs in start-up phase.* **Concentrate on helping programs achieve operational efficiency, including establishing a lending methodology and operational strategy for service delivery.** At this stage, donors often provide start-up capital. However, start-ups should be granted for a short time period—one project cycle. If efficiency is not achieved, cease support.

- *Programs achieving operational efficiency.* **Focus on institutions committed to tapping other sources of funds, with concrete targets and plans.** Place greater emphasis on improving financial performance reporting, meeting legal requirements to become a licensed financial intermediary or to gain access to commercial funding sources, and mobilizing savings to enhance institutional development.

- *Top-performing programs.* **Consider helping in the transition to full independence.** At this stage, stress mobilizing deposits, increasing capitalization through retained earnings or equity investment, and improving supervisory standards for microenterprise finance and strengthening policy dialogue with the government.

For further information, please contact CDIE's information clearinghouse by phone at (703)351-4006 or by fax at (703)351-4039. PN-ABS-530.

Viewpoint

The World Bank April 1995

Note No. 43

The Power of Collateral

How problems in securing transactions limit private credit for movable property

Heywood Fleisig

The first question any private loan officer is taught to ask is, "How do I get my money back?" Borrowers have offered two broad answers to that question: giving an unsecured promise to pay, and offering collateral that can be seized and sold by the lender if the borrower fails to pay. This Note discusses the second type of borrowing. Drawing on several World Bank-supported projects, it sets out how legal and regulatory constraints on using movable property as collateral limit access to credit in many client countries. The problem is potentially severe. In industrial countries, movable property—livestock, machines, inventory, equipment, standing crops—can represent as much as a third of the capital stock and half of investment. Where borrowers cannot use this property as collateral for loans, they must pay higher unsecured interest rates. Consequently, they hold less capital per worker and produce less output per person. In Bolivia, the loss in GDP from an inadequate framework for secured transactions is estimated at between 5 percent and 10 percent.

Collateral and lending

Why does a lender believe a borrower will pay? One way for the borrower to prove sincerity is to offer collateral: to place property at risk of being seized if the borrower fails to pay. The power of collateral to increase the amount that a creditor is willing to offer is apparent in most lending institutions. For example, the Bank-Fund Federal Credit Union offers loans of 6 months' salary with only a signature, 12 months' salary against a car or other movable property, and 4 years' salary against a house or other real estate. In these examples, the borrower, loan officer, loan committee, and lending institution are the same; only the collateral differs. In addition, the power of collateral to reduce risk overrides the increase in the term of the loan—the 6-month unsecured loan will have a higher rate than the 4-year car loan; the car loan will have a higher interest rate than the 15- or 30-year mortgage interest rate. These practices are not peculiar to the Credit Union. Private lenders in Bolivia, Bulgaria, or Boston behave the same way.

Barriers to using movable property as collateral

Despite the importance of collateral in enabling private lenders to offer larger loans with less risk and therefore at lower interest rates, legal and regulatory barriers make movable property nearly useless as collateral in many Bank client countries. The barriers arise in the following way. When a lender offers a loan against collateral offered by the borrower, the lender is said to take a *security interest* in the collateral. Three legal and regulatory issues are of key economic importance in limiting security interests in movable property:

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- The *creation* of security interests
- The *perfection* of security interests
- The *enforcement* of security interests.

These are abstract notions that are easiest to understand with an example. Consider cattle in Uruguay and Kansas. These places have similar topographies, well-educated populations, and advanced agricultural systems that place them among the world's most competitive agricultural exporters. In Uruguay, no private bank would accept cattle as collateral for a loan. By contrast, in Kansas, cattle are considered the best collateral for a loan. This is the view not only of private banks, but also of bank examiners. In Kansas, good banks have "cattle paper," and risky banks have "exposure to real estate." But in Uruguay, where banks also are closely regulated, the bank examiners prefer that banks take real estate as collateral for secured loans. How can such a difference exist?

In Uruguay, no private bank would accept cattle as collateral for a loan. By contrast, in Kansas, cattle are considered the best collateral for a loan.

Creating security interests

First, it is difficult to create a security interest in cattle in Uruguay. Suppose a bank lends against 100 cattle worth $200,000. Uruguayan law calls for enumeration of the property—an easy "pledge" against cattle might name the cattle: Bessie, Elmer, . . . —or identify them by tattoo. But this specific identification makes monitoring the loan expensive for the bank because the loan officer must ensure that his bank's specified 100 cattle are in the farmer's field—a different herd of 100 cattle would not secure the loan. The bank might try to get around this by writing a general pledge contract against, say, 100 calves—but in a year the calves would become cows, and the legal security of the contract would be questionable. By contrast, in the United States or Canada a binding agreement can be written secured by a *floating security interest* in "$200,000 in cattle."

Moreover, in Uruguay, the bank would have to worry that the farmer would sell the cattle without notifying the bank. The U.S. or Canadian bank, however, would automatically get a *continuing security interest* in the proceeds of the sale and could automatically attach them —whether they had been put into a bank account or a tractor.

Perfecting security interests

Second, it is difficult to perfect a security interest in Uruguay. To have confidence that collateral has value, the lender must be sure that no prior superior claims to the collateral exist. But how can the lender even be sure that the collateral belongs to the person possessing it? Suppose the cattle had already secured a loan or had been purchased on credit? In Uruguay, it is extremely difficult to search the records for prior claims against collateral. The lender must know the date of a prior agreement and cannot search by the name of the borrower or the description of the pledged asset. It is even more difficult in Bolivia, where the pledges are filed chronologically and the entire registry must be searched to discover a prior pledge. In Bulgaria, no separate registry for such security interests exists, and a search for prior claims would have to extend to each notarial registry in the country. In the United States and Canada, however, registries are public and easily searched, and it is not uncommon for all commercial agents in an area to know the size and sequence of the security interests in a farmer's livestock.

Enforcing security interests

Finally, it is difficult to repossess and sell the pledged collateral in Uruguay. Repossessing and selling collateral requires six months to

two years. Unlike in other systems, private parties cannot contract to repossess and sell collateral without a lengthy legal process. Neither can nonjudicial government officials. Nor are parties permitted to attach other property of the borrower, such as the proceeds of the sale of collateral. In Kansas, by contrast, cattle offered as collateral may be repossessed and sold in as little as one to five days. Loans represent a high percentage of the collateral's market value, so interest rates charged range between the prime rate and the home mortgage rates.

What to do?

First, consider some attempts to deal with the problem that have major shortcomings:

Make the loans anyway. Since no private bank will do this on its own, some kind of loan guarantee system will be required. Alternatively, a state-owned institution could make these loans. However, two problems arise with these options. First, the guarantee fund or the institution that makes these loans is going to have the same trouble collecting the loans as the private bank. Second, because borrowers will know that these loans are hard to collect there is a greater chance the loans will not be put to good use. The result is a money-losing government program without much effect on productivity and therefore a program that is subject to increasing political attack as the credit line goes into default and potential borrowers wait longer and longer for a chance to get ever-dwindling numbers of cheap loans.

Ignore the law. Some lenders simply seize and sell the collateral for a loan despite the absence of any legal sanction for these actions. Some leasing operations disguise the transaction, pretending that a seizure is not a repossession. Some nongovernmental organization lenders take the debtor's property with the passive consent or active participation of the police. In several countries, men with guns are dispatched to repossess and sell large and valuable pieces of machinery sold on credit.

Abuse the law. In some countries, lenders use a postdated check to convert nonpayment into a criminal offense. In Bolivia, for example, a lender will demand a postdated check in the amount of the loan and the interest. On the date that the loan is due, the lender requests payment. If the borrower cannot pay, the lender deposits the check and gets it back from the bank marked "check without funds." The lender brings the marked check to the police, who

. . . in Uruguay . . . repossessing and selling collateral requires six months to two years. . . . In Kansas, by contrast, cattle offered as collateral may be repossessed and sold in as little as one to five days.

arrest the borrower for writing a check without funds, a criminal act in Bolivia. The borrower spends about a week in the downtown jail, trying to raise the money through friends and relatives. If the borrower fails, conviction is virtually certain. The sentence for writing bad checks now is about four years. But before a legal reform in 1994, the judge also would set a civil penalty equal to the value of the bad check—and borrowers would stay in prison until they paid their debts. In La Paz, half the prison inmates are serving sentences for non-drug offenses; of that half, half are there for postdated checks. All of those interviewed in the course of the World Bank study were businesspeople. Many of them are single women without family connections to raise funds to cover the bad check. And many have their children living in the jail with them.

What's wrong with these solutions? To paraphrase, they are not only wrong, they are inadvisable. Formal sector lenders cannot afford to use illegal collection techniques because the

risk of civil and criminal damages is too great. Consequently, the vast resources of the formal sector are not tapped for credit. Movable property remains the domain of expensive informal sector methods. Why expensive? Expensive to individuals, because the subjective cost to a businessman of going to jail for a business miscalculation will tend to reserve these loans for only the highest-return operations. And expensive to society, because incarcerating risk-taking businesspeople is a dubious development strategy.

Better solutions

In the Bank's operations in Argentina, Bolivia, Bulgaria, and Uruguay, the following possible solutions have emerged for government consideration:

Creation of security interests: change the law to permit the creation of a wide variety of security interests in a wide variety of property.

Perfection of security interests: make public the records of the registries, restructure the public registries, change their incentives by introducing competition among public registries or permitting private registries to compete with public registries.

Enforcement of security interests: change the law to permit private parties to contract for nonjudicial enforcement of debt contracts.

This series is published to share ideas and invite discussion. It covers financial and private sector development as well as industry and energy. The views expressed are those of the authors and are not intended to represent an official statement of Bank policy or strategy.

Comments are welcome. Please call the FPD Note line to leave a message (202-458-1111) or contact Suzanne Smith, editor, Room G8105, The World Bank, 1818 H Street, NW, Washington, D.C., 20433, or Internet address ssmith7@worldbank.org.

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This Note draws on World Bank economic and sector work and lending operations in Argentina, Bolivia, Bulgaria, and Uruguay, undertaken under the broad supervision of Zeljko Bogetic, Mariluz Cortes, Vicente Fretes-Cibils, Jonathan Parker, R. Kyle Peters, Stephen Schonberger, and William Shaw. The work was carried out by a team that included Willem Buiter, Ronald C.C. Cuming, Nuria de la Peña, Ulrich Drobnig, Alejandro Garro, Lance Girton, Boris Kozolchyk, Graciela Rodriguez-Ferrand, Stephen Salant, Harry Sigman, and J.A. Spanogle, as well as many lawyers, economists, and financial specialists in the borrowing member countries. The underlying papers are available from the author.

Heywood Fleisig, Economic Adviser, Private Sector Development Department

Viewpoint

The World Bank April 1995

Note No. 44

The Right to Borrow

Legal and regulatory barriers that limit access to credit by small farms and businesses

Heywood Fleisig

When World Bank staff design credit programs in developing countries, they often find that lenders in the formal banking sector show little interest in small farms and businesses. Although their reluctance to lend is especially great for very small operators, such as artisans, street vendors, and subsistence farmers, surprisingly, it extends even to more substantial operations with several employees. Many explanations for this behavior have been posited, including banks' innate conservatism, the high unit costs of small loans, class differences between bank officers and small borrowers, excessively conservative bank regulation, and excessively loose bank regulation that permits bank lending to related parties, crowding out the smaller, presumably unrelated, borrowers. But another important explanation for this lending behavior lies in the laws, regulations, and institutions of these countries. Though these may often spring from efforts to protect unwary borrowers or the poor, they can instead force borrowers out of the formal banking system and into the hands of the very lenders from whom they were supposed to be protected. This Note, based on the results of Bank analysis, shows how such legal, regulatory, and institutional barriers limit access to credit.

Barriers arising from protecting borrowers

Many countries have specific laws and regulations that are intended to protect borrowers:

Homestead and exempt property provisions

All countries limit the ability of creditors to take property from debtors unable to service their debts. So, for example, no country whose lending laws were analyzed permits a creditor to seize a debtor's shoes or bed. Some countries also set a minimum amount of real estate that is exempt from seizure—the "homestead." This protection has a cost. if the land cannot be taken from the debtor, banks will not accept it as collateral. In a well-supervised banking system, examiners will regard borrowers offering such collateral as unsecured. For such unsecured loans, bank regulations require more capital or provisioning by the bank. That raises the cost of making these loans, and, because they usually are also riskier and smaller, banks find them unprofitable.

Other legal provisions limit the amount or type of movable property that a creditor can take from a debtor—exempt property. For example, the law may contain provisions limiting the

creditor's ability to take tools of trade from the debtor. Unless carefully drafted, such legal provisions can make lenders unwilling to make productive loans to small borrowers. Because the lender knows that the equipment to be purchased—a new sewing machine or wood lathe, for example—will be pooled with the borrower's exempt property, the lender is aware that it cannot be repossessed and sold and will not accept it as collateral for a loan.

Usury laws

Many countries limit the interest rate charged on loans to protect unwary borrowers from unscrupulous lenders. In practice, however, high interest rates are often justifiable. Many of the costs associated with a loan are fixed, and these fixed costs represent a higher percentage of a small loan than of a larger loan. Since operators of small farms and businesses are more likely to want a small loan than are operators of large farms and businesses, private lenders charge higher interest rates to small operators than to larger ones. The lender would ordinarily hope to recover these larger costs with some combination of higher interest rates and an up-front loan processing charge. In addition, the costs of monitoring small, unsecured loans are higher than those of monitoring larger, secured loans. A lender with a small, unsecured loan must regularly inspect the borrower's business premises to be confident that the business is still solid, while secured lenders know that they have the right to take property with some value even if the business is not solid. Finally, the risk associated with small loans that are unsecured can be higher than the risk associated with large loans that are secured. To compensate for the higher costs and risks of small, unsecured loans, private lenders could be expected to charge higher interest rates.

Private lenders do in fact charge high rates on unsecured loans. In Bolivia, for example, where the rate of inflation is less than 10 percent, interest rates amount to as much as 48 percent a year on small, unsecured loans made by nonprofit lenders with access to funds at zero interest. Rates run 70 percent a year on loans by unsubsidized public interest lenders attempting to cover their costs of operation. These rates may seem high and perhaps prompted the 3 percent per month usury limit in Bolivian law. But private borrowers operating small farms and businesses can face even higher implicit interest rates in the course of doing business. A street vendor in La Paz reported being charged 300 bolivianos in cash for a case of crackers or 310 bolivianos if she paid three days in the future—an implicit interest rate of more than 5,000 percent a year on the cost of carrying this part of her inventory.

For such a borrower, obtaining a loan at 4 percent interest per month from a nonprofit lender would result in annual interest savings equivalent to a substantial share of her income. Clearly, a usury law that limits loans to low interest rates just forces poor borrowers into other markets where usury laws are not enforced—thereby increasing the interest charges and making the poor worse off.

Solutions

Change the law to limit the homestead provision to a size of holding that balances protection against seizure with the economic cost of loss of access to loans and the landowner's freedom to contract; limit exempt property protection to clearly defined sets of goods and amounts of money and clearly distinguish between the existing stock of goods and goods newly purchased on credit; replace usury laws with laws requiring the disclosure of true annual interest rates and requiring that loan contracts set out their general implications in clear language.

Barriers that effectively discriminate against the poor

Many laws and regulations not specifically directed at the poor nevertheless have an important impact on them—and can sometimes be discriminatory in effect.

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Limits on using equipment and inventory as collateral

Barriers to using movable property as collateral limit access to credit. This especially penalizes operators of the smallest businesses who have only human capital—their heads, their hands. Typically, they also need to acquire movable capital—tools, transport equipment, merchandise inventories—to perform their work. To purchase this equipment on credit, small operators must be able to make a down payment and have the equipment itself serve as collateral, especially if they have no real estate to offer as collateral. Loans secured only by a personal guarantee often are too small and too expensive to finance productive equipment such as farm machinery, a taxi or microbus, or the inventory of a small store.[1]

Limits on using accounts receivable and loans as collateral

Operators of small farms and businesses get credit from many sources without offering collateral. Equipment dealers may sell them parts and small machines on credit. Dealers in fertilizer, herbicide, and seed may extend credit over the growing season. And wholesalers often extend short-term credit to retailers. These dealers can become essential sources of credit for unsecured borrowers because they get to know their customers well in the course of ordinary, noncredit transactions. Because getting good information about the behavior of these small borrowers is one of the largest expenses in determining their creditworthiness, nonbank creditors often have a large cost advantage over banks in supplying credit to them.

But nonbank businesses face the same difficulties as their customers do in getting access to credit. They typically are unable to use their holdings of movable property—their inventory, their stocks of new and used machines—to secure loans from banks. Limits on the dealer's ability to get credit put limits on the dealer's ability to give credit, breaking the chain of credit that could link the small borrower to the banks. As important in breaking the chain of credit is the difficulty nonbank lenders often have in using the credit they extend to their customers as collateral for loans from banks, either through accounts receivable or chattel paper financing. While formal sector banks may not be interested in making loans of less than $100 to operators of small businesses and farms, they could fund the refinancing of the businesses that make these loans quite lucrative. In the United States and Canada, for example, far smaller loans represented by credit card receipts are bundled together to secure commercial paper flotations that can amount to hundreds of thousands of dollars. When dealers and nonbank lenders can refinance the credit they offer, the supply of such credit expands and its cost falls. But expanding such financing requires a secured transactions law that permits easy, inexpensive public registration of security interests in accounts receivable or in chattel paper, and inexpensive transfer of these accounts if the borrower (the dealer or nonbank lender) defaults. Otherwise, these dealers and nonbank lenders will find it impossible to raise enough money to fund the loans they otherwise could profitably make.

Other legal and regulatory requirements

Other legal and regulatory requirements can discriminate against the poor by limiting their access to credit. Laws intended to protect minors by limiting their ability to sign binding contracts will force the heads of households of many poor families to turn to informal sector lenders. And creditors willing to make such contracts will be hampered in using them to get credit from the legal sector.

A requirement that loan contracts must be in writing and signed by the borrower can create a hardship for poor citizens who are illiterate, who cannot read and write in the language used by the banks, or who are blind.

Solutions

Reform the framework for secured transactions, especially with respect to the cost of transfer-

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ring the accounts of the account debtor, the registration of security interests in those accounts, and the collection of the accounts of the account debtor if the borrower cannot pay the loan secured by those accounts; carefully assess the costs and benefits and the public policy implications of the age of majority; change the law to conform to that cost and benefit calculation; consider alternative forms of contracting, including using fingerprints as signatures and witnesses to cosign as evidence of assent.

Institutional issues

Institutions give force to the law. Sometimes those institutions operate in ways that frustrate the law's intent.

Registries

Many of the lending instruments discussed here require public registration. Public registration is crucial because each lender needs to know whether any prior security interest in the collateral exists—for example, another loan that must be paid first from the proceeds of the sale of the collateral. A $100,000 house might appear to be adequate collateral for a $50,000 loan. But if the house already had a mortgage of $80,000 against it, which would have to be paid before the $50,000 loan, it would not be adequate collateral. A registry system that is open to the public and inexpensive to search makes it easier to determine the priority of security interests and thus the riskiness of a loan. Yet in many countries, registries can be searched only with official permission that is difficult to obtain, and sometimes registries are organized in ways that make a search technically difficult.

Credit information

Operators of small farms or businesses may not own land or movable equipment, but they could still establish a reputation for honesty and timely payment of debts. Their access to credit will expand if they can make their reputations known beyond the small circle of dealers and merchants with whom they deal. A credit reporting system that pools information about borrowers permits the poor to "capitalize" on their reputations by persuading other lenders to lend to them without security. It also reduces the risk in unsecured lending by making credible the threat that a creditor could spoil the reputation of an unsecured borrower who did not pay a debt.

Solutions

Improve state-run registries by restructuring them, decentralizing them and introducing competition, or by privatizing them; regulate public access to credit bureaus so that information collected can be distributed to interested parties; design a legal framework to allow people to challenge inaccuracies in information held by the credit bureau.

Conclusion

Many problems in access to credit arise from defects in the legal, regulatory, and institutional framework for extending credit. Bank projects aimed at building institutions and extending credit lines to enhance access to credit for operators of small farms and businesses will have greater impact when these larger issues are also addressed.

This Note draws on World Bank projects in Bolivia and Bangladesh undertaken under the broad supervision of Vicente Fretes-Cibils, Jonathan Parker, Susannah Knaudt, and Madhur Gautam. The findings represent the work of a team that included Ronald C.C. Cuming, Nuria de la Peña, Ulrich Drobnig, Alejandro Garro, Lance Girton, Graciela Rodriguez-Ferrand, Stephen Salant, Harry Sigman, and John A. Spanogle. Papers describing the projects in greater detail are available from the author.

[1] FPD Note 43 details the legal and regulatory roots of the inability to use movable property as collateral.

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Small and Microenterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries[1]

The purpose of these principles is to establish common standards for donor agencies to apply in supporting broader access to financial services for micro and small enterprises.[2] Such enterprises have historically lacked access to the formal financial system, but the growing success of many institutions provides confidence that access can be provided sustainably in many settings. It has now become possible to identify and agree upon the basic principles that support successful micro-level finance, so that donors can work in concert to ensure that lessons of success are translated to the institutions they support.

The framework for donor support to micro and small enterprise finance centers on two equally important and complementary objectives. First, **outreach** embodies the aim of expanding access to increasing numbers of low-income clients. Second, **sustainability** provides the means to expand and maintain outreach. These concepts underpin the guiding principles described here.

Different types of micro and small enterprise clients have different characteristics and demand different services. Hence it is desirable to encourage a range of institutions that use specialized methods to serve their particular market niches. These can include commercial and development banks, credit unions, mutual or community banks, non-governmental organizations (NGOs), finance companies, cooperatives, savings and credit associations, and other specialized intermediaries. At the same time, however, this document is based on the premise that fundamental principles of finance apply widely and must be observed by all institutions if they are to succeed. Moreover, donors must design their support mechanisms in ways that are consistent with best international practices and long-run development of a sound financial system.

This statement of guiding principles first identifies characteristics donors should seek in selecting institutions to support. It then describes appropriate forms of donor support. An annex lists reporting standards on outreach and financial performance.

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[1] This document is a joint product of the Donor's Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development. It was inspired by and is largely consistent with the recommended standards for support set out by a UN expert group of leading small and microenterprise practitioners convened by Women's World Banking in January 1994. The donor committees adopted the principles in their current form in June 1995, following consultations with key donor agencies involved in small and microfinance. This document is intended for use by project officers in donor and implementing organizations, managers, and policy makers.

[2] Included in the term micro and small enterprises are a wide range of enterprises (industry, transport, commerce, services, agriculture, etc.) ranging in size from part time, seasonal activities of a single person to small, formal enterprises employing several non-family members.

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I. Institutional Performance Standards and Plans

Intermediaries seeking support should be able to demonstrate the following characteristics, either in current operations or through credible plans underpinned by concrete measures. Since institutions are at different stages of development, it may be appropriate in some cases to adopt modified standards for limited support to new or transforming institutions.

A. Institutional Strengths

1. **Institutional culture, structures, capacities, and operating systems** that can support sustained service delivery to a significant and growing number of low income clients. Requirements include a sound governing structure, freedom from political interference, good fit to local context, competent and stable staff, a strong business plan for expansion and sustainability, and mission and vision which create a sense of purpose, ownership, and accountability.

2. **Accurate management information systems** that are actively used to make decisions, motivate performance and provide accountability for funds. Such systems are essential for effective and efficient management.

3. **Operations that manage small transactions efficiently**, with high productivity, as measured by variables such as loans per staff and operating costs as a percentage of average annual portfolio (while maintaining portfolio soundness).

4. **Meaningful reporting standards**. Transparent financial reporting that conforms to international standards and allows prospective funders to evaluate performance adequately. At a minimum, the raw data listed in the Annex should be reported, and institutions should regularly monitor financial condition using appropriate financial ratios derived from such data.

B. Quality of Services and Outreach

1. **Focus on the poor.** Evidence of service to low-income clients, women and men, especially clients lacking access to other financial institutions. The focus need not be exclusive, as mainstream institutions such as banks are encouraged to become providers, but it must entail a distinct commitment to reaching the poor.

2. **Client-appropriate lending.** For example, for micro-level clients, institutions should feature quick, simple and convenient access to small, short-term loans, often short-term, that are renewed or increased based on excellent repayments.

Use of collateral substitutes (e.g., peer guarantees or repayment incentives) or alternative forms of collateral to motivate repayment. Emphasis on character-based lending for smaller loans, with simple cashflow and project appraisal for larger and longer term loans.

3. **Savings services.** Offering savings mobilization services, where legally possible and economically feasible, that facilitate small deposits, convenient collections, safety, and ready access to funds -- either independently or with another institution.

4. **Growth of Outreach.** Making significant progress in expanding client reach and market penetration, demonstrating both strong client response to services offered and competence in service delivery management.

C. Financial Performance

1. **Appropriate pricing policies.** Offering loans at rates sufficient eventually to cover the full costs of efficient lending on a sustainable basis (after a reasonable start-up period), recognizing that poor entrepreneurs are able and willing to pay what it costs an efficient lender to provide sustainable financial services. Interest charges by the retail unit should be set to cover the costs of capital (at the opportunity cost, including inflation), administration, loan losses and a minimum return on equity.[3]

2. **Portfolio quality.** Maintaining a portfolio with arrears low enough that late payments and defaults do not threaten the ongoing viability of the institution. For example, organizations with loans in arrears over 30 days below 10 percent of loans outstanding and annual loan losses under 4 percent of loans outstanding satisfy this condition.

3. **Self-sufficiency.** Steadily reducing dependence on subsidies in order to move toward financial self-sufficiency. Achieving operational efficiency, i.e., covering all administrative costs and loan losses with client revenues within a reasonable time period, given local conditions. International experience shows that successful intermediaries have achieved operational efficiency in three to seven years, and full self-sufficiency, i.e., covering all financing costs at non-subsidized rates within five to ten years.

[3]It should be understood that costs of non-financial assistance provided to entrepreneurs may continue to receive subsidies. However, it is crucial that these costs be separated from the costs of lending operations, so that the financial viability of lending operations can be assessed.

4. **Movement toward financial independence.** Building a solid and growing funding base with clear business plans, backed by operational capacities, that lead to mobilization of commercial funds from depositors and the financial system, and eventually to full independence from donor support.

Financial performance standards apply only to activities that are an integral part of providing financial services. If programs also provide non-financial services, such as business advisory services, health, or education they must account for such services separately from financial services. Standards for financial self-sufficiency do not apply to such services, and defining appropriate standards for non-financial services is beyond the scope of this document.

II. Strategies for Donor Support

Funding based on large, ongoing subsidies with a charity rationale has failed. Such programs have drained resources without becoming sustainable, and have contributed to the mistaken notion that the poor are unbankable. · Funders should provide financial and other support in forms that foster the movement to scale, financial self-sufficiency, and independence from donor support, taking into account the particular characteristics of different types of institutions.

1. **Appropriate uses for grants.**

   - **Institutional development.** Support for institutional development is appropriate at all stages of an institution's life, and for a wide range of institutions, although the nature and extent of such support should evolve with the institution. Such support should become more selective, as institutions become able to meet more of their organizational development needs from within. It should also become more specialized, as institutions tackle more difficult problems.

   - **Capitalization**, or grants for equity are of strategic importance in enabling organizations to build a capital base. Capitalization can be used to generate investment income, build the loan portfolio, and leverage funds from local banks. One of the key purposes of providing capital funding is to enable institutions to mix costs of grant funds with commercial sources during the period it takes to build efficient operations and scale. Externally-financed capitalization should be used as a catalyst and complement to domestic mobilization of funds by local institutions. Grant equity contributions can also help institutions seeking to become formal financial intermediaries to meet minimum capital requirements.

- o **Operating losses.** Donors should avoid covering operating losses except during a clear, time-limited start-up or expansion phase. By the nature of the small loan business every program will take some time to reach a break even point. Donors should be willing to provide support during that time. Afterwards, however, such support becomes counterproductive.

- o **Fixed assets**. Donors may wish to support purchase of fixed assets, such as computers, vehicles or premises. Such funding may be seen as contributions to the equity base of the institution.

2. **Appropriate uses of loans.** Donor support through loans is appropriate for lending-based institutions that meet performance standards. However, loan capital from local and commercial sources should be sought as early as possible, even at start-up. Care should be taken to avoid burdening young institutions with foreign exchange risk in loans denominated in foreign currency, unless adequate precautions are taken. Donors are also advised to be careful not to undermine savings mobilization efforts of savings-based institutions, such as savings and credit associations by making loans available to them below the cost of mobilizing funds locally.

3. **Commercial sourcing of funds**. The transition to fully commercial sources of funding requires special forms of support that help introduce institutions to the financial system. Donors can act as catalysts to effect this transition through means such as:

   - o **Investor equity**, from both official and private sources. Donor support can help leverage private investment.

   - o **Second-tier operations**, which raise funds from commercial sources and onlend to microenterprise finance institutions.

   - o **Partial guarantees** of loans made by commercial banks to NGOs.

4. **Coherence of donor policies**. Institutions following sound principles for sustainability must not be undermined by others providing competing services below cost or in ways that cannot be sustained. When providing subsidies (grant or loan) to small and microenterprise institutions, donors should ensure that they coordinate that support with other funders, such that institutions are given clear incentives to become financially viable. In particular, donors need to consult each other regarding appropriate interest rates and other terms on which assistance to any given institution is supplied. Donors should also coordinate institutional support with sectoral policies such that financial institutions, including informal and semi-formal sectors, find enabling conditions for institutional development and growth.

ANNEX: MINIMUM REPORTING INFORMATION

Donors should require regular reporting on institutional performance and should base funding decisions on achievement of performance targets. The following tables cover the **minimum raw data** that should be reported, but do not include analytic indicators, such as financial ratios or adjustments for subsidy or inflation. The intent is to ensure the quality and comparability of data so that financial analysis can be conducted in a way that both donors and programs can interpret. Meaningful analysis requires a firm base of data. These indicators are intended to furnish such a base.

Portfolio and Outreach[4]

1. Number and amount of loans outstanding at beginning and end of reporting period	
2. Number and amount of loans disbursed during reporting period.	
3. Number and amount of small saver deposit accounts at beginning and end of reporting period. Show compulsory and voluntary savings separately.[5]	
4. Arrears (on a loans outstanding basis). Unpaid balance of loans with payments overdue more than 30 days. There should also be an aging of arrears report, covering, for example, 60 and 90 days and one year.	
5. Percentage of female clients.	
6. Number of staff (only those involved with savings and credit activities).	

[4] For institutions that offer a full spectrum of financial services, information should apply only to that portion of the institution's activities and overheads focued on small and microenterprises.

[5] Many programs require clients to deposit minimum amounts or pay into savings funds in order to be eligible for loans.

Interest Rate Policy

7. Effective annual interest rate paid by clients (incorporating all required fees, and calculated on a declining balance basis), both nominal and real. Effective rate paid to savers.	
8. Local annualized interbank lending rate and 90-day CD rate.	
9. Local annual inflation rate (give source).	

Income and Expense Information

INCOME	
10. Interest and fee income from loans (excluding accrued uncollected interest on non-performing loans)	
11.Income from investments	
12. Other operating income from financial services	
EXPENSES	
13. Staff expenses (salaries and benefits) [6]	
14. Other administrative expenses (includes depreciation)	
15. Loan losses. All loans over one year in arrears should be written off, as far as local rules permit. Institutions should describe their criteria in recording loan losses.	
16. Interest and fee expenses (itemized by source of funds)	
17. NET OPERATING PROFIT	
18. Non-operating income	
19. Non-operating expenses	

[6] Staff and administrative expenses should be those that relate to the provision of financial services. If an institution has significant non-financial activities, it should account for those costs separately, including the proportion of overhead expenses needed to support those activities. Costs paid directly by donors, such as expatriate salaries, should be included.

20. Donations:	
20a. For operating expenses	
20b.Capital contribution (identify purpose, e.g.,loan fund, equity, fixed assets)	

Balance Sheet Information

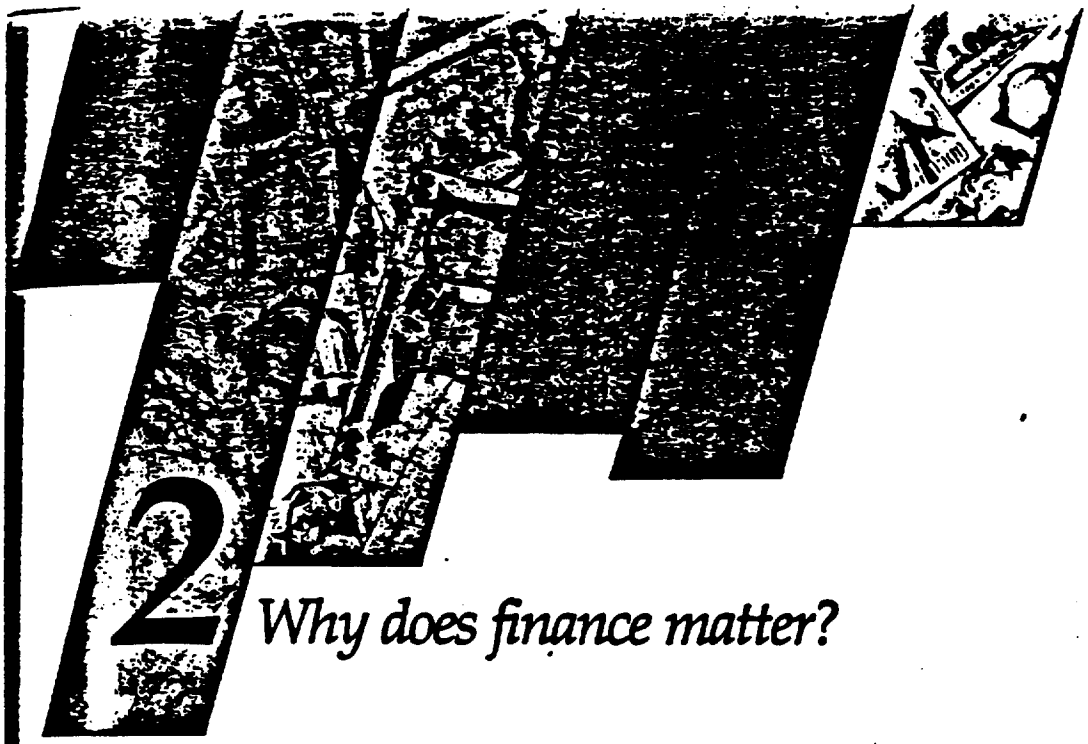
ASSETS	
21. Cash on hand and in banks	
22. Mandatory reserves	
23. Short term investments	
24. Loans outstanding (must match indicator 1, above)	
25. Less: Loan loss provisions	
26. Net portfolio outstanding	
27. Long term investments	
28. Fixed assets (after depreciation)	
29. Other assets	
30. TOTAL ASSETS	
LIABILITIES	
31. Savings and time deposits from target group clients (must match indicator 3, above)	
32. Other deposits	
33. Loans from central bank	
34. Loans from other banks	
35. Other short term liabilities	
36. Other long term liabilities	

EQUITY	
37. Paid in equity (shareholders)	
38. Donated equity	
39. Retained earnings	
40. Other capital accounts	
41. Current year profit or loss	
42. TOTAL LIABILITIES AND EQUITY	

Analytic Performance Indicators

The items listed here provide information in a raw form. In order to evaluate and compare performance, the raw data will have to be analyzed, through computation of ratios and other indicators. Informed opinions differ on which indicators are most important. Therefore, this document makes no attempt to specify those indicators. Rather, it provides for an information base to allow the calculation of a range of key ratios. Examples include: net profit, average loan and savings account size, adjustments for subsidy and inflation, operational and full self-sufficiency, return on assets and equity, administrative costs as a percentage of portfolio (required spread), portfolio yield, and staff productivity.

It is expected that every institution -- and the donors that support it -- will actively use such analytic indicators to monitor the institution's financial condition.



2 Why does finance matter?

Financial systems provide payment services. They mobilize savings and allocate credit. And they limit, price, pool, and trade the risks resulting from these activities. These diverse services are used in varying combinations by households, businesses, and governments and are rendered through an array of instruments (currency, checks, credit cards, bonds, and stocks) and institutions (banks, credit unions, insurance companies, pawnbrokers, and stockbrokers). A financial system's contribution to the economy depends upon the quantity and quality of its services and the efficiency with which it provides them.

Financial services make it cheaper and less risky to trade goods and services and to borrow and lend. Without them an economy would be confined to self-sufficiency or barter, which would inhibit the specialization in production upon which modern economies depend. Separating the timing of consumption from production would be possible only by first storing goods. The size of producing units would be limited by the producers' own capacity to save. Incomes would be lower, and complex industrial economies would not exist.

Finance is the key to investment and hence to growth. Providing saved resources to others with more productive uses for them raises the income of saver and borrower alike. Without an efficient financial system, however, lending can be both costly and risky. Self-financed investment is one way to overcome these difficulties, but profitable investment opportunities may exceed the resources of the individual enterprise. Investment by the public sector is another answer; in this case additional savings are mobilized through the tax system. But excessive centralization brings its own difficulties, especially in gathering the information needed to make sound investments. Efficiency therefore requires a balance among internally generated resources, centrally organized saving and investment, and market-based financial arrangements.

Market-based arrangements are voluntary. As such they are driven by the desire for profit, tempered by concerns about risk. Competition ensures that transaction costs are held down, that risk is allocated to those most willing to bear it, and that investment is undertaken by those with the most promising opportunities.

Such arrangements may take many forms but tend to mirror an economy's complexity and political orientation. Informal finance, such as loans within families and between friends or from pawnbrokers and moneylenders, is still important in many countries. But as economies grow, these arrangements need to be augmented by the services that only formal institutions—commercial banks, collective investment institutions, and capital markets—can supply. For example, by transforming the size and maturity of financial assets, formal

Box 2.1 Life without money

"Some years since, Mademoiselle Zelie, a singer . . . gave a concert in the Society Islands . . . in exchange for a third part of the receipts. When counted, her share was found to consist of three pigs, twenty-three turkeys, forty-four chickens, five thousand cocoa nuts, besides considerable quantities of bananas, lemons and oranges . . . as Mademoiselle could not consume any considerable portion of the receipts herself, it became necessary in the meantime to feed the pigs and poultry with the fruit."

W. S. Jevons
Money and the Mechanism of Exchange
(Jevons 1898, p. 1)

Even in modern economies many transactions do not involve money. For example, barter is used to escape taxation and regulation. In developing countries most exchanges within extended families are handled without cash. The multiple incomes of an extended family offer a substitute for insurance, pension plans, and social security. In many areas of the world, sharecropping involves a series of nonmonetary transactions concerning inputs, land tenure, crop sales, and so on. In some countries neighbors help one another to build their houses without payment (*gotong royong* in Java, barn raising in the United States).

The economy of ancient Egypt operated for 2,000 years before the invention of money (although precious metals served as a medium of exchange for some transactions). Even after several surrounding states adopted coinage, the government of Egypt opposed the use of money. The Inca Empire of Peru may not have used money as a medium of exchange, despite being exceptionally rich in gold and silver. Some religious societies (including the almost self-sufficient Jesuit Republic of Paraguay in the sixteenth and seventeenth centuries) and authoritarian or paternalistic communities (such as the large *haciendas* of Latin America) make little or no use of money, at least for internal transactions.

Nonmonetary transactions tend to be aspects of a longstanding social compact, whose individual parts cannot be valued separately. But in advanced economies most exchanges are impersonal. As Mademoiselle Zelie discovered, trade can be quite costly without a widely accepted medium of exchange.

institutions can mediate between the many small depositors who prefer liquid assets and the few large borrowers who need long-term loans to finance investment. They can provide other useful services too: insurance, hedging (using options and futures contracts), and so on. In a diversified market-based system, governments retain a key role as prudential regulators, because experience has shown that financial markets—essential though they are—can be prone to instability and vulnerable to fraud.

Finance and growth

Malthus predicted that growing populations and fixed amounts of land and other natural resources would ultimately stifle economic growth. But natural resource endowments have declined in importance in most high-income countries. In Great Britain, for example, the value of land and minerals was 60 percent of the value of all tangible assets in 1688 but only 15 percent in 1977. In fact, natural resources have not determined wealth. In 1870, Australia, a country rich in natural resources, had twice the per capita income of Switzerland, which has few; today Switzerland's per capita income exceeds Australia's by more than half. During the past three decades Hong Kong, Japan, the Republic of Korea, and Singapore have had among the world's highest per capita income growth rates despite their relatively poor resource endowments. Resource-rich Argentina has hardly grown at all.

The biggest difference between rich and poor is the efficiency with which they have used their resources. The financial system's contribution to growth lies precisely in its ability to increase efficiency.

Finance and trade

The financial system makes its biggest contribution to growth by providing a medium of exchange. In a barter economy, trade requires a "mutual coincidence of wants." It is therefore limited by the costly search for trading partners. Specialization is discouraged in economies with no medium of exchange, so their productivity is low. Money facilitates specialization by reducing trading costs and linking different markets. The adoption of a standard unit of account serves the same goal (see Box 2.1).

Historically, economies moved first from basic self-sufficiency to barter trade and then to trade against commonly accepted commodities such as

Table 2.1 Saving and growth in developing countries, 1965 to 1987

Country group by GDP growth rate	*Gross national savings/GDP*	*Gross investment/GDP*	*Change in GDP/investment*	*M2/GDP*
High growth (over 7 percent)				
Seven countries	28.0	28.6	26.3	43.0[a]
Excluding China	23.2	26.7	33.1	..
Medium growth (3–7 percent)				
Fifty-one countries	18.5	22.6	23.6	31.2
Low growth (less than 3 percent)				
Twenty-two countries	19.0	19.0	10.1	23.8

Note: Data are weighted averages times 100 and are based on a sample of eighty developing countries. M2 is currency in circulation plus demand, time, and savings deposits at banks. Investment is gross domestic investment.
a. Because of lack of data, average is for 1977–87 only.
Source: IMF, *International Financial Statistics*, and World Bank data.

gold. Maintaining inventories of commodity money was costly, and the safekeepers of gold and other commodity monies soon learned the advantages of allowing the direct exchange of deposit certificates. Such economizing on the use of commodity money gave birth to deposit money and banking. The continuing search for cheaper means of payment led to paper money, credit cards, and electronic transfers.

Most developing countries have a widely accepted medium of exchange, although they will need more advanced payment systems as their economies become larger and more complex. But, some countries, particularly in Latin America, have failed to provide a currency with a stable value. In inflationary economies local currency becomes less acceptable as a medium of exchange. Inflation also undercuts money's use as a unit of account: it makes financial contracts riskier, reduces the information imparted by relative prices, and distorts the allocation of resources.

Finance and saving

Saving determines the rate at which productive capacity, and hence income, can grow. On average, the more rapidly growing developing countries have had higher saving rates than the slower-growing countries (see Table 2.1). These rates are influenced by many factors. In analyzing them it is useful to distinguish between the flow of "saving" and the stock of "savings." In this Report, "saving" will always refer to the flow of real resources that are not consumed in the period under study and that are therefore available for investment. "Savings" will refer to the stock of accumulated saving, or wealth. An increase in the stock of financial assets will be called "financial deepening."

Many factors affect the saving rate: the rate of income growth, the age composition of the population, and attitudes toward thrift. The services provided by government, such as social security, can affect saving, as can taxes and government deficits. Macroeconomic and political stability affect expectations and thus affect saving. Whether financial variables affect the saving rate is still an open question.

Liquidity and ease of access may make financial instruments a more attractive home for savings. And financial services may encourage saving if they raise the net returns. Higher interest rates raise the return, but they can also enable savers to achieve a target stock of financial wealth with a lower saving rate. The effect of higher interest rates is therefore ambiguous. Empirical estimates range from a large positive effect to no effect at all.

Although interest rates have an uncertain effect on the amount people save, their effect on the form in which people save is clear. High interest rates favor financial over nonfinancial forms of saving. A recent study using 1985 data for eighty-one developing economies found that the ratio of liquid liabilities to GNP (a measure of financial depth) rose by 0.75 percentage point in response to a 1.0 percentage point increase in the nominal interest rate paid on deposits. However, the ratio fell by 1.70 percentage points in response to a 1.0 percentage point increase in the rate of inflation. (This asymmetry may reflect the fact that some liquid liabilities—currency, for example—pay no interest and thus cannot fully compensate savers for inflation. It may also reflect a risk premium that rises with the inflation rate.) Overall, higher real interest rates are likely to lead to financial deepening as savers switch some of their saving from real to financial assets and from foreign to domestic assets. Conversely, the negative real interest rates that many countries saw during the 1970s discouraged the holding of financial assets.

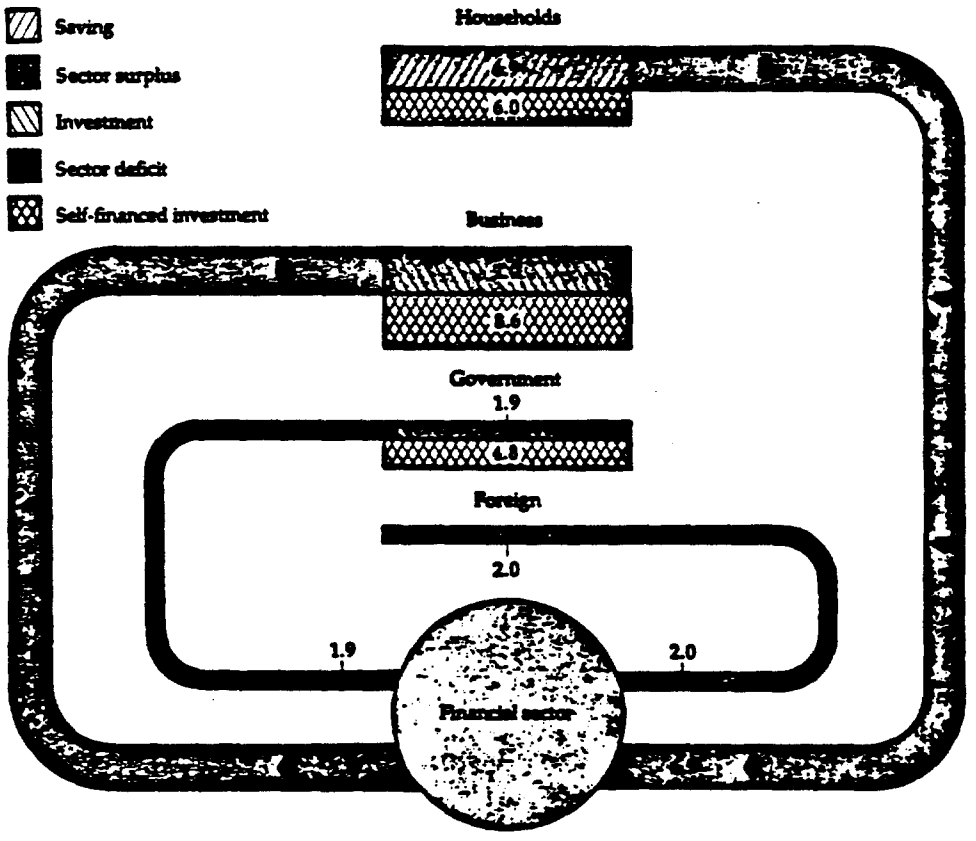
Governments can influence financial saving in

other ways too. By imposing direct taxes on banks, by requiring banks to hold noninterest-bearing reserves at the central bank, or by forcing banks to invest in low-interest government bonds, they reduce the return on bank deposits. Historically, governments raised finance by debasing commodity money. Today they do the same by granting themselves a monopoly in the creation of currency. The rent earned from this monopoly is called seigniorage (see Chapter 4). The more governments rely on it for revenue, the less savers are inclined to hold their wealth in financial form. As discussed in the next section, the amount saved in financial form affects the productivity of investment.

Finance and investment

The financial system intermediates only part of a country's total investment, because firms and households finance much of their investment directly out of their own saving. Only when investment exceeds saving is it necessary to borrow, just as when saving exceeds investment it is necessary to lend. The financial system's task is to move ex-

Figure 2.1 Average saving and investment rates and sectoral surpluses and deficits for fourteen developing countries
(percentage of GNP)



Note: Data are based on the sample of fourteen developing countries listed in Table 2.2.
Source: Honohan and Atiyas (background paper).

Table 2.2 Average sectoral surpluses in fourteen developing countries, selected years
(percentage of GNP)

Country and period	*Households*	*Business*	*Government*	*Foreign*
Cameroon, 1980–84	4.0	−9.4	2.7	2.8
China, 1982–86	7.0	−8.1	0.3	0.8
Colombia, 1970–86	3.5	−4.6	−0.2	1.3
Côte d'Ivoire, 1971–78	1.5	−7.7	1.3	4.4
Ecuador, 1980–85	5.1	−6.8	−2.5	5.0
India, 1970–82	5.5	−1.2	−5.5	1.1
Korea, Rep. of, 1980–85	7.0	−13.4	1.1	5.2
Malaysia, 1980, 1985–86	16.8	−7.2	−12.2	1.7
Philippines, 1983–85	9.1	−7.0	−3.6	2.9
Portugal, 1977–79, 1981	14.3	−16.1	−7.3	7.6
Thailand, 1981–83	6.8	−6.5	−4.3	5.7
Tunisia, 1977, 1980–84	2.1	−13.7	2.5	9.1
Turkey, 1971–81	7.7	−11.0	−0.9	3.2
Yugoslavia, 1970–85	7.0	−8.2	0.7	1.2
Average (weighted)	6.9	−7.0	−1.9	2.0
Self-financing ratio[a]	215	55	72	—

Note: Sectoral surpluses may not sum to zero where figures have been derived from independent sources.
a. A self-financing ratio is a sector's saving divided by its investment, expressed as a percentage. This ratio overstates true self-financing to the extent that there is intrasectoral borrowing or lending. Data are derived from the weighted sectoral saving and investment averages shown in Figure 2.1.
Source: Honahan and Atiyas (background paper).

cess saving from economic units in surplus to those in deficit.

Figure 2.1 shows the average saving and investment rates for fourteen developing countries. Households saved 12.9 percent of GNP and invested 6.0 percent; that left them with a surplus of 6.9 percent of GNP. Businesses saved 8.6 percent of GNP and invested 15.6 percent; that left them with a deficit of 7.0 percent of GNP. The foreign sector was a net lender and the government a net borrower. The financial sector is the channel for all these flows. Note that the country-by-country sectoral balances which underlie these averages vary widely. Table 2.2 shows the balances for each of the countries that are aggregated in Figure 2.1. The surplus of the household sector, for instance, ranges from Côte d'Ivoire's 1.5 percent (in 1971–78) to Malaysia's 16.8 percent (in 1980–86).

Taking the fourteen countries together, Table 2.2 shows that businesses financed 55 percent of their investment from their own saving (in the form of depreciation allowances and retained earnings). Governments financed 72 percent of their investment from their saving (that is, from the excess of taxes and other income over consumption spending plus transfers). And households as a group financed all of their investment from their saving. Altogether, roughly half of all investment was self-financed.

An advantage of self-finance is that, in combining the acts of saving and investing, it internalizes all the information, transaction, monitoring, and enforcement costs that would be involved if the resources were lent to someone else. No complex contracts, collateral, or other devices are required to reduce the risks inherent in lending. The shortcoming of self-finance is that an individual's investment opportunities may not match his or her resources or may be inefficiently limited by them.

Even though the financial system intermediates only part of total investable resources, it plays a vital role in allocating saving. In the early stages of development, relatives, friends, and moneylenders may be the only sources of external finance. As the financial system grows, local banks, then national financial institutions, and finally securities markets and foreign banks become sources of funds for investors. Smoothly functioning financial systems lower the cost of transferring resources from savers to borrowers, which raises the rate paid to savers and lowers the cost to borrowers (see Box 2.2). The ability of borrowers and lenders to compare interest rates across markets improves the allocation of resources.

Historically, the quality of investment has been at least as important for growth as the quantity. Although the fastest-growing countries had higher rates of investment than the others in Table 2.1, empirical studies generally find that less than half the growth in output is attributable to increases in labor and capital. Higher productivity explains the rest. Higher labor productivity reflects better

Box 2.2 Transaction costs and the supply of credit

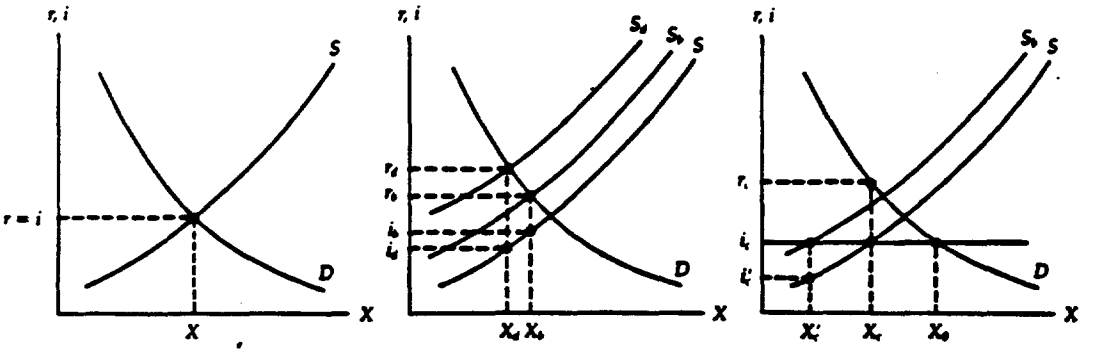
The impact of financial intermediation and interest rate ceilings on credit can be demonstrated geometrically. In the diagrams in Box figure 2.2 the horizontal axis measures the quantity of borrowing or lending per unit of time (X), and the vertical axis measures the cost of borrowing (r) and the return for lending (i). The economy's demand for credit is depicted in the first diagram by the downward-sloping curve labeled D. Its negative slope reflects, in part, the increasing quantity (per unit of time) of profitable investment as the cost of borrowing declines. The upward-sloping curve labeled S depicts the economy's supply of credit, the amount of saving offered to others either directly or through intermediaries such as banks. Its positive slope reflects, in part, the increasing share of total saving provided for financial assets as their return rises relative to the return on real assets or investment abroad. If there were no transaction costs or interest rate regulations, the market-determined rate of interest would be $r = i$, and the amount of credit per period would be X.

It is costly, however, for lenders to locate creditworthy borrowers directly. In the center diagram, the amount lenders must charge borrowers to cover that cost is reflected in the curve S_d. The vertical distance between this curve and the supply of funds curve (S) is the amount of these transaction costs (including the cost of covering the expected defaults). If lenders had to find borrowers on their own, they would be willing to supply X_d in the expectation of earning (after deducting expected costs) i_d. For that amount of credit borrowers would be paying r_d. Transaction costs introduce a wedge between the cost to borrowers and the return to lenders, which reduces the amount lent.

Banks or other intermediaries exist, in part, because they are able to reduce the transaction costs of borrowing and lending. This is reflected in the curve S_b. The wedge between the cost to borrowers and the return to lenders is now the banks' spread. Assuming that bank spreads are less than the costs of direct lending, the amount lent increases from X_d to X_b, the return to lenders increases from i_d to i_b, and the cost to borrowers falls from r_d to r_b. The better banks are at reducing transaction costs, the greater these effects. Reducing taxes on banking (such as unremunerated reserve requirements, which are a part of these costs) has the same effect.

The third diagram shows the effect of an interest rate ceiling (the horizontal orange line at i_c). If the ceiling is applied to deposit rates, it will reduce the amount lent (to X_c) and raise the cost to borrowers (to r_c). If the ceiling applies instead to lending rates, banks will set deposit rates at i_c', deducting transaction costs. The amount deposited (and lent, when abstracting from reserve requirements) will be X_c'. The excess demand for credit ($X_c - X_c'$) cannot be satisfied, and lenders will ration the available supply.

Box figure 2.2 The supply of and demand for credit



ealth, skills, education, and work effort; higher apital productivity reflects technical progress and ne more efficient use of saving.

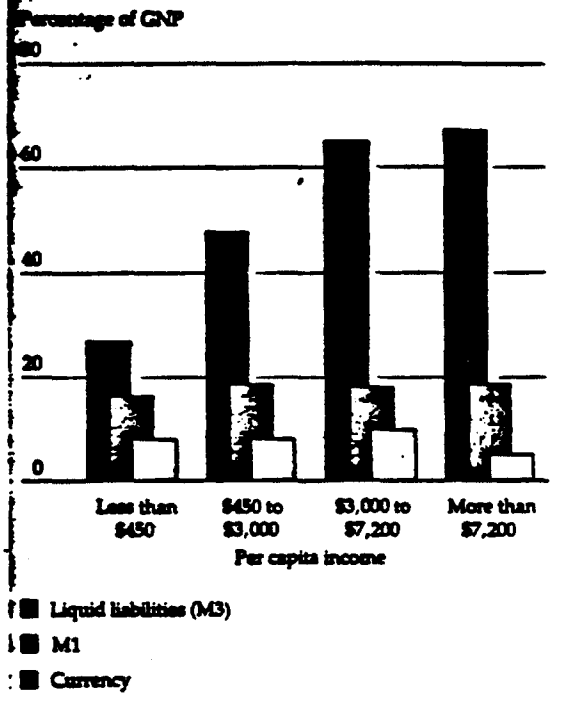
As more saving moves through the financial system, financial depth increases. The financial systems of higher-income countries are usually deeper (as measured by the ratio of liquid liabilities to GNP) than those in poorer ones (see Figure 2.2).

They are also deeper in the most rapidly growing countries than in the slowest-growing countries (as shown by the ratio of M2 to GDP in Table 2.1).

Faster growth, more investment, and greater financial depth all come partly from higher saving. In its own right, however, greater financial depth also contributes to growth by improving the productivity of investment. Investment productivity, as measured by the ratio of the change in GDP to investment (the inverse of the incremental capital-output ratio—ICOR), is significantly higher in the faster-growing countries, which also have deeper financial systems (Table 2.1). This suggests a link between financial development and growth. How might this work? It was noted above that positive real interest rates favor financial saving over other forms of saving and therefore promote financial deepening. Provided that intermediaries are good at selecting viable projects, greater intermediation will ensure that the better investments are financed and will thereby increase the average productivity of investment. Table 2.3 groups the countries of Table 2.1 that had meaningful interest rate data according to their real interest rates: positive, moderately negative (0 to −5 percent), and strongly negative. The first group had lower inflation rates, deeper financial sectors, moderately higher investment rates, and significantly more productive investments than the others.

More important, the growth rates of the countries with positive real interest rates were considerably higher on average than those of the others. As the world economy adjusted to the first oil price shock of the early 1970s, productivity and growth fell nearly everywhere. But the fall was much

Figure 2.2 Indicators of financial depth



Note: Data are unweighted averages by income group. M1 is the sum of currency and demand deposits. Liquid liabilities are the sum of M1, time and savings deposits, and other deposits at financial institutions.
Source: Neal (background paper).

Table 2.3 Growth rates and other economic indicators for country groups with positive, moderately negative, and strongly negative real interest rates, 1965 to 1973 and 1974 to 1985
(average percent)

	1965–73			1974–85		
		Negative			Negative	
Indicator	*Positive*	*Moderately*	*Strongly*	*Positive*	*Moderately*	*Strongly*
Real interest rate	3.7	−1.7	−13.7	3.0	−2.4	−13.0
GDP growth rate	7.3	5.5	4.6	5.6	3.8	1.9
M3/GDP	28.9	27.0	29.1	40.3	34.0	30.5
Investment/GDP	21.4	19.7	21.4	26.9	23.2	23.0
Change in GDP/investment	36.7	31.1	21.7	22.7	17.3	6.2
Change in real M3/real saving	18.7	12.7	6.4	16.6	8.2	−0.9
Inflation rate	22.2	7.1	40.2	20.8	23.9	50.3
Volatility of inflation rate	17.1	5.3	27.2	12.2	9.1	23.5

Note: Real interest rates were calculated from nominal rates according to the following formula: $[(1 + r) / (1 + p) - 1] \times 100$, where r is the deposit rate and p is the inflation rate. Inflation is the percentage change in the consumer price index (CPI). M3 is currency plus the sum of nonbank deposits of the public at all identified deposit-taking institutions. Real saving is gross domestic savings deflated by the average annual CPI rate. Volatility of inflation is the absolute deviation of the inflation rate from its level the year before.
Source: Gelb (background paper).

Box 2.3 Real interest rates and growth

Most developing countries have periodically held their interest rates below market-clearing levels. These artificially low interest rates have "repressed" their financial systems, shrinking financial assets in real terms especially at times of high inflation. If financial depth promotes economic growth, artificially low real interest rates may be an obstacle to development.

A background study for this Report estimated the relationship between real interest rates and growth for the thirty-three developing countries with populations of more than 1 million and acceptable data for the period 1965–85 (the same countries that are grouped by interest rates in Table 2.3). When the data for these countries were averaged over each of two periods, 1965–73 and 1974–85 (to take into account the marked deterioration in growth of virtually all countries after the first oil shock), higher real rates of interest on short-term deposits were indeed associated with faster growth. In a simple regression where *GY* is the growth rate, *R* is the real interest rate, and *SHIFT* is the dummy for the second period

$$GY = -0.12 + 0.20R + -0.02\,SHIFT \qquad \bar{R}^2 = 0.45$$
$$(-2.5) \quad (5.2) \quad (-3.4)$$

However, assessing the impact of interest rates on economic performance is not straightforward. Causation could run in either direction. To analyze the association between interest rates and growth, this study decomposed the relationship into a chain of relationships more likely to run in one direction. The hypothesized chain ran from interest rates to financial depth and to saving and from financial depth to the productivity of investment.

The resulting estimates showed that higher real interest rates (obtained by raising repressed rates toward modestly positive levels) are associated with increased financial depth and with a modest increase in saving and investment. In the second link in the hypothesized chain, financial depth was strongly associated with more productive investment. When the estimates of each link are put together, they suggest that, although real interest rates have a smaller effect on growth than indicated in the simple regression, the association is strong and appears to operate primarily through the effect of greater financial depth on the productivity of investment. (Note, however, that countries with repressed financial systems often suffer serious distortions in other sectors of the economy as well. The strong relationship between real interest rates and growth may therefore reflect the correlation between macroeconomic imbalances and price distortions, particularly the negative association between high inflation rates and growth, as well as financial repression.)

Box figure 2.3 plots some of the country data used in this study. The value of each country's average investment rate (horizontal axis) is plotted against its average growth rate (vertical axis) for the second period (1974–85). Although higher investment rates are associated on average with higher growth rates, the figure shows that the relationship is loose. The differences between growth rates and investment rates reflect differences in the productivity of investment. Any line drawn from the origin represents a given growth-investment ratio (the inverse of the incremental capital-output ratio); if all investments were equally productive, differences in growth rates would reflect differences in investment rates only, and all points would fall on a line that represents the average productivity of investment. In the figure that line—labeled "average productivity of investment"—corresponds to the sample average. Thus the position of points with respect to the line reflects differences in the productivity of investment among the sample countries, with those above the line being more productive than the average and those below it less.

The blue squares depict countries with positive real interest rates, the white squares those with moderately negative rates, and the red squares those with strongly negative rates. Investments in all the countries with positive real rates were more productive than average. Investments were generally less productive than average in the countries with strongly negative real rates, four of which actually had negative growth rates over the period.

greater in the countries with negative real interest rates. Overall, output grew almost three times faster, on average, in the countries with positive real interest rates than in the countries with strongly negative rates. Further analysis suggests that positive real interest rates helped growth mainly by improving the quality of investment and not just by increasing the quantity of investment (see Box 2.3). Although the rate of investment was only 17 percent higher in the countries with positive real rates, the average productivity of their investment was almost four times higher. Note, however, that many of the countries with positive real interest rates also had more stable macroeconomic policies and more open trading systems, which should also raise growth rates.

Risks and costs of finance

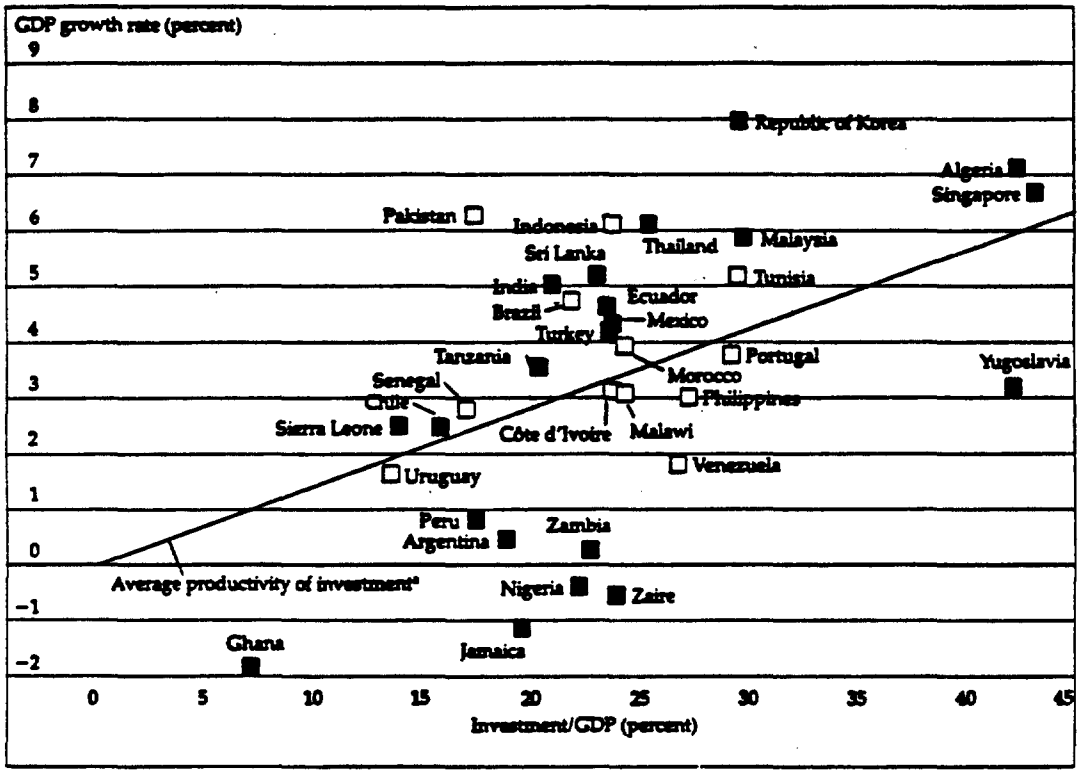
Lending is risky. Intermediaries must cover the costs of devising contracts that limit risk, of monitoring and enforcing those contracts, and of losses.

Box figure 2.3 Real interest rates, investment, productivity, and growth in thirty-three developing countries in 1974–85

■ Positive real interest rates

□ Moderately negative real interest rates (0 to −5 percent)

■ Strongly negative real interest rates (less than −5 percent)



a. Line represents sample average.
Source: Gelb (background paper).

The extent of financial contracting depends on the extent to which cultural, legal, and institutional arrangements can reduce these costs. If they remain prohibitive, businesses will prefer to rely on self-finance.

Risks

Financial contracts involve credit risk, price risk, and liquidity risk. Credit risk is the danger that the borrower will default. Price risk is the risk of loss caused by unexpected changes in prices—in interest or exchange rates, for example. Liquidity risk is the risk of being unable to sell financial assets quickly, except at a steep discount. In addition, there is the risk that the default of one or a few large borrowers will endanger the whole financial system. This is called systemic risk.

Informational asymmetries are one source of credit risk. Entrepreneurs have "inside" information about their own projects and creditworthiness. Lenders can reduce credit risk either by de-

Box 2.4 Swapping risk

All economic activities are subject to a wide variety of technical, economic, and financial risks. Many risks are amenable to actuarial calculations and can be covered by straightforward insurance policies, but others are not. Financial systems can help to overcome some risks by redistributing them among market participants.

Some types of risk can be limited through portfolio diversification; other risks can be hedged by using an appropriate instrument, such as a forward contract or option. The key to any hedge is to find a counterparty willing and able to take the other side of the contract. Financial institutions have become adept at inventing hedging instruments and arranging hedging contracts between different parties.

One hedging instrument has become quite popular in the 1980s and has contributed greatly to the growing integration of national financial markets. It is the "swap." Swaps involve the exchange of future streams of payments between two or more parties and enable the participants to convert debt servicing obligations from one currency into another or from fixed to floating interest rates. Swaps exploit the segmentation of financial markets that causes differences in the markets' perception of different borrowers. Thus, although a triple-A-rated firm may be able to borrow in both dollars and yen at a lower rate than a B-rated firm, it may have a comparative advantage in borrowing in yen because of its greater name recognition. Yet the second firm may desire yen debt, perhaps because it exports to Japan. A currency swap allows both firms to borrow where they have a comparative advantage (thus reducing market segmentation), swap loans and repayment streams to match their desired risk profiles, and end up with a lower cost of funds. The same principles are at work when a firm borrowing at fixed interest rates swaps payment streams with one borrowing at floating rates.

The importance of hedging devices is clearest when there are none. For example, in many developing countries firms—including those with foreign currency liabilities—are prohibited from holding foreign currency assets and cannot buy forward contracts; this limits their ability to hedge their foreign exchange risk. Similarly, developing country farmers, who cannot participate in world futures markets, are unable to hedge the substantial risks associated with fluctuations in the "world" prices of their crops. In these circumstances producers are likely to invest less and produce less.

veloping their own expertise in the selection of borrowers or by relying on information from institutions such as credit rating agencies. Measures that increase the information available to lenders, such as the strengthening of accounting and auditing requirements, improve lenders' ability to identify the borrowers with the best investment opportunities. When information is poor, lenders can discriminate between borrowers only in very broad terms.

To cover risk, lenders raise the interest rate they charge on loans. But this may be partially self-defeating, because the more creditworthy borrowers may choose not to borrow, which would leave the lender with less creditworthy clients. (This is the problem of adverse selection.) Furthermore, to cover the higher cost of borrowing, clients may take on riskier projects. (This is the problem of moral hazard.) Because of their limited ability to identify risks and monitor behavior, lenders tend to require collateral and to ration credit to the most creditworthy borrowers rather than to charge higher interest rates on riskier loans. Borrowers with little collateral are likely to be the most affected by credit rationing.

Financial risk can be reduced by improving the availability and quality of information about borrowers (individuals, enterprises, or financial intermediaries), by improving the design and enforcement of loan contracts, and by enlarging the range of instruments so as to permit greater diversification of portfolios. Risk cannot usually be eliminated altogether, but the irreducible risk can often be transferred to those more willing to bear it. Loan maturities, the choice of adjustable or fixed interest rates, equity and venture capital arrangements, and collateral or cosigner requirements are all examples of different risk assignments. Much recent financial innovation has been driven by attempts to exploit comparative advantage in risk bearing (see Box 2.4).

Transaction costs

The services offered by financial institutions require the collection and processing of a great deal of information and the design, monitoring, and enforcing of contracts. Providing these services is expensive. Financial institutions must cover administrative costs (essentially payroll and rent), taxes, the cost of capital and of adhering to government regulations, and losses from default. They do

so by charging fees for specific services and interest on loans.

The burden of costs will shift between the parties according to the arrangements adopted. Informal financial entrepreneurs rely on personal knowledge of borrowers; their information costs are low. In more advanced systems information and enforcement become more expensive. In the early stages of financial development, banks build the cost of gathering credit information into their spreads. Later, firms supply more information on their own behalf. A corporation issuing bonds or equities must provide investors with information about itself. Firms send audited accounts to their shareholders and to the tax authorities. They may pay a credit rating agency to grade their securities.

Transaction costs are also borne by depositors, investors, and government agencies. Depositors incur costs in visiting bank branches and waiting in line to cash checks. Investors devote resources to analyzing information. Government agencies usually bear some of the costs of monitoring and enforcement. A securities and exchange commission may be called upon to certify the accuracy of information provided in corporate prospectuses; deposit insurance corporations may assume responsibility for monitoring deposit institutions. Government agencies generally cover their costs by levying fees on issued securities or collecting premiums from insured institutions.

Spreads between borrowing and lending rates and between buying and selling prices reflect the intermediary's costs, expected loan and trading losses, reserve requirements, and taxation. Commercial banks' spreads vary with the size and risk of loans. The average spread between lending rates and the cost of funds in a high-income country is between 2 and 3 percentage points. In noninflationary developing countries, spreads are similar to those in industrial countries, but because the range of services offered may be more limited and operating procedures more cumbersome, depositors' and borrowers' combined transaction costs may be higher. Spreads in inflationary countries can be more than 10 percent, although that reflects the burden of high reserve requirements as well as transaction costs. Prime borrowers may be able to acquire funds through international markets for a fee as low as one-tenth of 1 percent of the amount raised. Although spreads tend to be narrower in direct transactions than in intermediated ones, the difference is partly offset by the additional costs borne by the principals.

High accounting standards and strong contract enforcement help to reduce the risk of loss. Competition, however, is the most effective way to keep transaction costs low. Access to a wide range of institutions and markets, including international markets, stimulates competition.

Government intervention

Governments intervene in the provision of financial services for many reasons. Historically, they have controlled the means of payment, both to guarantee its soundness and to collect seigniorage. More recently, governments have tried to use their control of money creation to influence the level of economic activity and their control of the allocation and pricing of credit to influence the composition of investment. (Chapter 4 discusses the recent experience of the developing countries with policies of this sort.) They have also intervened to ensure that financial intermediaries behave prudently.

Fractional reserve banking systems (in which banks hold only partial reserves against liabilities and lend out the rest of their deposits) have suffered from occasional instability, excessive risk taking, and fraud. The liabilities issued by banks in response to the demands of depositors are short-term, highly liquid, and supposedly low-risk. Loans, by contrast, are usually longer-term, less liquid, and riskier. This difference is one reason banks charge borrowers more than they pay depositors. But because banks are so highly leveraged, relatively small losses on loans can leave them unable to honor their liabilities. When the public suspects that a bank is insolvent, the result is often a run on the bank, which sometimes spreads to other, solvent, banks. The drain of bank reserves causes a multiple contraction in bank credit. When runs become widespread, as they occasionally did in the nineteenth and early twentieth centuries, financial panic can trigger a collapse of the credit-payment process and a sharp recession.

Governments have devised ways of dealing with bank runs. When they occurred, central banks—acting as lenders of last resort—provided liquidity by rediscounting sound loans. In several high-income countries the government provided deposit insurance. By guaranteeing the value and liquidity of deposits up to a certain size, deposit insurance was designed to prevent runs from starting (see Box 2.5). The lender-of-last-resort facility was designed to prevent them from spreading.

Although prudential regulation has a different rationale than economic regulation aimed at alter-

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Box 2.5 Deposit insurance

Most high-income and a few developing countries have established deposit insurance schemes. Deposit insurance guarantees the nominal value and liquidity of deposits up to a certain size. The insurer is an institution, generally government-owned, established for that purpose, and funded with premiums paid by the institutions whose deposits are insured. Deposit insurance can help to establish confidence in the safety of saving with banks (or other covered institutions) in countries with limited banking habits. The principal targets of deposit insurance are small, unsophisticated depositors who are least able to assess the soundness of a particular depository. By assuring depositors that their money is safe even if the depository is not, deposit insurance supplements the central bank's lender-of-last-resort role in forestalling bank runs.

Like all insurance, deposit insurance suffers from the risk of moral hazard. Because insured depositors no longer need to be concerned about the quality of their depository's assets, market regulation of bank behavior is reduced. A considerable degree of market regulation can be retained if deposit insurance coverage is limited to relatively small deposits. The interbank deposit market, which has become an important source of short-term liquidity for all advanced banking systems, can impose a significant measure of discipline on banks and should never be insured. This contrasts with the savings and loan associations in the United States, which, in addition to having insured deposits, do most of their short-term borrowing from the Federal Home Loan Bank System, which lends according to less demanding standards (see Box 5.4 in Chapter 5). An inescapable fact of deposit insurance is that it places greater responsibility on government to see to it that insured institutions behave prudently.

With or without insurance, depositors would be fully protected if banks were closed and liquidated the moment their capital fell to zero. This is not a practical possibility: the condition of a bank cannot be known to inspectors minute by minute and, because liquidation takes time, asset values can decline before liquidation can be completed. However, up-to-date market accounting, frequent inspection, and swift action by inspectors to close insolvent banks are clearly important in minimizing losses. In some countries the laws establishing deposit insurance provide the mechanisms for exactly such steps. Furthermore, the enhanced supervisory capability that sometimes accompanies the establishment of deposit insurance can and should be used to spot problems in bank management and in banks' portfolios well before insolvency occurs and to compel banks to take corrective action.

ing the allocation of resources, it too affects the structure and efficiency of the financial sector. For example, many governments have honored the liabilities of insolvent financial institutions even when there was no formal insurance. Government guarantees and lender-of-last-resort facilities, however, changed the behavior of both depositors and bankers. Depositors and other buyers of bank liabilities that were either explicitly or implicitly insured no longer had to monitor banks to protect the value of their deposits. Bankers no longer had to worry about runs, so they could make riskier loans. Governments therefore had to regulate and supervise the system.

Deposit insurance, coupled with regulation and supervision, has reduced the problem of bank runs but has been less successful in preventing fraud and excessive risk taking by banks, as the present widespread insolvency among the financial institutions of the developing countries makes clear (see Chapter 5). And high-income countries have not been exempt (see Box 5.4). It is often argued that government supervision is not an efficient substitute for market supervision—in the form, for example, of monitoring and control of bank managers by stockholders and depositors. Innovative financial entrepreneurs have often been able to evade the rules; those intent on deceiving bank examiners have often succeeded in hiding losses for some time.

Many countries have therefore moved in recent years to strengthen the role of the private sector in monitoring and controlling financial enterprises. Some have set higher capital requirements for financial institutions. This ensures that the owners have an adequate stake in the efficiency with which depositors' resources are used. Similarly, stringent audit and reporting requirements make an institution's financial condition visible to depositors and investors. And yet some governments have also covered losses that in the past would have been borne by market participants. This runs counter to the principle of allowing market signals a greater role in supervising the system.

The task of balancing efficiency, which requires freedom to act, and stability, which evidently requires a degree of government regulation, is extremely difficult. Some theorists argue for an un-

compromising market-based approach, but in practice all governments have chosen some form of supervision. If markets are to judge, price, and allocate risk correctly, governments must clearly define the areas in which they have taken responsibility—and allow losses to be incurred in those that are not insured. (Chapter 6 discusses prudential regulation in more detail.)

The structure of the financial system

The financial system consists of many institutions, instruments, and markets. Financial institutions range from pawnshops and moneylenders to banks, pension funds, insurance companies, brokerage houses, investment trusts, and stock exchanges. Financial instruments range from the common—coins, currency notes, and checks; mortgages, corporate bills, bonds, and stocks—to the more exotic—futures and swaps of high finance. Markets for these instruments may be organized formally (as in stock or bond exchanges with centralized trading floors) or informally (as in over-the-counter or curb markets). For analytical purposes, the system can be divided into users of financial services and providers.

Users of financial services

Financial institutions sell their services to households, businesses, and government. The boundaries between these sectors are not always clear-cut.

HOUSEHOLDS. The household sector includes small, mainly unregulated firms and individuals. Their main financial needs are for payment services, for liquid assets in which to save, and for relatively small amounts of credit. They seek convenience (nearby branches, for example), simplicity, liquidity, and security.

After making their own investments, households as a group have surplus resources to lend (Figure 2.1). Hence, they demand convenient assets to hold, This demand, as well as the demand for a medium of exchange, may be met by currency. To a lesser extent it may be met by bank deposits, although hoarding commodities or participating in informal saving arrangements are alternatives. Accumulated investment in housing is a large part of the nonliquid wealth of households at all but the poorest income levels. As incomes rise, insurance and contractual savings schemes (life insurance and pensions) also become important.

Households also need credit. Street vendors, for example, need short-term finance to purchase daily stocks. Small farmers need seasonal or medium-term credit to buy capital. Would-be homeowners need long-term mortgage financing. Households are often unable to convince financial institutions that they are creditworthy. So they turn to lenders who do not require formal business records or collateral—to family and friends or to local pawnbrokers and moneylenders. (Chapter 8 examines informal finance in greater detail.)

BUSINESSES. Wealthier households and corporations have more complicated financial needs. They require check and wire transfer payments; deposits in larger amounts and at longer maturities; letters of credit; guarantees; purchase and sale of foreign exchange; underwriting; advice on financial, accounting, and tax matters; and so forth. The business sector is invariably a net borrower; it needs short-term credit to finance inventories and long-term funds to finance capital expansion. Nevertheless, it also holds a substantial share of gross financial assets. For example, in 1984, businesses held 48, 49, and 64 percent of demand deposits in Korea, Malaysia, and Tunisia respectively.

The business sector includes public as well as private enterprises. Public enterprises are generally in capital-intensive industries such as utilities and transportation. In developing countries many of the larger manufacturing firms are publicly owned as well. Many public enterprises have been run not to generate profit but to provide employment and to supply goods and services at reasonable prices. Because many have incurred losses, they have been unable to finance their investment from retained earnings. Public enterprises have been heavy borrowers in both domestic and foreign markets. Their losses have been a drain on national saving.

Some of the largest corporations can meet most of their demand for financial services by themselves and may even be able to supply financial services to others: trade credits to their customers, for instance. They can also tap financial markets directly by issuing their own financial instruments (commercial paper, bonds, equity securities, and so on). Yet direct financing has been negligible in most developing countries and unimportant in most high-income ones. In France, Italy, Japan, and the United Kingdom, for example, stocks and bonds financed an average of less than 9 percent of corporate investment; 30 percent of it was financed with bank loans and the rest from internally generated funds.

GOVERNMENT. As well as being regulators of their financial systems, governments are among their clients. All governments use payment services. In most developing countries, governments, like businesses, are net borrowers, and they use the financial system as a source of funding for current and capital spending. In industrial countries, government deficits are financed mainly by selling securities to the public. In developing countries they are usually financed by borrowing from banks. In Sierra Leone, Zaire, and Zambia, for example, more than 70 percent of bank credit has gone to the government in recent years, and in Mexico 55 percent. Much of that credit was supplied by the central banks, which thereby increased the stocks of reserve money in these countries. The inflation caused by excessive monetary growth has greatly retarded the development of the financial sector in developing countries, especially since interest rates have often been held down.

Governments have also used the financial system to serve development or other goals. They have directed credit, often at subsidized interest rates, to priority sectors. Many developing country governments own banks or other financial institutions and thus play a direct role in allocating resources. Monetary policy is conducted through the financial sector (see Box 2.6). The influence of governments on the amount and pattern of investment has therefore been much greater than their own investment spending would suggest.

Providers of financial services

Financial systems differ from country to country, yet there are many similarities. In addition to the central bank, most countries have five main classes of financial institution: deposit and credit institutions, contractual savings institutions, collective investment institutions, securities markets, and informal financial enterprises. (Chapters 7 and 8 discuss the services provided by these parts of the financial system in more detail.) Casualty insur-

Box 2.6 Monetary policy

Governments intervene in finance partly to control the supply of money and credit. When the budget deficit is large, governments often cover it by creating money. Excessive creation of money to cover budget deficits is the most common cause of inflation. When the fiscal deficit is not a consideration, the objective of monetary and credit policy is usually to maintain stable prices.

Governments have various tools to control the monetary aggregates. Perhaps the most common technique in developing countries is for the central bank to specify credit ceilings for each commercial bank. Such ceilings have been criticized because they discourage competition and the mobilization of deposits.

Another approach is for the central bank to fix the amount of deposit liabilities that can be created by the banking sector by imposing reserve requirements and controlling the quantity of reserves available to banks. Central banks often control the level of reserves through the refinancing facilities they provide to commercial banks. But if refinancing is used to channel credit to preferred sectors, it cannot easily be used for monetary control as well. Other countries use the movement of government deposits between commercial banks and the central bank to control the level of reserves. In countries with more developed financial systems, central banks adjust bank reserves, and hence the money supply, through the purchase or sale of government securities. These transactions are called open market operations. When the central bank buys a security, it pays with a check drawn on itself, thereby increasing its liabilities. Open market operations cannot be used in a system without an established government bill market. Monetary control with open market operations leaves the allocation of credit to market forces.

The degree of integration with world financial and capital markets also affects the execution of monetary policy. An open and fully integrated economy that chooses to maintain fixed exchange rates would have to maintain the money supply at the level demanded at the "world" price level and interest rate. Any other quantity of money would result in changes in the foreign exchange reserves of the central bank. The central bank's purchase or sale of foreign exchange would replace open market operations as the tool for determining bank reserves and, hence, the money supply.

A fixed exchange rate constrains the central bank's ability to create money and is thus a potential source of monetary discipline. A market-determined exchange rate restores a measure of domestic monetary independence. With either fixed or floating exchange rates, central banks will need to set reserve requirements at levels comparable to those in other countries if banking business is not to be driven abroad. Noninterest-earning reserve requirements are a tax on banks and as such will affect their competitiveness.

Table 2.4 The institutional structure of selected financial systems, 1985

Country	Assets as a percentage of total gross assets of the financial system						As a percentage of GNP	
	Central banks	Deposit banks	Specialized lending institutions	Contractual savings institutions	Collective investment institutions	Long-term debt securities and equities[a]	Net financial assets	Total external debt
Developed markets								
Australia	5	31	14	17	1	33	..	—
Canada	1	33	2	26	8	30	165	—
France	6	56	10	7	5	16	109	—
Germany, Fed. Rep. of	4	41	14	9	2	30	158	—
Japan	2	45	9	6	7	30	300	—
Sweden	4	27	18	16	1	35	..	—
United Kingdom	1	35	1	26	3	34	188	—
United States	2	28	7	19	4	40	210	—
Average	3	37	9	16	4	31	188	—
Emerging markets								
Argentina	32	43	11	5	0	10	..	80
Brazil	27	32	12	2	4	23	59	50
Chile	14	44	1	11	1	28	75	145
India	10	47	6	12	1	24	65	19
Korea, Rep. of	9	53	14	4	10	10	66	57
Malaysia	7	34	12	13	3	32	247	52
Nigeria	23	46	2	3	7	19	49	26
Pakistan	21	65	1	2	1	11	45	39
Philippines	30	38	14	3	3	14	38	82
Portugal	20	72	1	2	1	4	124	85
Thailand	16	55	12	1	0	17	89	47
Turkey	33	54	4	6	0	3	27	50
Venezuela	20	46	25	1	0	8	65	74
Average	20	48	9	5	2	16	79	62

Note: Total financial system assets are the assets of all the institutions shown in this table plus the stock of outstanding securities and equities. To eliminate double-counting caused by the assets of one institution being the liabilities of another, net financial assets have been approximated by the sum of total liquid liabilities (IFS, line 55l) plus securities and equities. To deflate these stocks by the flow of GNP, five-quarter arithmetic averages are constructed from year-end data for 1984 and 1985, assuming constant exponential growth during the year.
a. The sum of government bonds, corporate bonds, and corporate equity.
Source: IMF, *International Financial Statistics*, and World Bank data.

ance companies are also generally considered part of the financial sector, but they are not discussed in this Report.

Table 2.4 compares the structure of the financial sector in high-income countries with its structure in some of the more advanced developing countries. Banks in developing countries hold a bigger share of all financial assets (48 percent) than they do in industrial countries (37 percent). The table understates this dominance, because the developing countries included are those with the most sophisticated financial systems. When central banks are included, the predominance of the banking sectors of most developing countries is even greater, for the central banks in the sample hold 20 percent of the financial sector's assets in developing countries compared with only 3 percent in developed markets. In addition to issuing currency and overseeing the operation of the payment system, the central bank acts as banker to the government and to other banks. In contrast, nonbank intermediaries and contractual savings institutions hold a much larger share of financial assets in high-income countries than they do in developing ones. The relatively small domestic financial sectors of the developing countries stand in sharp contrast to their relatively large reliance on foreign financing.

Different financial institutions provide services that are both complementary to and competitive with each other. Deposit institutions offer payment and liquid deposit facilities, and contractual savings institutions provide illiquid savings opportunities that cater to the longer-term needs of customers. Collective investment institutions offer small investors the benefits of professional management and low-cost risk diversification, encouraging them to diversify their savings into marketable securities. On the lending side, commercial banks have traditionally provided working capital and trade finance, but longer-term lending is gaining with the spread of universal banking. Factoring companies specialize in financing inventories

and receivables, whereas development banks and leasing companies provide long-term investment finance.

Money and capital markets provide investment instruments appropriate for contractual savings and collective investment institutions, whose services to the saving public are thereby improved. The efficient functioning of financial markets also depends on institutions that lend and borrow little on their own account: investment banks, securities brokers, and credit rating agencies. Commercial banks also improve the working of financial markets by providing credit and payment facilities to market makers and other market participants.

Different financial institutions and markets compete for a limited pool of savings by offering different instruments. Money and capital markets increase competition between suppliers. Money markets give merchant banks, or commercial banks with limited branch networks, greater access to funds. Because such banks specialize in lending to larger corporations, the corporate loan market may be highly competitive, even though a few large domestic banks may continue to dominate the retail deposit market.

Money markets also provide large corporations and nonbank financial institutions with efficient short-term instruments for investing their liquid funds and thus compete directly with commercial banks' traditional deposit facilities. They also enable large corporations to issue short-term securities in the form of commercial paper and thus further reduce the market power that large banks may have in the domestic banking sector. Finally, capital markets enable contractual savings and collective investment institutions to play a more active role in the financial system.

The complementary and competitive interaction of financial institutions has policy implications. To promote an efficient financial system there must be competition, but the system must also offer an array of services. Rather than restrict the growth and diversification of the main banking groups, governments in the larger economies would be wise to promote greater competition by encouraging money and capital markets, specialized credit institutions (such as leasing and factoring companies), and contractual savings and collective investment institutions. Economies too small to support such specialized institutions can spur competition by allowing economic agents to buy financial services abroad.

The financial systems of many developing countries are inadequate, or less efficient than they could be, or both. Efficient financial systems help countries to grow, partly by mobilizing additional financial resources and partly by allocating those resources to the best uses. As economies develop, so must the financial systems that serve them. The next chapter illustrates the central role of finance in development by reviewing the evolution of financial systems since preindustrial times.

Financial sector issues in developing countries

Governments have made control over finance an important tool of their development strategies during the past few decades. Most believed that without intervention their financial systems would not be cooperative partners in the development effort. Dependent in the 1950s and 1960s on imports of manufactured goods and exports of agricultural products and raw materials, developing economies adopted a variety of strategies to promote rapid industrialization and the modernization of agriculture. A few, such as Hong Kong, the Republic of Korea, and Singapore, attempted from early on to integrate their economies with international markets. Most countries, however, pursued an industrialization strategy based on import substitution. Some provided only moderate and relatively uniform protection to domestic industries, primarily through tariffs, and others (Argentina, India, and Tanzania, for example) provided extensive protection through high tariffs and quantitative import restrictions.

Developing country governments also took an active role in economic decisionmaking. At the very least, governments owned and controlled capital-intensive infrastructure such as roads, ports, water and electric power utilities, and telecommunications. Many also controlled selected enterprises in heavy industry and natural resource extraction. Several countries went further, bringing other industrial and commercial enterprises under government control as well. In centrally planned economies, large-scale production was carried out by government entities to the virtual exclusion of independent organizations, decentralized decisionmaking, and market forces.

Although the extent of intervention varied among countries, nearly all governments considered it necessary to intervene in the financial sector in order to channel cheap credit toward the sectors that were to be at the forefront of development. The financial systems of most developing countries in the 1950s and 1960s could not adequately support a process of industrialization and agricultural modernization. Formal financial systems usually consisted of a few institutions, often foreign-owned, which had branches in the major cities only. These provided financing mainly to trading companies, mines, and plantations, which were often foreign-owned as well. Local businesses had difficulty borrowing from banks; local farmers had no access to them at all. An indigenous informal financial sector made up of moneylenders, traders, and pawnbrokers provided loans to farmers and small businesses (see Chapter 8). Informal lenders charged high rates, however, and the scale of lending was small. There were few sources of equity and long-term finance for industry, and what was available was expensive. In some countries the banks were owned by industrial groups. This reduced the access of outsiders to finance and concentrated a great deal of wealth and power in the hands of a few.

Chapter 2 stressed the roles of risk, information, and transaction costs in determining the supply of finance. In developing countries, investment was relatively risky. Production was in new sectors and used technologies unfamiliar to the work force, entrepreneurs and managers were inexperienced, and marketing channels had not been developed. Natural calamities and fluctuating commodity prices could drastically affect the incomes of farmers. Government policy was a constraint and a source of uncertainty: trade and pricing policies discriminated against exports and agriculture; devaluations and tariff changes could radically alter a firm's competitive position and the cost of servicing its foreign debt; trade and foreign exchange restrictions could reduce access to needed imports. Volatile inflation caused abrupt swings in relative prices, periodic recessions reduced product demand, and government borrowing crowded firms out of the financial markets.

Furthermore, the instruments and markets through which risks could be pooled or transferred were undeveloped. Financiers lacked the tools to evaluate, price, and monitor risks. The weakness of accounting, auditing, and disclosure regulations limited the information available to lenders about borrowers. Legal procedures for collateral and foreclosure were poorly specified. These factors, together with uncertainty about borrowers' prospects and the future inflation rate, deterred creditors from providing long-term funds; lack of information and collateral discouraged banks from lending to farmers and small businesses.

Governments could have tried to increase the willingness of creditors to provide long-term finance and equity capital by modernizing legal systems and making contracts more easily enforceable; by clarifying property rights and improving title transfer and loan security; by improving bank regulation and supervision; by training accountants and auditors; and by ensuring adequate disclosure of information. Chapter 6 discusses such changes in more detail. But institution building takes time. Understandably, many governments wanted faster results. Moreover, many wanted to use the financial system for such purposes as allocating resources to projects with high social returns, redistributing income, reducing costs in state-owned enterprises (SOEs), and offsetting the effects of an overvalued exchange rate and restrictive trade policies.

Rather than lay the foundations of a sound financial system, most governments concentrated on intervention designed to channel resources to activities that they felt were poorly served by existing financial institutions. Toward this end, they nationalized the largest, and in some cases all, commercial banks; in Costa Rica, India, Indonesia, Mexico, and Pakistan, for example, the majority of banking system assets are government-owned. In addition, they created and supported development finance institutions (DFIs), which were specifically mandated to provide long-term finance to particular sectors. Governments applied interest rate and credit allocation controls to public and private institutions alike and ordered banks to open branches in rural areas. Bilateral and multilateral aid agencies participated in targeted credit programs by providing financial support and institutional assistance.

Governments in high-income countries also intervened in their financial systems. Although they exerted some influence over the flow of credit, interest rate and credit controls were less extensive than in developing countries. The principal emphasis was instead on measures designed to safeguard the stability of the financial system. In developing countries, however, governments paid inadequate attention to regulatory and prudential matters, to the detriment of their financial systems.

Government intervention in credit allocation

Developing country governments have played a large role in credit allocation. For example, in Pakistan in 1986, 70 percent of new lending by the national banks, which dominate the banking system, was targeted by government, although this proportion was reduced substantially by 1988. In India about one-half of bank assets had to be placed in reserve requirements or government bonds, and 40 percent of the remainder had to be lent to priority sectors at controlled interest rates. In Yugoslavia in 1986, 58 percent of short-term loans were directed credits. In Brazil in 1987, government credit programs accounted for more than 70 percent of the credit outstanding to the public and private sectors. In Turkey in the early 1980s, roughly three-quarters of all financial system advances were made at government directive or at preferential interest rates, or both, although the proportion has since fallen (see Box 4.1). In Malaysia directed credit has accounted for an estimated 30 percent of bank portfolios.

Many such regimes were immensely complicated. At one point Korea had 221 formal directed credit programs. In 1986 the Philippines had forty-nine schemes for agriculture and twelve for indus-

Box 4.1 Directed credit in Turkey

In the early 1980s roughly three-quarters of all advances from the Turkish financial system were made at government directive, at preferential interest rates, or both. The preferred borrowers were the public administration, state-owned enterprises, farmers, exporters, artisans and small firms, house buyers, industrial investors, backward regions, and so on. Within agriculture, there were programs for sales cooperatives, credit cooperatives, and the like. Programs in other sectors were also subdivided—for example, by loan maturity—with different interest rates and conditions for each. Banks were also required to place 20 percent of their deposits in medium- and long-term credits.

To help banks defray the cost of loans at low interest rates, the Interest Rate Rebate Fund subsidized preferential credits by levying a surcharge on nonpreferential credits. The central bank operated an extensive system of rediscounts for priority sectors. In addition to these basic systems, the State Investment Bank (which lent to state-owned enterprises and has since been abolished) received special loans from the Treasury and from the social security system at favorable interest rates, the central bank provided low-interest loans directly to state-owned enterprises, and the government kept substantial noninterest-bearing deposits at the Agricultural Bank.

In the early 1980s these policies helped to push real interest rates on nonpreferential credit to between 30 and 50 percent. Rates remain high today, but the large public sector borrowing requirement is now the main cause. The government has recently liberalized the credit system. Direct credit and rediscounts made available by the central bank were reduced from 49 percent of total credit in 1980 to 18 percent in 1987. By 1986 there were only five categories of central bank rediscount rates; three years earlier there had been thirty. The proportion of credit extended on preferential terms (defined as credits bearing negative real interest rates) declined from 53 percent at the end of 1983 to 35 percent in September 1987. Preferential credit is now provided only for agriculture, industrial artisans, exports, and housing. Interest rates on short- and medium-term directed credit were raised substantially in early 1988.

try. Interest rates, maturities, and eligibility criteria were often different for each program.

Directed credit programs usually targeted industry, state-owned enterprises, agriculture, small and medium-scale firms, and (to a lesser extent) housing, exports, and underdeveloped regions. In the case of industry the aim was to provide cheaper long-term finance and foreign exchange and thus to promote investment and rapid industrialization. In the case of agriculture it was to raise output and speed the introduction of new technologies. Credit directed to small enterprises was intended to generate employment; in housing, the intent was to provide affordable homes for poor households. Export credit programs sought to bridge the period between production and payment and to compensate exporters for industrial and trade policies that were biased against them.

Interventions were of five main types: lending requirements imposed on banks, refinance schemes, loans at preferential interest rates, credit guarantees, and lending by DFIs. In Brazil commercial banks were required to allocate between 20 and 60 percent (depending on bank size) of their net sight deposits for agriculture. In Mexico banks were required until recently to use 31, 10, 6, and 1.6 percent of their deposit and other liabilities for lending to the government, DFIs, housing, and exports, respectively. Forced lending has now been eliminated as part of a comprehensive financial liberalization program. Banks in Burundi, Turkey, and Tunisia had to use 8, 20, and 43 percent respectively of their deposits (or other categories of assets and liabilities) for medium- and long-term lending or investment in public sector bonds (although in Tunisia the requirement has recently been reduced). In Nigeria banks were required until recently to comply with a scheme in which credit was allocated among sixteen sectors; portfolio requirements now apply to only two sectors, agriculture (15 percent) and manufacturing (40 percent).

In many countries commercial banks, and sometimes also DFIs, could refinance loans to preferred sectors on attractive terms. Bangladesh has twelve refinancing schemes. Turkey in 1983 had about thirty categories of rediscount rates, although by 1986 it had only five. Indonesia's central bank operates thirty-two different schemes. In a sample of sixty-five developing countries more than half had export refinance schemes. Many of the banks initially attracted by the interest rate spreads in these programs later found them inadequate to cover the high default rates.

Governments often specified preferential interest rates for lending to priority sectors. These rates were substantially lower than those on regular loans, which themselves were often kept artificially low. In Peru in 1980–82 the average differential between general and preferential real rates was 32 percentage points; the corresponding figure in Turkey was 36 percentage points.

Some governments have also provided guarantees. In high-income countries credit guarantees are the main form of assistance to small businesses. At least seventeen developing countries—including Cameroon, Colombia, India, Korea, Malaysia, Morocco, Nepal, the Philippines, and Sri Lanka—have established formal guarantee schemes for small and medium-scale enterprises. Guarantees and crop insurance have also been used in support of agriculture in countries such as Brazil, India, Mexico, Panama, and Sri Lanka. At least ten developing countries have guarantee schemes for preshipment export credit; even more have export insurance schemes.

Development finance institutions have been perhaps the most common means of directing credit. They were actively encouraged and supported by bilateral and multilateral creditors. Virtually all developing and high-income countries have at least one, and many have a special institution for each priority sector. Kenya, for example, has five government DFIs and three others in which the government has a big stake: one each for agriculture, tourism, and housing; four for industry; and one that serves the former East African Community. Brazil and India both have complex systems of national and state DFIs. The importance of DFIs varies from country to country, however. Industrial DFIs accounted for less than 10 percent of credit outstanding to manufacturing in Malaysia and Thailand in 1987, whereas in Mexico and Turkey they accounted for around one-third. In Morocco, the three sectoral DFIs accounted for 79 percent of all long-term finance. In some countries virtually all formal credit for agriculture and housing is provided by public institutions.

The impact of directed credit programs on credit and growth

It is impossible to be precise about the effect of directed credit on the allocation of resources. In some countries it is likely that the programs have had little impact, because they supported lending which would have happened anyway, because they offered only weak incentives, because directives were not enforced, or because the programs covered only a small share of total credit. In other countries, however, directed credit programs had a significant effect. In Korea, reflecting the bias of credit directives, industry's share of credit increased from 44 percent to 69 percent between 1965 and 1986. In Pakistan and Tunisia there was a sharp decline in the share of commerce in total credit; this too reflected the bias of directed credit in favor of other sectors.

State-owned enterprises in some countries have clearly benefited from directed credit, especially if foreign financing is taken into account. The share of SOEs in nongovernmental borrowing from domestic banks in 1983–85 was 56 percent in Guyana, 43 percent in Mexico, 25 percent in Nepal, and 18 percent in Brazil. The share of SOEs in value added was much lower—in Guyana and Mexico not more than 25 percent and in Brazil and Nepal less than 5 percent. The foreign obligations of SOEs now account for more than half the external debt of Brazil, the Philippines, and Zambia. By 1986 the outstanding stock of foreign loans to SOEs for a sample of ninety-nine developing countries was twice that to the private sector. Although SOEs are capital-intensive, and therefore might be expected to borrow heavily, the way in which the enterprises were managed is a large factor in their high indebtedness. Artificially low prices, excessive staffing, or activities that were inherently unviable have resulted in low profits and low retained earnings. Borrowing was necessary not just for investment but also to cover losses.

In some countries, such as Ecuador (see Box 4.2) and Sri Lanka, lending programs for small and medium-size enterprises are succeeding in attracting the participation of local banks. Small firms almost everywhere continue to have difficulty obtaining funds, however. Lenders have avoided participating in schemes or have concentrated their support on the wealthier enterprises. Banks have been reluctant to use guarantees because the procedures are slow and complicated.

Export credit programs have increased exporters' share of credit in several countries. But the schemes have sometimes been narrow in coverage. In many countries they have not applied to indirect exporters, and small and new exporters also have difficulty. Preshipment refinance is not always automatic and fluctuates with changes in monetary and credit policy.

Although individual sectors have benefited from directed credit, the overall effect on growth is hard to gauge. Fast- and slow-growing countries alike

Box 4.2 Lending program for small enterprises in Ecuador

In 1980, Ecuador's Corporación Financiera Nacional, the country's largest government-owned development finance institution, established a fund—Fondo de Fomento para la Pequeña Industria y la Artesanía (FOPINAR)—to refinance loans from local financial institutions to small enterprises. The fund is autonomous and operates from a head office in Quito as well as from regional branches. Its financing has come principally from multilateral institutions via the government, which bears the foreign exchange risk. At the end of 1988, FOPINAR had approved the refinancing of 7,467 loans averaging $14,000. Enterprises outside the main urban centers have received 48 percent of the loans (by value).

There are now some forty participating financial intermediaries. The government-owned Banco de Fomento Nacional (BFN), primarily an agricultural bank, accounts for 45 percent of the loans to about 75 percent of the borrowers. Private development finance institutions and commercial banks account for the rest. (The four most active banks account for around 23 percent of total lending, and other banks and finance institutions each account for between 1 and 3 percent.) To participate in the program, the institutions must meet criteria regarding the quality of their FOPINAR portfolio, their overall debt-to-equity ratio, and their standing with the central bank and the superintendency of banks. In order to encourage the participating institutions to become more independent, the program requires them to provide 10 percent of project costs from their own resources. Terms and conditions have been designed to provide FOPINAR and the institutions with adequate spreads (currently 2.5 percent and 5.0–6.0 percent respectively) and to keep interest rates to borrowers positive in real terms. The latter goal has not been fully achieved, mainly because of the very high inflation of the past year and the lack of an automatic procedure for adjusting interest rates.

Collection has been quite good. Arrears on the FOPINAR portion of the discounted loans of the private development finance institutions and commercial banks have averaged less than 3 percent. In June 1988 arrears represented about 11 percent of their overall portfolios.

FOPINAR's independence has allowed it to respond flexibly to changing conditions. FOPINAR actively promoted the program and set terms that were sufficiently generous to attract the financial institutions. It has helped to train the institutions' staff, and they and FOPINAR have accorded a high priority to supervising the loans. Automatic debiting of the institutions for amounts due to FOPINAR gives them an incentive to judge their lending carefully.

have intervened extensively in credit allocation. What matters is whether those who thereby received directed credit used their resources more productively than those who were denied credit would have. This is almost impossible to ascertain, although in some countries well-designed credit programs undoubtedly did improve resource allocation. In countries with highly protectionist trade regimes and macroeconomic instability, directed credit reinforced existing distortions. When structural adjustment was finally undertaken, many of the firms that had been financed became unprofitable. In countries that minimized price and other distortions and maintained macroeconomic stability, directed credit appears to have been more successful.

Credit programs can be useful when used to tackle the inadequacies of financial markets. For example, in countries without venture capital or equity finance, new and risky firms have found it difficult to obtain outside financing. Rather than forgo these investments, governments have directed commercial banks and DFIs to provide the necessary financing. Because of the high risk, interest earnings have not covered portfolio losses, and lenders (or their guarantors) have frequently lost money. It is possible, however, that some of the high-risk firms have been sufficiently successful to compensate for the poor performance of others and that the overall program produced a net gain for the economy. Yet few governments and DFIs have turned out to be successful venture capitalists. Equity finance is a more appropriate way to finance risky ventures than bank loans. If governments establish the conditions necessary for equity finance, intervention will not be necessary.

Even well-designed credit controls tend to lose effectiveness if maintained too long. Moreover, the potential for mistakes grows as economies become more complex. The Korean government, for example, exercised extensive control of credit allocation through a combination of moral suasion and explicit programs. The policy was successful: the economy grew rapidly. Nevertheless, the government made mistakes in the latter half of the 1970s, encouraging large investments in shipping and

heavy industry that resulted in excess capacity and slower growth in the early 1980s. Recognizing the inefficiencies of excessive intervention, the government has begun to liberalize its financial policies (see Chapter 9).

Directed credit programs have often been used not to correct the inadequacies of financial markets but to channel funds to priority sectors regardless of whether these were the most productive investments. Policies aimed more directly at goods markets or at the distribution of income—price reform in agriculture, grants for the poor, and so on—might have been more successful and would have avoided many of the drawbacks of directed credit.

Problems of directed credit programs

The interest rates charged on directed credits often deviated substantially from rates on nonpreferential credit. The large implicit subsidy had to be borne by someone. Subsidies have sometimes been covered by low-cost loans from international agencies, by a charge against public spending, or by cheap rediscounts from the central bank. Otherwise, they had to be covered by cross-subsidization: higher rates charged to other borrowers, lower rates paid to depositors, smaller profits (or greater losses) for financial institutions. Such subsidies were often substantial: in Brazil in 1987 they were estimated at between 4 and 8 percent of GDP. In Mexico subsidies relating to development finance institutions and official trust funds were estimated to average 3 percent of GDP during 1982–87. Subsidies of this magnitude, when financed by the central bank or charged to the government budget, have compromised efforts at monetary or fiscal restraint.

Subsidized credit often failed to reach its intended beneficiaries. Lenders misclassified loans in order to comply with central bank directives. Within priority sectors, larger and more influential borrowers benefited most. Much was at stake: acquiring subsidized credit could sometimes add more to profits than producing goods. A review of ten small and medium-scale industry projects showed that the distribution of loans was skewed in favor of larger firms. Studies of agricultural and housing programs show similar results. Directed credit programs do redistribute income, but not necessarily in favor of the poor (see Box 4.3). Furthermore, when rates of return in targeted activities were lower than elsewhere, borrowers did not use directed credit as intended. A study of an agricultural scheme in Colombia found that nearly half the funds had been diverted to other uses. Korea had an active curb market in which those with access to subsidized credit at times lent to others without.

Box 4.3 Credit and income redistribution in Costa Rica

In Costa Rica, subsidized agricultural credit has been extended by four commercial banks, all government-owned. They were well positioned to reach the small farmer. By the mid-1970s the three smaller banks had more than thirty regional offices and the largest (Banco Nacional) had more than a hundred, two-thirds of which were rural offices specializing in credit for small farmers.

Data for Banco Nacional, which accounted for 60 percent of agricultural credit disbursed, reveal that in 1974 just 10 percent of its agricultural loans accounted for 80 percent of the total agricultural credit it extended. The distribution of agricultural credit (and hence subsidies) disbursed by Banco Nacional was actually more skewed than the distribution of income and land. Low interest rates on the loans implied subsidies equivalent to 4 percent of GDP and almost 20 percent of value added in agriculture. That suggests an average credit subsidy of $10,210 on each of the big loans that accounted for 80 percent of the credit. In 1974 a family with an income of $10,500 was in the top 10 percent of the income distribution.

By limiting the availability of credit to nonpriority firms, directed credit programs have crowded such firms out of formal credit markets and forced them to rely on retained earnings or more expensive borrowing from informal sources. Enterprises (in India, for example) have sometimes become quasi-financial intermediaries themselves because formal markets did not serve them adequately.

Once directed credit programs are begun, they create a constituency of beneficiaries who do not want them stopped. This has made it extremely difficult for governments to reduce their support of such programs—regardless of how costly or inefficient governments perceive them to be.

The impact of directed credit programs on financial systems

Whatever conclusion is drawn concerning the impact of directed credit programs on growth and the distribution of income, it is clear that they have

Box 4.4 The Botswana Development Corporation

The Botswana Development Corporation (BDC) was established in April 1970. It is owned by the government of Botswana, although three foreign agencies, including the International Finance Corporation, own nonvoting preference shares. The BDC is not a typical development finance institution. It has tried to identify and establish new projects through wholly owned or joint-venture subsidiaries, the latter with foreign participation. The BDC has investments in about sixty companies in many sectors, including commercial farming, tourism, commerce, industry, property development, financial services, and transportation. Most of its loans are to its subsidiaries and affiliates. It has also tried to help local entrepreneurs through its involvement in Tswelelo, a development bank for small enterprises.

The BDC's portfolio is sound. Less than 1 percent of the total loan portfolio is in arrears, and only a few of the companies in which it has equity holdings are showing losses. The BDC's financial performance has been equally strong (except for a small loss in 1985, due mainly to Air Botswana, which has since been divested into a separate parastatal). In recent years the BDC's rate of return has averaged 5 percent on net worth.

The BDC has been criticized for not divesting and for crowding out the private sector. As a result of its recent initiatives, however, the Sechaba Investment Trust and Stock Brokers Botswana Ltd. have been formed as the first of their kind in Botswana. The Sechaba Investment Trust will enable the BDC to start privatizing some of its profitable companies and give citizens an opportunity to invest in private corporations.

The BDC has developed into a mature development finance corporation. It is financially strong, has sound procedures, and has played a key role in the development of Botswana's financial system. The BDC owes its achievements to a strong and growing economy, a conservative investment and lending strategy, independent management, and a highly qualified staff.

damaged financial systems. Many directed credits have become nonperforming loans. The ability to borrow at cheap rates encouraged less productive investment. Those who borrowed for projects with low financial returns could not repay their loans. In other cases borrowers willingly defaulted because they believed creditors would not take court action against those considered to be in priority sectors. The distorted allocation of resources and the erosion of financial discipline have left intermediaries unprofitable and, in many cases, insolvent. Extensive refinance schemes at low interest rates have reduced the need for intermediaries to mobilize resources on their own, leading to a lower level of financial intermediation. Moreover, by encouraging firms to borrow from banks, directed credit programs have impeded the development of capital markets.

The adverse impact of directed credit on financial institutions is clearest in the case of development finance institutions. Industrial DFIs were generally deemed a success in their early years. Some of them have been conservative lenders and have managed to avoid excessive political interference; especially in countries with sound trade, fiscal, and monetary policies, they have continued to perform reasonably well (see Box 4.4). But for most the assessment is now far less positive. Portfolios and financial performance have deteriorated markedly; many DFIs are insolvent, and some have had to be closed. In a sample of eighteen industrial DFIs worldwide, on average nearly 50 percent of their loans (by value) were in arrears, and accumulated arrears were equivalent to 17 percent of the portfolio value. For three of these institutions, loans accounting for between 70 and 90 percent of the portfolio value were in arrears. The situation may be worse than the numbers show, because the rescheduling of overdue loans and growing loan portfolios reduce arrears ratios. Industrial DFIs have continued to depend on governments and foreign official creditors for funding because poor performance left them unable to pay market rates of interest, because the term structure of interest rates often forbade the higher rates necessary to mobilize longer-term resources, and because markets for longer-term domestic instruments were poorly developed.

The economic shocks of the 1980s added to the arrears of many industrial DFIs, but the roots of the problem usually lay deeper. Most industrial DFIs specialized in medium- and long-term lending for investment. Such lending was vulnerable to business cycle fluctuations and provided insufficient diversification of risk. Because most industrial DFIs did not provide working capital finance, take deposits, or provide other current services, and because they invested in equities to only a

limited extent, they also lacked up-to-date information on their borrowers. Furthermore, when weak DFIs diversified into deposit taking, they were unable to compete with commercial banks.

Multilateral lenders encouraged industrial DFIs to calculate economic as well as financial rates of return. This is undoubtedly useful in distorted environments, but it may have diverted attention from the borrower's overall prospects, management capabilities, and day-to-day operating decisions. Many DFIs have permitted clients to finance investments with too little equity. Moreover, because many DFIs relied heavily on foreign resources, they had to pass foreign exchange risk on to clients who could neither bear nor hedge it. When currencies were devalued, many firms could not repay the loans. Finally, like government-owned commercial banks, government DFIs have had trouble recruiting and retaining competent staff because of uncompetitive salaries. Managers appointed for political reasons have often been unqualified and open to outside pressure in making loans.

The performance of agricultural DFIs has also been poor. Studies show default rates ranging from 30 to 95 percent for subsidized agricultural credit programs. Agricultural DFIs have suffered from many of the same problems as industrial DFIs: too much government intervention, overreliance on governments and official creditors for funding, inappropriate lending criteria (such as crop and livestock models that hold little relevance for the farms under review). In addition, lending to small farmers is relatively risky and has high transaction costs, especially if combined with technical assistance. And governments have often been unwilling to foreclose on small farmers, which has seriously eroded financial discipline.

Housing finance institutions have had problems, and several have been closed, but on the whole they have fared better than industrial and agricultural DFIs. They have had more success in mobilizing resources, although funding in some cases has come from compulsory savings schemes. The better housing banks view themselves as household sector banks and offer a range of services. They also tend to be located in countries with legal systems that make it possible to enforce collateral arrangements. Some housing intermediaries, pressured to behave like social agencies rather than bankers, have lent on excessively high loan-to-income or loan-to-value ratios; this has caused losses and poor recovery from collateral. Where fixed interest rates were charged on mortgages but inflation and short-term deposit rates were rising (as in several Latin American countries and in the United States in the 1970s), housing banks that depended on short-term deposits were badly hurt. Mortgage indexation has provided some protection, but in countries such as Argentina and Brazil indexation was tied to wages; when these declined in real terms, the banks were left short of income.

Macroeconomic policies and financial development

In some countries macroeconomic instability has compounded the difficulties that financial systems now face. Macroeconomic conditions in developing countries in the 1980s were the result not only of external shocks but also of the development strategies that had been pursued in the 1960s and 1970s.

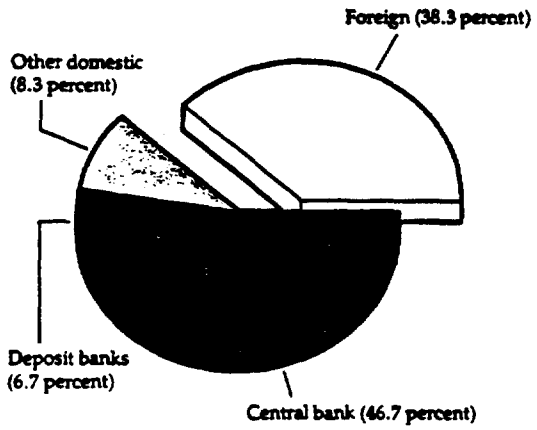
Government borrowing and inflation

By the 1980s many developing countries had come to rely on foreign borrowing to help finance increasing public sector deficits. When the inflow of foreign capital dried up in the early 1980s, some countries were able to reduce their fiscal deficits. But many were not. They lacked adequate instruments of taxation; social and political considerations made it hard to cut spending; and most of their external debt had been contracted at floating rates, so that the rise in real interest rates sharply increased the cost of servicing that debt.

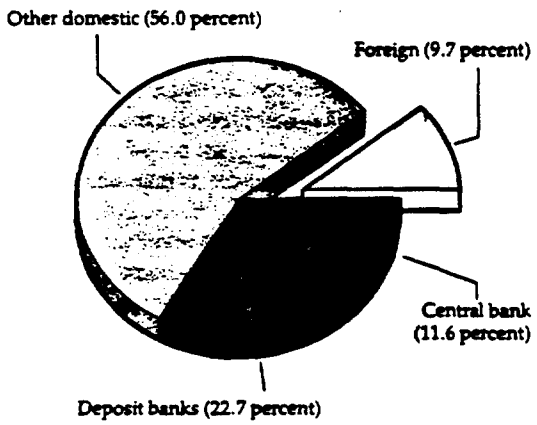
Central government deficits tell only part of the story. A more complete definition of the deficit is the public sector borrowing requirement (PSBR), which in principle consolidates the net borrowing needs of all public sector entities, including public enterprises and the central bank. In practice, it often excludes some entities for lack of data. In some countries the reported PSBR became quite large. For example, in 1984 the PSBR was 15 percent of GDP in Argentina, 11 percent in Chile, 8 percent in the Philippines, and 13 percent in Yugoslavia.

PSBR data are unavailable for many countries, but Figure 4.1 shows how central government deficits, the narrow measure of public borrowing, were financed in twenty-four developing and eleven high-income countries in 1975–85. The contrast between the two groups is striking. In the developing countries 47 percent of the deficit was financed by borrowing from the central bank, 15 percent by borrowing from domestic financial institutions and markets, and 38 percent by borrow-

Figure 4.1 Central government borrowing by source, 1975 to 1985



Developing countries



High-income countries

Note: Data are GDP-weighted averages. The developing country sample consists of Bolivia, Burkina Faso, Burma, Chile, Cyprus, Dominican Republic, Arab Republic of Egypt, Gabon, Indonesia, Republic of Korea, Liberia, Mexico, Morocco, Nepal, Nicaragua, Pakistan, Thailand, Togo, Tunisia, Uruguay, Venezuela, Yemen Arab Republic, Zaire, and Zimbabwe. The high-income sample consists of Australia, Austria, Canada, Finland, France, Federal Republic of Germany, Italy, Netherlands, Sweden, United Kingdom, and United States.

ing from abroad (although foreign financing declined from 44 percent in 1975–82 to 26 percent in 1983–85). High-income countries, in contrast, relied mainly on nonbank financial institutions and markets to finance their deficits, borrowing less than 12 percent of the total from central banks.

The governments of developing countries turned to their central banks because domestic financial markets were too shallow to meet their needs. To the extent that central banks financed such borrowing by issuing money, the result was higher inflation. The average inflation rate in developing countries increased from 10 percent a year in 1965–73 to 26 percent in 1974–82 and 51 percent in 1983–87. Inflation rates in high-income countries also rose in the 1970s but have been held to less than 5 percent a year in the 1980s. Half of all developing countries continue to enjoy single-digit inflation, but the number of countries with double- and triple-digit inflation has risen in recent years (see Table 4.1). During 1983–87, seven countries (Argentina, Bolivia, Brazil, Nicaragua, Peru, Sierra Leone, and Uganda) had average inflation rates of more than 100 percent, whereas in 1965–73 none did, and between 1974 and 1982 only Argentina did. Four of the seventeen highly indebted middle-income countries had triple-digit and eleven had double-digit inflation during 1983–87, which underscores the interrelation of external debt, fiscal deficits, and inflation. Other factors, such as repeated devaluations, have added to inflationary pressures, but deficit financing has provided the primary impetus.

One way or another, the domestic financing of large public sector deficits has taxed the financial process. Inflation is a tax on certain financial assets (see Box 4.5). Although some governments have sought to reduce the inflationary impact of public sector borrowing, the measures adopted are, in effect, alternative forms of taxation. Argentina, for example, set reserve requirements on demand deposits at more than 70 percent, Brazil at more than 40 percent, and Zaire at 51 percent. Reserve requirements constitute forced loans to the central bank, usually at below-market rates. Another approach has been to require banks, insurance companies, and other financial institutions to invest part of their funds in low-yielding government bonds. India and Pakistan, for example, have used this approach to finance large budget deficits at low cost while maintaining reasonable price stability (although Pakistan has curtailed the practice in recent years).

High reserve requirements and forced investments in low-interest government securities crowded out private sector borrowing and discouraged financial intermediation. The implicit tax reduced intermediaries' profits or was passed along to depositors and borrowers in the form of lower

Table 4.1 Average annual inflation rates, 1965 to 1987
(percent)

Item	*1965–73*	*1974–82*	*1983–87*
High-income countries	5	9	4
Developing countries	10	26	51
China and India	3	4	7
Other low-income	20	16	13
Highly indebted countries	14	45	120
Other middle-income	6	15	12
Number of developing countries with inflation rates in excess of			
20 percent	4	15	27
30 percent	2	9	17
100 percent	0	1	7

Note: The average annual rate of inflation is measured by the growth rate of the GDP implicit deflator. Aggregates for country groups are GDP-weighted averages. Data for developing countries are based on a sample of eighty-eight countries.

deposit rates or higher lending rates. Explicit taxes on financial intermediation, as in Turkey and the Philippines (see Box 4.6), exerted additional upward pressure on the spread between deposit and lending rates.

The impact of interest rate policies and inflation

Interest rate controls and inflation have set back financial development in many countries. Governments kept interest rates low partly to encourage investment, partly to redistribute income, and partly because they themselves wished to borrow cheaply. Many governments also believed that low deposit rates (the corollary of low lending rates) would not discourage financial saving.

Experience has shown that some of these ideas were wrong. As Chapter 2 pointed out, there is strong evidence that real interest rates and inflation have a significant effect on financial savings,

Box 4.5 The inflation tax

An economy's willingness to hold money—that is, its demand for money—generally grows with its real GNP. Such demand may also change in response to yields on other assets and expectations. If the money issue exceeds the increase in the economy's willingness to hold money, the result is inflation, which operates like a tax. Asset holders "pay" the tax by losing purchasing power on their money holdings. Those who have issued money liabilities "collect" the tax in the form of a reduction in the real value of their liabilities. To the extent that the money issuer pays interest on these liabilities, it returns some of the tax to asset holders. Central banks typically do not pay interest sufficient to offset the tax on their money issue: they pay no interest on currency and usually a below-market interest rate on reserves. Box table 4.5 provides estimates of the inflation tax (as a share of GNP) flowing to the central bank on reserve money for ten countries in 1987.

It might seem that a high inflation rate implies a high inflation tax as a percentage of GNP, but this is not always so. High inflation rates (that is, high rates of inflation tax) discourage people from holding money. When the money stock held by the economy is a small percentage of GNP, the inflation tax will be correspondingly small. Hence, if inflation has been high and the money stock—the tax base—has declined as a percentage of GNP, the central bank must issue a larger amount of money and generate a higher inflation rate to secure a given amount of revenue.

Box table 4.5 The inflation tax in selected countries, 1987

Country	*Inflation tax (percentage of GNP)*	*Reserve money (percentage of GNP)*	*Inflation rate (percent)*
Argentina	4.0	6.3	174.8
Côte d'Ivoire	0.5	14.4	3.4
Ecuador	2.0	8.1	32.5
Ghana	2.0	7.9	34.2
Mexico	3.7	6.0	159.2
Nigeria	0.9	9.6	9.7
Peru	4.8	9.1	114.5
Philippines	0.6	8.0	7.5
Turkey	2.8	7.9	55.1
Zaire	4.2	8.2	106.5

Note: The inflation tax is defined as the decline in the purchasing power of average reserve money (IFS, line 14) due to inflation. It is calculated as $M \times [i/(1+i)]$, where M is the average reserve money at year-end and year-beginning and i is the decimal inflation rate measured by the change in the CPI from December to December. [Over any interval for which the prices rise by i, each money unit loses $i/(1+i)$ of its purchasing power.]
Source: IMF, *International Financial Statistics*, and World Bank data.

Box 4.6 Taxation of financial intermediation in the Philippines

Like many countries, the Philippines collects special taxes from financial institutions. The most important of these are the gross receipts tax (GRT) and the implicit tax on reserve requirements.

The GRT is imposed on all receipts (income and capital gains) of a bank. Formerly applied at a uniform rate, it is now imposed on a sliding scale, with a rate of 5 percent for instruments with maturities of less than two years. Lower rates apply to longer maturities, with those of more than seven years free of tax. The implicit tax on reserve requirements arises because these are remunerated at 4 percent, which is much lower than market interest rates. Reserve requirements have varied but have for several years been more than 20 percent of bank deposit liabilities (except for long-term deposits of more than two years, which attract a much lower rate).

The impact of these taxes increased markedly during 1983–85. Major devaluations and an acceleration of inflation led to a sharp increase in interest rates as the authorities acted to restore stability. By the end of 1984, with money market rates at around 35 percent (compared with inflation of only 5 percent over the following twelve months), a bank would have had to earn more than 47 percent on a short-term loan simply to service money market borrowings, in view of the reserve requirements and the GRT. In other words, at the margin these taxes added more than 12 percentage points to the cost of intermediation. In fact, bank lending rates and spreads were held down by the weakness of demand for loans and the banks' continued access to funds from depositors at lower interest rates. Nevertheless, the combined burden of the GRT and the implicit tax on reserve requirements in 1984 exceeded 150 percent of value added in the banking system. The impact of the taxes has since come down with the decline in interest rates.

A withholding tax on deposit interest income, which is levied at the rate of 20 percent, also imposes some distortions. Although a credit against income tax, it is not refundable if the computed income tax liability falls below the amount of the tax already withheld. A further imposition is the lending requirement for agrarian reform—10 percent of banks' net loanable funds—which virtually all banks satisfy by investing in eligible government securities. Although these securities now carry market interest rates, this was not the case until recently.

and various studies have found that financial savings and the rate at which these are lent are positively related to economic growth.

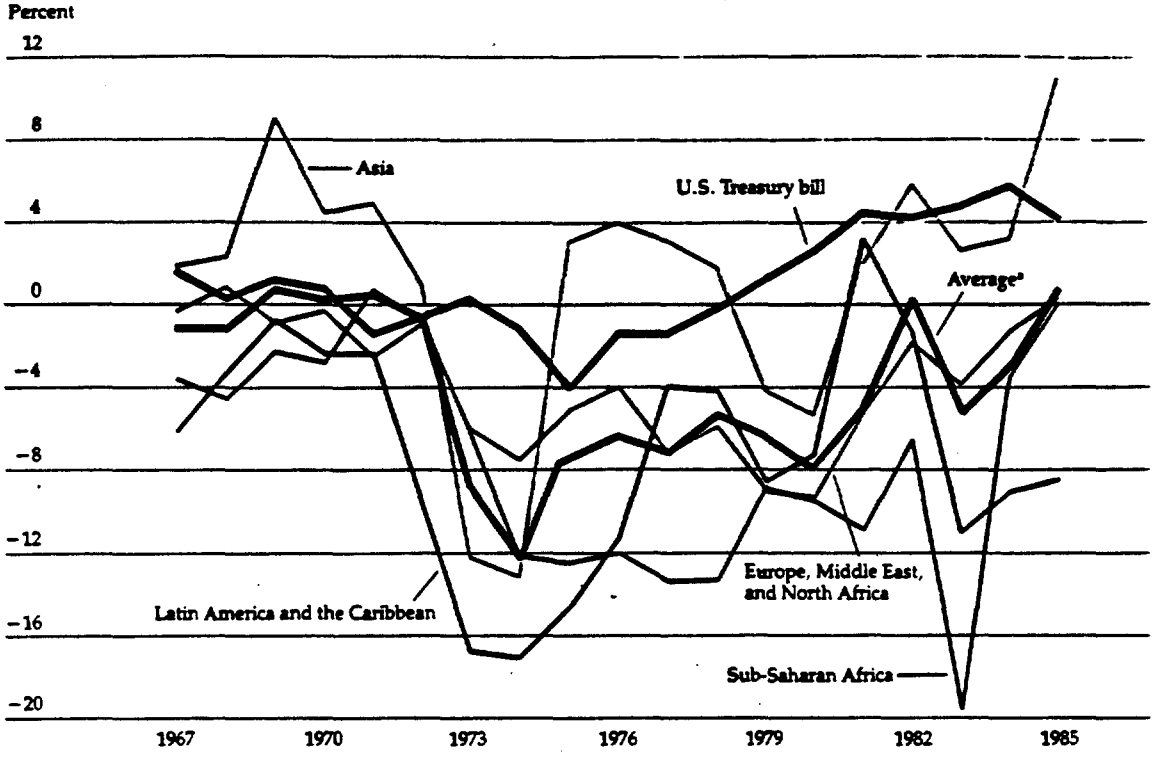
Figure 4.2 compares real interest rates in thirty-five developing countries (as a group and by region) with the U.S. Treasury bill rate between 1967 and 1985. Except for a brief period after the first oil shock, real interest rates were much lower in the developing countries—and substantially negative for much of the period. Within the sample, average real rates were almost consistently negative in Africa, Europe, and Latin America. In Asia, however, average real rates were positive in most years.

Negative real interest rates were sometimes the result of deliberate policy, but sometimes they were inadvertent, a consequence of governments' failure to modify administered rates to compensate for rising inflation. Even in the absence of government regulation, the level of real interest rates has been highly sensitive to inflation because of lags in the adjustment of nominal rates. In Argentina, Israel, and Uruguay in the 1980s, volatile inflation caused sharp fluctuations in real rates.

Because of this link between inflation and real interest rates, macroeconomic stability is vital for financial sector development. In countries that have maintained low and stable inflation through prudent monetary and fiscal policies, financial sector growth has been rapid, even where interest rates were (moderately) regulated. The financial sectors of Japan and Malaysia have grown rapidly during the past three decades, thanks largely to price stability. Malaysia's financial depth, as measured by the ratio of M2 to GNP, rose from 31 percent in 1970 to 75 percent in 1987. Thailand's financial sector has grown rapidly since inflation was brought down; using the same measure, financial depth grew from 34 percent in 1980 to 60 percent in 1987, as real interest rates became positive. In contrast, Argentina has long suffered from high and variable inflation; its financial depth, which exceeded 50 percent of GNP in the late 1920s, had declined to around 30 percent of GNP by 1970 and to 18 percent by 1987 (see Figure 4.3). Other high-inflation countries, such as Bolivia and Yugoslavia, have also experienced slow or negative growth in financial depth.

In the 1970s the problem was low real interest rates. In the 1980s, however, some countries have experienced high real interest rates. Although most developing countries still place restrictions on interest rates, there has been a trend toward

Figure 4.2 Real interest rates in developing countries and the United States, 1967 to 1985



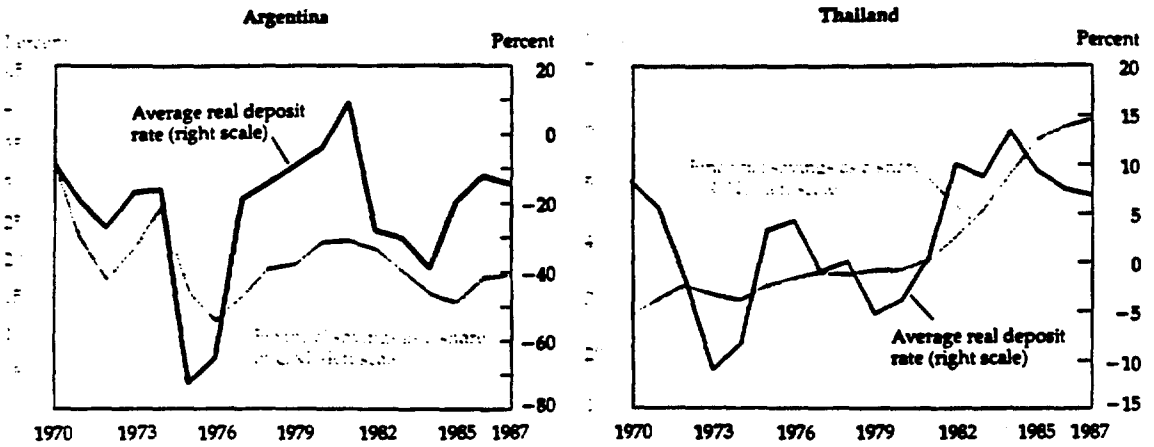
Note: Data are unweighted averages based on a sample of thirty-five low- and middle-income countries, eight of them in Europe, Middle East, and North Africa and nine in each of Sub-Saharan Africa, Asia, and Latin America and the Caribbean.
a. Average for the sample of thirty-five developing countries.
Source: Gelb (background paper) and IMF, *International Financial Statistics*.

deregulation. Some countries with unstable macroeconomic conditions and distressed banks and borrowers have seen real interest rates on nonpreferential credit rise to high levels (see Table 4.2). Real rates have also been high in some economically stable countries that administered rates, (for example, Korea and Thailand) because of a decline in inflation and strong loan demand. Although moderately positive real interest rates are desirable, extremely high real rates are not. They can cause distress among borrowers (see Chapter 5) and swell fiscal deficits. Chapter 9 returns to the difficulties confronting governments that intend to liberalize their financial systems.

Interest rate controls and inflation have had other adverse consequences as well. As noted above, artificially low interest rates cause excess demand for credit and force financial institutions to ration their lending—which may favor borrowers who need the money least. By preventing financial institutions from charging higher interest rates on longer-term and riskier loans, governments' interest rate policies have discouraged the very sort of lending they sought to foster. Together with directed credit programs, they have also discouraged competition. The combination of inflation and low deposit rates has led to capital outflows and thereby reduced the resources available for relending by financial intermediaries. The development of unofficial (curb) markets, however, has alleviated some of the adverse consequences of interest rate and other controls (see Box 4.7).

Inflation, by causing uncertainty and instability in relative prices, makes longer-term investments

Figure 4.3 Financial savings and the real deposit rate in Argentina and Thailand, 1970 to 1987



Note: Financial savings are M2 (currency in circulation plus demand, time, and savings deposits at banks) and are five-quarter averages.
Source: Gelb (background paper); IMF, *International Financial Statistics*; Easterly 1989; central bank bulletins; and World Bank data.

riskier and more difficult to finance. It also makes the future purchasing power of financial contracts less certain. Even when interest rates are not regulated, uncertainty about future inflation makes it hard for lenders and borrowers to agree upon an appropriate fixed nominal interest rate. The lender risks inflation turning out higher than expected, the borrower risks inflation turning out lower than expected. The higher and more variable the inflation and the longer the time horizon, the greater the risks. In countries such as Argentina loans of more than thirty days became unusual.

Several countries that have had chronic inflation, including Brazil, Chile, Colombia, and Israel, have authorized the use of indexed financial contracts. Indexation links the value of the financial contract to a price index. If indexation is complete, if the index accurately reflects prices, and if adjustment is immediate, indexation denominates the contract in terms of purchasing power rather than money. At high inflation rates, private sector borrowers often find it too risky to take on purchasing power obligations, because they fear their income will fail to keep pace. The public sector, in contrast, does not have this problem. It cannot go bankrupt in its domestic markets as long as it has the power to

Table 4.2 Real loan interest rates for selected countries, 1980 to 1986
(percent)

Country	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*
Argentina	5.1	31.2	−18.7	−22.9	−29.7	−6.3	3.9
Brazil	−2.5	4.9	26.2	0.2	7.5	−0.1	−0.1
Chile	12.1	38.8	35.7	15.9	11.5	11.1	7.5
Colombia	..	..	..	..	..	14.1	11.8
Indonesia	..	..	10.9	9.9	16.4	17.4	13.1
Korea, Rep. of	−12.3	5.1	6.6	7.9	7.4	6.6	8.6
Philippines	..	4.2	8.9	−5.4	−15.0	21.7	17.9
Thailand	1.4	5.9	16.0	13.3	19.2	15.2	15.1
Turkey	−0.6	50.2	37.7	28.0	28.7	42.0	51.0

Note: Real interest rates were calculated from nominal rates according to the following formula: $[(1 + r) / (1 + p) - 1] \times 100$, where r is the interest rate and p is the inflation rate.
Source: Easterly 1989.

Box 4.7 The curb market

In many developing countries, economic regulation (often in the form of interest rate controls) has led to the growth of an unregulated curb market, which can be an important source of funds for both business and households. In the Republic of Korea, it has been estimated that the outstanding obligations in the curb market in 1964 were roughly equal to 70 percent of the volume of loans outstanding from commercial banks. By 1972 the ratio had been reduced to about 30 percent, largely as a result of interest rate reforms in the formal sector in the mid-1960s. After the monetary authorities reduced interest rates in the late 1970s, there was a resurgence in the market. But the market has recently declined again. Business shifted from the curb market to nonbank institutions that were allowed to offer substantially higher returns.

According to one survey, about 26 percent of firms borrowed from the curb market, which supplied about 20 percent of their total borrowing. About 70 to 80 percent of credit from the curb market to small and medium-size firms was extended without collateral. But the curb market uses a sophisticated credit rating system, and prime companies pay an interest rate substantially lower than less creditworthy ones. The average annual interest rate on curb loans was 24.0 percent in 1985, when the general bank loan rate was 10.0–11.5 percent.

The curb market has been closely integrated with the formal market. According to one popular method of transaction, an informal lender makes a savings deposit at a bank branch, which then extends a loan to a borrower designated by the depositor. The informal lender thereby earns the savings deposit rate plus about 1 percent a month from the borrower, without any risk of default.

The curb market has been a significant part of the financial system in other countries as well. In Argentina, for example, the reimposition of interest rate controls and financial repression after 1982 led to the rapid expansion of the curb market. According to one estimate, informal credit from the curb market represented nearly a quarter of the total granted by commercial banks and finance companies in 1984.

Experience shows that the curb market becomes active when the formal financial sector is heavily regulated and interest rates are held below market levels. The curb market is effectively an unregulated bills market.

print money. Thus at high rates of inflation, most indexed contracts are issued or backed by the government or by public entities. Indexing financial instruments can be useful in inducing lenders and borrowers to make longer-term commitments at some middle range of inflation, say 10 to 40 percent a year, but it is no substitute for controlling inflation. If unaccompanied by adequate stabilization measures, indexation tends to make inflation worse (see Box 4.8).

As an alternative to indexing, some countries, including Turkey, Uruguay, and Yugoslavia, have adopted foreign currency deposit schemes. In effect, these index deposits to the exchange rate. Such schemes have increased the flow of savings into the financial system. But they can also complicate monetary management. Since the domestic value of the foreign exchange deposits rises automatically with currency devaluation, the monetary aggregates tend to accommodate inflationary pressures. To the extent that loans extended against foreign exchange deposits are denominated in domestic currency, the banks lose with each devaluation if the interest rate differential is insufficient to cover the change in currency values. This puts pressure on the central bank to provide accommodation. In Yugoslavia, for example, central bank losses on the foreign currency deposit scheme have added to inflationary pressures.

Exchange rate policies and financial development

During the 1970s many developing countries allowed their exchange rates to appreciate in real terms. This was made possible by relatively favorable terms of trade and by the availability of foreign loans to finance the resulting current account deficits. The real appreciation of the exchange rate favored production of nontraded over traded goods and encouraged reliance on imported inputs. Financial institutions accordingly allocated a larger share of credit to firms in the nontraded goods sector, as Figure 4.4 illustrates in the case of Colombia.

Overvalued exchange rates and controlled interest rates combined to stimulate capital outflows. These flows were illegal in countries with foreign exchange controls, but such controls have rarely been effective. Although capital flight is hard to measure, the discrepancies between increases in

Box 4.8 Financial indexation in Brazil

By 1964 Brazil's inflation rate had risen to 100 percent a year. A new government took office in April 1964 determined to stabilize the economy. It felt unable to cut the deficit immediately, but wanted to finance it with noninflationary debt sales in domestic financial markets. This was impossible because exorbitant real interest rates would have been needed to compensate bondholders for bearing the inflation risk. In 1965, therefore, the government issued an indexed Treasury bond—a bond whose principal and interest would be adjusted periodically in line with the inflation rate. The government also encouraged the indexation of other financial instruments, including savings accounts and corporate debentures.

The experiment had mixed results. Indexation undoubtedly succeeded in increasing the flow of savings through the financial system and to the government (see Box table 4.8). Corporations, however, remained reluctant to issue indexed debentures because they were unsure whether the returns on their assets could keep pace with index-linked obligations. There was a similar problem in the housing market. Most mortgages could not be fully index-linked because wages generally lagged behind inflation. Borrowers' monthly payments were therefore linked to wages, which were usually adjusted once a year, and their outstanding mortgage balances were indexed to prices. The housing finance system grew rapidly through the late 1960s and 1970s. But when inflation once again reached the triple-digit level in the 1980s, the system faced severe liquidity problems because liabilities and assets rose much faster than wage-linked income cash flow. Moreover, when prices accelerated, asset holders tended to switch their portfolios from money-denominated instruments to indexed instruments. This created sharp liquidity pressures for commercial banks and short-term financial markets, from which asset holders withdrew resources, as well as for housing finance intermediaries, which had difficulty coping with large and often temporary resource inflows.

The government succeeded in financing more of its deficit with indexed bonds. In the 1980s, however, the real stock of indexed bonds increased—in part, because most bonds carried an exchange rate clause and in February 1983 there was a sharp real devaluation, but also because the public sector's borrowing needs rose markedly. Inflation accelerated and the debt servicing requirements on the indexed bonds added significantly to the public sector borrowing requirement. As part of its 1986 Cruzado Plan, the government suspended most forms of financial indexation, hoping to relieve the "inflation-feedback" spiral that indexation seemed to be causing. When the Cruzado Plan failed and inflation revived toward the end of 1986, nominal interest rates surged. The government found itself in the same position as in the mid-1960s. It again began to issue index-linked bonds.

Box table 4.8 Key financial instruments, selected years, 1965 to 1985
(percentage of GDP)

	Nonindexed				*Indexed*			
Year	*M1*	*Exchange acceptances*	*Treasury bills*	*Total*	*Time and savings deposits*	*Treasury, state, and municipal bonds*	*Real estate bonds*	*Total*
1965	17.2	1.3	—	18.5	0.6	0.9	0.0	1.5
1970	14.6	3.4	0.3	18.3	2.8	4.4	0.8	8.0
1975	13.5	4.2	2.8	20.5	8.3	5.5	0.7	14.5
1979	9.3	2.1	3.0	14.4	10.3	3.7	0.1	14.1
1985	3.9	1.3	0.3	5.5	13.6	9.1	0.0	22.7

Note: 1980 was an anomalous year because a limit was placed on financial indexation.
Source: For 1965–79, Goldsmith 1986; for 1985, based on central bank data.

external debt and the uses of finance recorded in the balance of payments accounts—especially for many Latin American countries in the early 1980s—point to massive capital flight. Capital outflows are not an exclusively Latin American phenomenon, of course. There have been capital outflows from member countries of the West African Monetary Union, which have few restrictions on capital transfers. Thailand, which also had relatively liberal policies toward capital movements, experienced capital outflows when U.S. interest rates increased sharply in the early 1980s; these outflows stopped when domestic interest rates were adjusted accordingly.

distress by lowering interest rates. Lower deposit rates, however, contributed to inflation and capital flight by encouraging holders of wealth to turn away from domestic financial assets toward goods or foreign financial assets. The process of disintermediation and the declining demand for domestic financial assets compounded banks' difficulties, and the declining demand for money also amplified the inflationary effects of excessive money creation.

Financial distress may not be the principal cause of inflation, but the complex interaction between financial weakness and macroeconomic policy is certainly important. Distress and inflation are mutually reinforcing. Measures to assist banks have frequently added to inflation and thereby aggravated the distress they were meant to relieve. Resolving the banks' portfolio problems and preventing their recurrence calls for a clearer understanding of why so many firms are unable or unwilling to service their loans.

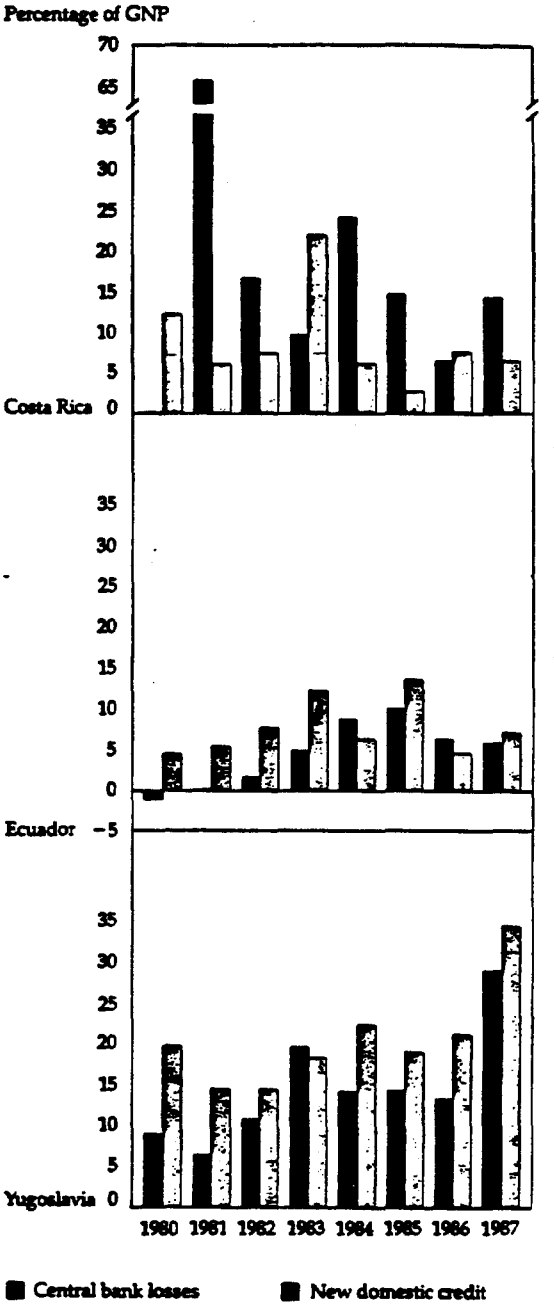
Roots of financial distress

Explanations of firms' financial difficulties can be grouped under three headings: macroeconomic conditions, industrial and financial policy, and debtor and creditor behavior. The importance of macroeconomic factors is clearest for the countries with large external debt burdens. The countries with the most acute domestic financial distress have generally been those with the most severe foreign debt difficulties. The external shocks that led to the international debt crisis and the policy adjustments that came after it left many domestic firms unprofitable and unable to service their debts, domestic or foreign.

The macroeconomic shocks of the early 1980s are only a proximate cause of financial distress, however. The financial and industrial policies pursued by many countries during the 1960s and 1970s left their financial systems weak and vulnerable to change. Banks were often directed to provide subsidized credit to firms in favored regions or sectors. In some countries firms in priority sectors have been consistently unprofitable. In others they were profitable only as long as they were protected; today such firms account for a large proportion of nonperforming loans.

In most cases macroeconomic conditions, directed credit programs, and interest rate controls are the principal factors underlying the current difficulties of firms and their creditors (as discussed in Chapter 4). But they are not the only factors. Many

Figure 5.2 Central bank losses and new domestic credit in selected developing countries, 1980 to 1987



Note: Central bank losses are approximated by the central bank's "Other items, net" (IFS, line 17r), which are mainly foreign exchange valuation losses.
Source: IMF, *International Financial Statistics*, and World Bank data.

Box 5.3 How good bankers become bad bankers

The quality of management is an important difference between sound and unsound banks, and in most countries the better-managed financial institutions have succeeded in remaining solvent. Four types of mismanagement commonly occur in the absence of effective regulation and supervision.

- *Technical mismanagement.* Poor lending policies are the most common form of technical mismanagement and are usually a consequence of deficient internal controls, inadequate credit analysis, or political pressures. Poor lending policies often lead to excessive risk concentration, the result of making a high proportion of loans to a single borrower or to a specific region or industry. Banks sometimes lend excessively to related companies or to their own managers. Mismatching assets and liabilities in terms of currencies, interest rates, or maturities is another common form of technical mismanagement.
- *Cosmetic mismanagement.* A crossroads for management is reached when a bank experiences losses. Strong supervision or a good board of directors would ensure that the losses are reported and corrective measures taken. Without these, bankers may engage in "cosmetic" mismanagement and try to hide past and current losses. There are many ways to do this. To avoid alerting shareholders to the difficulties, bankers often keep dividends constant despite poorer earnings. And to keep dividends up, bankers may retain a smaller share of income for provisions against loss, thereby sacrificing capital adequacy. If a dividend target exceeds profits, bankers may resort to accounting measures that increase net profits on paper, even if more taxes must be paid as a result. By rescheduling loans, a banker can classify bad loans as good and so avoid making provisions. The capitalization of unpaid interest raises profits by increasing apparent income. The reporting of income can be advanced and the recording of expenditure postponed.
- *Desperate management.* When losses are too large to be concealed by accounting gimmicks, bankers may adopt more desperate strategies. The most common of these include lending to risky projects at higher loan rates and speculating in stock and real estate markets. Such strategies, however, involve greater risk and may well lead to further losses. The problem then becomes one of cash flow: it gets harder to pay dividends, cover operating costs, and meet depositors' withdrawal demands with the income earned on the remaining good assets. To avoid a liquidity crisis a bank may offer high deposit rates to attract new deposits, but the higher cost of funds eventually compounds the problems.
- *Fraud.* Fraudulent behavior sometimes causes the initial losses, but once illiquidity appears inevitable, fraud becomes common. As the end approaches, bankers are tempted to grant themselves loans that they are unlikely to repay. Another common fraud is the "swinging ownership" of companies partly owned by the bank or banker: if a company is profitable, the banker will arrange to buy it from the bank at a low price, and if the company is unprofitable, the banker will sell it to the bank at a high price.

several developing countries that liberalized their financial sectors.

The lack of clear legal procedures for dealing with insolvent banks has been another obstacle to prompt action. In Argentina, for example, the Central Banking Act did not empower the central bank to take over banks, replace managers and directors, or order owners to provide new capital. As a result, intervention led to numerous lawsuits.

The difficulty of foreclosing on defaulting borrowers has caused losses for many banks. In some countries willful default is encouraged by the fact that bankruptcy and foreclosure procedures are slow and cumbersome. In Egypt, Pakistan, Portugal, and Turkey, for example, loan recovery proceedings frequently drag on for several years (see Box 6.4 in Chapter 6). In others, willful default has a more political cause: borrowers in priority sectors such as agriculture realize that governments are reluctant to let lenders foreclose. The default rate among small farmers in Ghana and India, for example, has been particularly high.

In sum, poor prudential regulation and supervision, together with inadequate legal systems, let lenders and borrowers in many countries behave in ways that have added to banks' losses.

Lessons of financial restructuring

As the 1980s proceeded, the distress of financial institutions in some countries precipitated crises and so forced the authorities to take action. As Box 5.1 indicates, intervention ranged from the closing of a few intermediaries with a small fraction of total assets, as in Malaysia, to the closing and replacement of nearly every bank, as in Guinea. During the next few years many more countries—especially those contemplating broader programs

Box 5.4 The U.S. savings and loan crisis: the lessons of moral hazard

More than 500 of the 3,000 savings and loan associations in the United States were insolvent at the beginning of 1989. The cost to the Federal Savings and Loan Insurance Corporation (FSLIC) of restructuring the S&L industry through liquidations, consolidations, and assisted mergers was, as of early 1989, estimated to be roughly $80 billion in terms of present value. Because its own assets were insufficient to meet the potential obligations, FSLIC had been unable to close or otherwise dispose of many insolvent institutions, and so loss-making S&Ls were allowed to remain in operation. In early 1989 the U.S. government announced its intention to cover the FSLIC shortfall through a combination of government funding and higher deposit insurance premiums to be paid by S&Ls.

The difficulties of the S&L industry began in the late 1970s. S&Ls had traditionally lent funds on twenty-to-thirty-year mortgages at fixed rates and funded themselves with short-term deposits. Higher inflation rates in the late 1970s and early 1980s and the correspondingly higher interest rates that S&Ls had to pay on deposits sharply depressed earnings.

The response of the U.S. Congress and several state legislatures was to authorize S&Ls to take on a wider range of lending and borrowing. Ceilings on deposit rates were phased out, and the maximum size of an insured deposit went up from $40,000 to $100,000. Unfortunately, lawmakers paid less attention to strengthening the system of prudential regulation and supervision. Increased lending and borrowing powers gave S&Ls new opportunities for loss as well as profit. They were required to risk little of their own capital; any losses beyond those amounts would be absorbed by FSLIC. This gave them strong incentives to take greater risks, since they would enjoy all the gains but suffer only some of the losses. In addition, deposit insurance premiums were levied at a flat rate per dollar of deposit, so the premium structure did not discourage risk taking. Insurance experts and economists use the term "moral hazard" to describe this situation of distorted incentives.

Although only a minority of S&Ls fell prey to moral hazard, they did so with gusto. Their losses were compounded by changes in the tax law that made real estate (in which many of these S&Ls had invested) a less attractive investment; by a severe economic downturn in oil-producing areas, particularly Texas; by delays in the imposition of remedial prudential regulations; by delays in the closure of insolvent S&Ls; and by an accounting system that used historical cost-based values rather than current market values to determine income and solvency.

Valuable (albeit costly) lessons have been learned from this experience. Appropriate prudential regulation must accompany the economic deregulation of deposit-taking institutions that are explicitly or implicitly insured by the government. Adequate capital levels, preferably related to risks undertaken, are vital. Risk-related insurance premiums can help. Strong supervisory and examination powers, enforced by well-trained and well-paid personnel, are important. Market value accounting systems are indispensable. Finally, if an institution falters toward insolvency, early regulatory intervention is necessary to prevent small problems from exploding into costly horrors.

of structural reform—will face difficult choices concerning the restructuring of their domestic financial institutions and the reshaping of their financial systems. Even some countries that have already taken steps may find further intervention necessary because many institutions still in operation are insolvent.

Restructuring a financial system is both a challenge and an opportunity. Not all institutions are worth recapitalizing; some need to be closed or merged with healthier ones. Restructuring gives countries a chance to build financial systems that can better provide the services their changing economies need.

Rationale for intervention

During the 1980s more than twenty-five developing countries have undertaken extensive reorganizations of their financial institutions. In most cases financial crises had occurred or were imminent, and governments could not stand aside. Other countries, such as Pakistan and Sri Lanka, have not experienced crises but have nonetheless taken steps to strengthen their financial systems. Several of the centrally planned economies have decided to reorganize their financial systems to make them more efficient and competitive. Many governments, however, have been reluctant to take action, and their delay has led to continued losses at the institutional level and slower recovery at the macroeconomic level.

The authorities in some countries may be unaware of the seriousness of the situation, since a bank's poor health is not always apparent from its audited financial statements. Even when governments understand the problem, they are often unwilling to act. Some may hope that intervention

will not be necessary because defaulting borrowers will start to repay or because banks will make adequate provisions for their bad loans. But, as Box 5.5 argues, the likelihood of spontaneous recovery is low. Other considerations—the budgetary costs of restructuring, issues of fairness in allocating the losses, the embarrassment of bad loans made to public enterprises or political allies, or fear of bank runs—also lead governments to ignore the problem as long as they can.

If there is no crisis, should governments intervene merely to relieve financial distress? One reason most may have to is that earlier interventions have made a market solution unlikely. By providing implicit or explicit deposit guarantees and by regularly granting assistance to troubled banks and firms, governments have suppressed the market forces that otherwise would have eliminated or reorganized unprofitable firms and allocated the associated losses. Until governments take the further step of performing the market's loss-allocating function, losses will continue. As losses mount, so do the costs of supporting the loss-making institutions. The continuing costs of periodic support will eventually outweigh the one-time cost of restructuring.

Governments can either take the next step, by performing the market's loss-allocating function,

Box 5.5 Can banks "muddle through"?

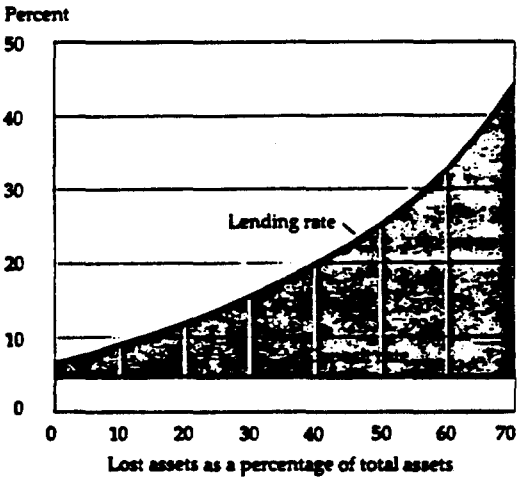
Governments have often refrained from intervening in the financial sector in the hope that ailing banks will recover spontaneously. Rather than obliging the banks to make provisions for their losses (which might force those with losses larger than capital into bankruptcy), many governments have permitted them to operate with impaired capital positions. For banks to recover unaided, at least one of two things must happen: enough defaulting borrowers must resume servicing their debts or banks must earn enough to restore capital adequacy.

Simply waiting for economic upturn is risky. In the meantime, only banks whose remaining good assets can generate more than enough income to cover costs will be able to begin recapitalizing themselves. In recent years the earnings of many large U.S. banks, for example, have been sufficient to enable them to make substantial provisions against nonperforming international loans. The larger a bank's nonperforming loans, however, the smaller its income and the longer it will need to recapitalize itself. If a bank is losing money, spontaneous recovery is impossible.

To increase income, banks may increase the spread between deposit and loan rates. Box figure 5.5 shows the spread necessary for a "typical" bank (as defined in the note to the figure) to recapitalize itself through retained earnings over a period of five years. A bank with initial losses equaling 20 percent of assets, for example, would need a spread of 7.1 percent to recapitalize itself in five years. In practice, competition will limit the amount by which spreads can be enlarged. Banks that set lending rates too high or deposit rates too low eventually lose business to competitors. Similarly, government efforts to assist the entire financial sector by mandating larger spreads are likely to aggravate banks' difficulties: too large a gap between deposit and loan rates causes lenders and borrowers alike to seek cheaper intermediation.

A "wait and see" approach is likely to prove costly. To recapitalize themselves, banks with large losses (losses greater than their capital) must increase earnings substantially. If efforts to increase earnings lead bankers to engage in overly risky behavior, however, new losses will make spontaneous recovery even less feasible.

Box figure 5.5 Lending margins needed to recover in five years from given levels of loss



Note: This example assumes administration costs of 2 percent of assets, a required capital-to-assets ratio of 5 percent, a reserve requirement of 10 percent of assets, a deposit rate of 5 percent, and no defaults among new borrowers.

or take a step in the other direction, by withdrawing deposit guarantees and ending financial assistance to unprofitable intermediaries, so that the problems have to be resolved by the private sector. Once losses have become substantial, a market-imposed solution is likely to be costlier than government action because it could lead to bank runs and the loss of foreign credit lines. Events in Argentina, Chile, Colombia, Thailand, and Turkey illustrate the difficulty. After initially allowing creditors of failed institutions to lose money, the authorities in each country were forced to extend assistance to prevent widespread bank runs. Prompt government action is thus the less costly route, in terms of both the economic costs of continued resource misallocation and the accumulated financial losses that the government is likely to end up bearing.

Aspects of intervention

The central aim of intervention to relieve financial distress has not been to protect the interests of bank managers or bank owners or even to preserve particular banks as institutions but rather to keep the financial system as a whole in operation. Rehabilitating insolvent financial institutions has been the first step in that process. Most governments chose to close only small banks; larger ones, particularly those that were critical elements of the financial system, were merged or recapitalized.

Intervention has consisted of across-the-board relief, case-by-case restructuring, or a combination of the two. Case-by-case restructuring requires manpower, skill, and time, as the authorities must make management-level decisions concerning the fate of individual institutions. If, in addition, the costs of information and of bargaining with creditors are high, an across-the-board approach may look attractive. It seems faster, and it may be politically more palatable because it is less obvious who gains and who loses.

One across-the-board solution is to generate inflation deliberately to reduce real debt burdens. This happened in Argentina between 1981 and 1983. Another is for the authorities to absorb the banks' foreign exchange losses, as in Costa Rica, the Dominican Republic, Ecuador, and Yugoslavia. Across-the-board intervention, however, has usually proved wasteful. Since financial distress has seldom been evenly distributed among lenders or borrowers, much of the relief has gone to firms and intermediaries that did not need it. More important, troubled borrowers and banks usually need restructuring, not just financial assistance. Restructuring is feasible only as part of a case-by-case approach.

INFORMATION FLOWS. Most countries have discovered that the information needed to judge the intermediaries' financial condition is either unavailable or unreliable. In only a few developing countries is bank supervision sophisticated enough to indicate the quality of an institution's earnings and portfolios. Even banks' audited statements are often misleading: interest is accrued whether it is received or not, nonperforming loans are rolled over, and new loans are provided to cover unpaid interest. Even banks with very few performing loans may report profits and pay taxes and dividends. One large state-owned bank in Latin America, for example, showed positive earnings for 1987, but three months after publishing its accounts its managers admitted that 60 percent of all loans were nonperforming. Insolvent, illiquid, and unprofitable, the bank lost approximately $100 million during 1987 alone.

Despite the poor quality of financial statements, in countries with serious financial distress there were usually warning signals. Some institutions offered deposit rates higher than those offered by other intermediaries, a sign that they were short of cash. At the macroeconomic level, real interest rates well above the average return on investment suggested that many firms were short of funds and were borrowing to remain in business. In some countries the failure of smaller institutions such as finance companies and new banks provided further evidence of widespread distress. Normally, governments tax banks through various mechanisms, including reserve requirements. Where loan portfolios deteriorated, however, the authorities were forced to cut the rate of taxation. As the amount of assistance to troubled banks increased, central bank profits declined, and some central banks even sustained large losses.

In short, acute distress has generated signals ranging from high real interest rates, widening interest rate spreads, a decline in the ability of banks to satisfy reserve requirements, and complaints from established borrowers about the scarcity of credit to the more obvious sign of failures among smaller intermediaries. Even if a central bank lacks the precise information that a good system of supervision would provide, it can hardly be unaware of widespread distress.

Better information about banks' portfolios gives the authorities a clearer idea of the intervention

that may be necessary. The authorities in several countries, among them Bolivia and Ghana, commissioned external auditors to conduct independent audits of domestic banks. But lack of precise information is not a reason to refrain from taking action. The government of the Philippines relied upon the management of the two largest banks (the Development Bank of the Philippines and the Philippine National Bank, which are publicly owned and together hold about half of the banking system's assets) to identify nonperforming assets. It then assumed responsibility for all nonperforming loans above a certain value, along with a corresponding amount of liabilities.

At the heart of any review of a bank's financial condition is the issue of accrual of unpaid interest and the provisioning of loans. Because loan rollovers and interest capitalization have been common, the quality of loan portfolios can be judged only if loans are classified by the probability of their being serviced rather than simply by whether they are current or in arrears. In practice, adjusting for accrued but unpaid interest has been the single largest correction to banks' accounts following intervention. This underlines the importance of forcing banks to stop accruing interest and to make provisions for bad loans as soon as debt service is interrupted.

ALLOCATING LOSSES. Once governments intervened, they had to decide how to allocate losses in excess of capital and provisions. Regardless of formal obligation, most governments protected depositors against loss to avoid bank runs. Foreign creditors were also protected, even where they had lent to domestic banks without the benefit of government guarantees, as in Chile. Taxpayers had to absorb the losses instead.

Most governments have decided that the private owners of insolvent institutions should be replaced or at least have their ownership diluted. The techniques for doing this vary. In the United States the courts appoint the deposit insurance agency as receiver, and that agency arranges for the sale of institutions. In Colombia and Spain the law allows the government to write off the value of shares and to issue new shares to other than former shareholders. In Thailand existing shareholders were allowed to keep their shares, but the issuance of many new shares greatly reduced their value. After restructuring insolvent banks, the Chilean government provided cheap credit and generous tax incentives to those willing to buy shares in the two biggest banks.

Most governments have decided to replace management as well, in the hope that new managers, distanced from the mistakes of the past, will be able to make the changes necessary to restore the banks to profitability. In addition to loan foreclosure and recapitalization, measures to lower operating costs and improve profitability were needed—for example, closing branches and reducing staffing levels, establishing new interest rate structures, and eliminating loss-making activities. The Development Bank of the Philippines cut its staff by 50 percent, closed thirteen of its seventy branches, and plans to privatize all but thirteen of its remaining branches. In Guinea the number of people employed in the financial sector fell from 2,350 to 530, and lending to the public sector (including state-owned enterprises) has virtually ceased.

Failure to hold bank owners and managers responsible for past problems may encourage excessive risk taking in the future and thereby cause further financial instability. In large markets such as the United States, finding new owners and managers willing to take over weak institutions is usually straightforward, but in smaller markets there may be few potential buyers and few managers with the necessary expertise. Moreover, arranging the transfer to new management may take some time. So governments have sometimes found themselves responsible for the institutions in which they intervened. Both the Spanish and Chilean governments, for example, became the owners and operators of several restructured banks until suitable buyers were found.

COST CONSIDERATIONS. At the time of intervention the economic costs of financial distress have already been incurred in the form of poor past investments and slower growth in output. Restructuring has no economic cost. On the contrary, it brings an economic gain in that the economy may once again enjoy the benefits of a well-functioning financial system. The budgetary cost of restructuring consists of the government's cash outlays, which are a transfer from taxpayers to the creditors of insolvent banks.

This cost has depended on the extent to which the banks' losses exceeded their capital. In the United States, for example, the expected cost of dealing with the remaining insolvent S&Ls is equivalent to approximately 2 percent of GNP, and in Spain the estimated losses of banks were equivalent to 16.8 percent of GNP. In some developing countries banks' losses as a percentage of GNP

have been even larger. The cost of paying off depositors has been one reason most governments have chosen to close small banks and rehabilitate the bigger ones.

To make insolvent intermediaries solvent again, governments took over bad assets. In some cases they acquired bank liabilities at the same time; in others they replaced the bad assets with good ones. The authorities in the Philippines chose the first approach; they drastically shrank the balance sheets of the two largest banks by assuming 76 percent of their assets and a corresponding share of their liabilities. The second solution was more common, however; governments bought bad assets in exchange for long-term government securities, and the interest on the securities was then used by banks to pay interest on deposits. This method was used, for example, in Chile. Buying the bad assets for cash would have been too large a fiscal outlay and might have added to inflation by expanding the money supply.

Over time, restructuring costs are bearable, even for a country in which the bad assets acquired by the authorities amount to as much as 20 percent of GNP. In such a case, if the real interest rate paid on government bonds is 5 percent, the annual real cost to taxpayers will be 1 percent of GNP. And that figure may exaggerate the additional cost to the taxpayer. In most cases the government has already been paying some form of subsidy to help banks cover their losses. Furthermore, it may be able to realize something on the nonperforming assets.

Once the authorities have acquired the bad assets, they must decide what to do with them. A mechanism is needed to pursue bad debtors and dispose of physical assets taken over in foreclosure proceedings. Central banks have generally proved ineffective at recovery and liquidation. One possibility is to commission the banks that made the original loans to handle them on behalf of the central bank, but this has worked only when the banks were under new management and freed from the obligations of previous relationships. Another course, followed by the Philippines, is to establish an independent recovery agency with its own funding and staff.

Over the longer run, many countries have decided that their central banks should not be responsible for intervening in banks, ordering recapitalization, changing management and directors, or handling the disposition of nonperforming loans and the liquidation or merger of insolvent banks. Some countries have set up specialized institutions to handle these tasks. In the United States they are carried out by the deposit insurance agencies, which collect premiums to cover the losses of insolvent intermediaries. In keeping with their obligation to cover those losses, the insurance agencies have the power to inspect insured banks. The advantage of an insurance arrangement is that, in principle, it shifts the cost of monitoring intermediaries and covering their losses from the government to the financial system and codifies the procedure for dealing with troubled institutions. This is likely to produce quicker action than the ad hoc approach of most developing countries.

Restructuring borrowers. The portfolio problems of financial institutions reflect the difficulties of their clients. If loss-making firms are not restructured, the newly recapitalized banks that lend to them will eventually become insolvent again. Restructuring indebted borrowers is harder than restructuring financial institutions. Bank restructuring may involve closing branches and laying off personnel, but it mostly entails rewriting paper claims. Restructuring companies raises the same difficult issues of management, ownership, and fairness that have to be addressed in the case of banks, but it also calls for decisions about the viability of firms, the restructuring of physical assets, and the disposition of large numbers of employees.

Because recapitalized banks are in a new position of strength with regard to their former clients, they can refuse to lend money to those they think nonviable. Thus, in principle, restructured financial institutions have an important role to play in the restructuring of loss-making firms. But if the private sector's restructuring skills are undeveloped, if the borrowers in need of restructuring are large, or if the legal system is weak, governments may have to play a more active role, perhaps with the help of outside experts. Box 5.6 provides an example of the complexities that can be involved in restructuring a large, overindebted firm.

Reforming the financial system

The present frailty of financial institutions in many developing countries is the visible expression of a complex set of problems. Financial distress in many cases was precipitated by the macroeconomic shocks of the 1980s, but its roots lie in the development strategies followed since the 1960s. Banks in many countries were directed to provide subsidized credit to priority sectors and public en-

Box 5.6 Restructuring a large corporation: a Mexican example

The Valores Industriales S.A. (VISA) group, an integrated beverage and consumer goods conglomerate with more than 40,000 employees, is one of Mexico's largest industrial concerns. During the late 1970s VISA borrowed heavily to finance ambitious expansion and diversification plans, but by 1987 it could no longer service its debt. Like other Mexican companies that had borrowed abroad, VISA was hurt by devaluation, high interest rates, and the recession that began in 1982. As debt service began to consume most of its severely depressed cash flow, investment plans had to be postponed and basic maintenance expenditure reduced to a minimum. The consequent decline in efficiency and productivity made matters worse, and in early 1987 VISA engaged the International Finance Corporation (IFC) to help it formulate a restructuring proposal that would restore the conglomerate's viability and reduce its $1.7 billion debt to a sustainable level.

Eighteen months of negotiations among the existing shareholders and creditors, Mexican government agencies, and new investors and creditors produced a complex restructuring agreement. VISA was to merge two large companies—fully integrating their manufacturing facilities—redeploy some of its other installations, and reorganize its administration. In addition, several noncore businesses would be sold.

VISA offered its creditors a variety of options, including debt buybacks at a discount, debt-for-debt swaps (including exchange of VISA debt for sovereign debt), and debt-to-equity conversions. The array of options made it easier for VISA to meet the needs of its sixty-seven creditors, who held varying views of VISA's future profitability, had different liquidity preferences, and faced different accounting and loss provision regimes. Creditors were also permitted to trade claims among themselves. Some creditors chose to receive cash for their claims, at a substantial discount from face value. Others rescheduled $153 million at floating market rates and $75 million at lower fixed rates and also received an equity stake in the restructured company.

To finance its restructuring and debt reduction program, VISA raised $334 million in cash from new and existing shareholders and investors. Of this, $135 million came from new long-term loans, $36 million from bond sales to the Mexican public, and $5 million from public share offerings in the Mexico City Stock Exchange; the sale of assets (including automotive parts firms and hotels) brought $108 million, and a foreign institutional investor bought a $50 million equity stake.

The restructuring restored VISA's competitiveness and reduced its debt from $1.7 billion to $0.4 billion, leaving it a viable concern. The success of its negotiated debt reduction program was based on the sharing of losses between lenders and shareholders. Many more firms in developing countries will have to go through similar reorganizations to become viable.

terprises and often were not permitted to foreclose on defaulting borrowers; occasionally the process was more political than developmental, with loans being made to friends of the government. Many loans went to industries in which countries had no comparative advantage and which were profitable only as long as they were protected. By the 1980s many firms became unable to service their debts. This is not to suggest that all directed loans were mistakes; many were successful. Financial institutions are highly leveraged, however, and so can be bankrupted if even a small fraction of their loans go bad. The inadequacy of prudential regulation and supervision meant that most institutions were not made to take adequate provisions or write off bad loans, and their books gradually became a catalogue of past mistakes.

Problems at the microeconomic level were exacerbated by macroeconomic policy in many countries. Interest rate ceilings hindered the growth of financial systems and encouraged capital flight. Overly expansionary fiscal policies led governments to borrow heavily at home and abroad. Financial distress has been most serious in countries with large external debts. Domestic borrowing in those same countries crowded out private sector borrowing and produced inflation. In countries with greater macroeconomic stability, financial distress tends to be chronic rather than acute.

Economic recovery requires the restructuring of financial intermediaries and insolvent firms. It also requires a policy environment in which finance can become less a tool for implementing interventionist development strategies and more a voluntary market process for mobilizing and allocating resources. The success of that transition depends partly on increasing lenders' confidence that future financial contracts will be honored, which in turn calls for an improvement in the ability of lenders to assess risk and to enforce contracts. This is the subject of the next chapter.

Industrial countries introduced far more complex bankruptcy statutes during the nineteenth century to deal with a larger number of different creditors. And in the twentieth century, with the emergence of large corporations, reorganization rather than liquidation became an important objective of bankruptcy statutes—first in the United States and more recently in other countries as well.

Apart from these ultimate remedies, creditors have traditionally made extensive use of collateral (mortgages, floating charges, liens, and so forth) and personal guarantees to reduce the probability and cost of default. Consequently, annual loan losses of commercial banks in industrial countries have typically been less than 1 percent of outstanding balances (which has helped to keep total intermediation costs at less than 4 percent). Nonperforming loans in many developing countries are now 20 percent of total loans and in some cases more. Profitable lending becomes almost impossible at these default rates, because few investments will yield returns high enough to cover the interest that must be charged (see Box 5.5 in Chapter 5). Only optimistic speculators or borrowers who intend to defraud the lender would be willing to borrow large sums at real rates of interest in excess of 10 or 15 percent.

The ultimate security of the lender is the commercial success of the borrower. This should be the primary basis for the decision to lend. But it is often difficult for lenders to assess the probability that a project will succeed. People who write eloquent loan and project proposals are not necessarily good managers or entrepreneurs, and vice versa. Bankers have thus traditionally been very conservative in their lending decisions and have relied largely on the track record of loan applicants. This inevitably meant that people with substantial wealth could borrow more than others. Since wealth can be acquired by inheritance as well as by entrepreneurial gifts, the governments of many developing countries viewed lending on the security of personal property as in conflict with their development objectives. For example, the Tandon study group appointed by the Reserve Bank of India pointed out in the early 1970s that "nationalization of the major commercial banks . . . called for a new policy with respect to deposit mobilization . . . and equitable disbursal of credit. The banking system was asked to adopt a new approach as a credit agency, based on development and potential rather than on security only, to assist the weaker sections of society . . . the security-oriented system tended to favor borrowers with strong financial resources, irrespective of their economic function" (Banking Laws Committee 1978, p. 77). This approach overlooks the fact that credit decisions are rarely the best way to deal with social inequities.

Developing the legal foundations

The development of clear legal rules concerning the economic rights and obligations of different agents should go hand in hand with economic and financial development. In rural societies local sanctions have played an important part in limiting dishonesty by contracting parties (see Chapter 8), but urbanization has made local sanctions less effective. More complex rules and regulations are required to govern the impersonal relations of modern commercial life. And the emergence of large corporations has called for a continuously evolving set of rules to resolve the shifting conflicts of interest among shareholders, managers, bondholders, employees, and consumers.

Most developing countries have legal systems that were imposed during colonial rule. These were often at odds with local custom. Indonesia's sophisticated system of customary *adat* law uses legal concepts (for example, with respect to land tenure) that are quite different from those in the civil and commercial codes imported by the Dutch. Under the Dutch, adat law applied to Indonesians and Dutch law to Europeans and modern institutions such as companies and banks (since adat law does not cover loan contracts or similar transactions). These parallel systems are still in use today. Inevitably, they cause conflict and uncertainty, and weak judicial administration has compounded the problems. As a result the legal system has a diminished role in the settlement of disputes. Even in countries with only one legal system, the difficulties can be severe. A report of the Indian Banking Laws Committee (1978, p. 76) observed that "the present chaotic state of our credit-security law, particularly of our personal property security law, is primarily due to the application of archaic principles and concepts of Common Law developed a century ago."

In contrast to other developing countries, Korea and Thailand have imported and adapted foreign legal systems on their own initiative. Korea enacted new codes based on German law in 1958 and 1962 (see Box 6.1). Thailand adopted a civil and commercial code based on the French and German codes in 1923. Japan had done the same in 1898 and 1899. In all three cases local customs and polit-

Box 6.1 Civil and commercial law in Korea

Korea is one of the few countries that have introduced a comprehensive Western system of law on their own initiative. Like China, Korea was traditionally a Confucian society in which relations were structured not according to law but according to ideas of familial hierarchy, with the king or emperor at the top. After a period under Japanese domination (and Japanese civil law), the newly independent Republic of Korea set out to devise an entirely new legal framework. New civil and commercial codes were enacted in 1958 and 1962. Both were modeled largely on the German civil and commercial codes but contained significant changes to reflect local customs and traditions, particularly with regard to family law and succession. The Korean codes introduced some interesting innovations. For example, Korean law permits the use of mortgages on real property to secure future advances under a line of credit—a useful device that is not usually allowed by civil law.

Like most other civil codes, modern Korean law distinguishes between ordinary people and merchants; the commercial code applies only to the latter. Contractual obligations are more clearly defined than in most other developing countries, and enforcement is swift. Reorganization and bankruptcy are modeled on the U.S. bankruptcy code, which emphasizes the rehabilitation of a corporate debtor rather than the distribution of its assets to creditors.

ical conditions when the new codes were introduced were quite different from those prevailing in the countries whose legal systems were used as models. But the need to furnish their economies with a legal infrastructure that would facilitate exchange and financial intermediation was pressing. All three governments adapted the foreign codes to local customs (particularly with respect to family law) and to economic circumstances.

In some countries inherited legal systems have not been updated to meet the changing needs of the economy. In addition, commercial laws may be weakly enforced because of cumbersome procedures or because inadequate resources are devoted to the task. But just as too few rules can create uncertainty, so can too many—especially if they keep changing.

To make their legal systems more effective, governments need to provide for acceptable collateral (an issue closely related to the assignment and transferability of property rights), to rationalize company legislation (especially with regard to disclosure of information and bankruptcy and reorganization proceedings), and to strengthen law enforcement. Contract performance can be improved by making breach of contract more costly. Provision of security, such as pledged or mortgaged assets and third-party guarantees, is one approach. Lenders can ensure repayment in other ways too: by attaching covenants to the loan contract, by appointing a representative to the board of directors, through contingent ownership of assets (by means of convertible debt securities, for example), and by closely monitoring the borrower.

Property rights and collateral

The legal recognition of property rights—that is, rights of exclusive use and control over particular resources—gives owners incentives to use resources efficiently. Without the right to exclude others from their land, farmers do not have an incentive to plow, sow, weed, and harvest. Without land tenure, they have no incentive to invest in irrigation or other improvements that would repay the investment over time. Efficiency can be further served by making property rights transferable. A farmer might then sell his land to a more productive farmer and take up another occupation for which he is better suited. Together, these rights to use, benefit from, and freely dispose of an asset constitute ownership.

China's rural economic reforms consisted mainly of restoring land tenure to households. Farmers in China do not own their land, but tenure is now fairly long term; it amounts to the leasehold concept of common law. Farmers can use this leasehold as collateral. The success of the reforms dramatically illustrates the benefits that can spring from changes in an economy's legal infrastructure.

Property rights are not usually absolute. The state claims a share of the benefits from the use of resources in taxes—to pay for, among other things, the protection of property rights from external and internal threats. Societies recognize many other restrictions on property rights for the common good, including the right of eminent domain to build roads, harbors, power lines, and other infrastructure. Property rights may also be limited in time—for example, through leasehold of land rather than absolute ownership or (less directly) through inheritance taxes applied to a broad range of assets.

Changes in the value of resources as a result of

economic development may require an expansion and redefinition of property rights from time to time, especially since conflicts between rights over different resources cannot be fully avoided. As resources become scarcer and more valuable, property rights become more important. Gradually, they have been extended to formerly "free" goods such as pastures, water, coastal fishing zones, broadcast frequencies, geostationary satellite orbits, technical inventions, and other intellectual property. Property rights are becoming universal.

MORTGAGES. The assignment and transferability of property rights promote economic efficiency directly by creating new incentives, but also indirectly by making financial intermediation possible. They do this by allowing borrowers to offer security in the form of mortgages over real estate or other collateral. Some assets are better collateral than others. Immobile, general purpose assets, such as real estate, have very desirable properties: they cannot be easily misappropriated, and they can be quickly resold for an amount close to the purchase price. A copper smelter, in contrast, retains its value only if it can compete with other plants and the price of copper does not fall. Extensive debt financing of copper smelters is therefore risky.

When taking collateral, the lender is mainly interested in the efficient transfer of property rights, because the security is invoked only in the case of default and may deteriorate or disappear if too much time elapses before he can take possession. Mortgages over land and other real estate are therefore one of the best forms of collateral. In most countries real estate accounts for between half and three-quarters of national wealth. If ownership is widely dispersed, tenure is secure, and title transfer is easy, real estate can be good collateral for nearly any type of lending (see Box 6.2). Unfortunately, these conditions are not always met in developing countries. Land distribution is often skewed, tenure (if any) insecure, and title transfer cumbersome. One key to a smoothly functioning system of land tenure is land registers supported by cadastral surveys. In many developing countries these are still woefully inadequate or missing altogether.

Often, a loan secured with real estate will finance not the acquisition of real estate but something entirely different, perhaps a new entrepreneurial venture. The risk for the lender remains low because the borrower is bearing the entrepreneurial risk. But if the entrepreneur has no suitable collateral, the risks to the lender increase dramatically. The lender will then need far more information and perhaps a share in the proceeds if the venture proves a success. Venture capital, equity participation (with or without parallel loans), debt securities convertible into equity, and profit sharing ac-

Box 6.2 Financial and economic effects of land tenure in Thailand

Thailand has a relatively efficient system of land tenure, title transfer, and use of collateral. In 1901 the government introduced the Torrens system in which land titles are based on cadastral land surveys and registered with central land record offices. The use of land as collateral increased significantly, but land registration was concentrated in the more heavily populated areas. In the early 1960s half of the land area of Thailand was designated as national forest reserve, including land that was already being farmed. Most farmers in the forest reserve have no transferable title to their land, but the government has enforced the forest reserve policy flexibly and has not evicted farmers. About one-fifth of the farmed land does not have secure and transferable title.

Although uncertainty about continued possession does not seem to worry untitled farmers, lack of titled ownership affects their access to institutional credit. Untitled farmers cannot provide collateral and are limited to borrowing on the basis of personal or group guarantees or from moneylenders. (Moneylenders charge interest rates of 40–50 percent, compared with about 15 percent for loans from financial institutions.) In a sample study of matched groups of titled and untitled farmers, titled farmers were able to borrow on average three times more per acre of land. Secure land title not only affected the ability to obtain mortgage credit (which accounted for half of all credit among titled farmers) but also doubled access to unsecured credit.

Thanks to easier access to credit, titled farmers made significantly more land improvements and used significantly more machinery and other inputs. As a result they enjoyed 12–20 percent higher farm revenues and 12–27 percent higher productivity than untitled farmers in similar regions. The government has recently taken steps to improve land tenure for untitled farmers.

Box 6.3 Islamic banking

Several Islamic countries have recently introduced banking on Islamic principles. They include Iran, Malaysia, Pakistan, and Saudi Arabia. Islamic principles permit profit but do not allow fixed interest on deposits or loans. Nevertheless, Islamic banking can be made to work quite well and provides an interesting contrast to commercial banking practices elsewhere. In countries such as Pakistan the introduction of Islamic banking has improved the functioning of the financial system in some respects—for example, by making returns to financial instruments more market-driven.

Islamic banks offer savers risky open-ended mutual fund certificates instead of fixed-interest deposits. (This is not unlike cooperative banks and mutuals in the West, where deposits earn variable interest and double as equity.) Difficulties arise on the lending side. Arrangements to share profits and losses lead to considerable problems of monitoring and control, especially in lending to small businesses. In practice, profit sharing under *musharakah* agreements is often based on prior estimates of profit. Another way to avoid explicit interest charges is to combine commercial and financial contracts—for example, through hire-purchase arrangements or advance purchase by banks of inputs which are then resold at a markup.

Another difficulty has been to devise suitable government securities. A rather liberal interpretation of Islamic principles would permit discounted securities. Other possibilities include linking returns to nominal GDP growth or to the return on certain revenue-earning public projects.

cording to Islamic principles (see Box 6.3) are all examples of such arrangements.

In some countries other assets can serve as collateral. Inventories and other movable goods are inherently poor collateral because they have comparatively little value, are destructible, and can be sold privately and informally. They are difficult to use as collateral when left in the possession of the borrower. A partial solution is to make some goods legally "immovable" by creating special title registers. This is feasible only for a few large and high-value movables, such as ships, aircraft, motor vehicles, or industrial machines. Another solution is to store commodities of a standardized quality in certified warehouses and issue warrants. Rice warehouse warrants have been used in Japan for several centuries. The spread of such facilities in various countries has increased the use of inventories as collateral.

For goods in transit, the bill of lading can serve as security. Documentary export-import credit is an important application of this sort of collateral. Korea and some other countries have further developed this idea by creating a domestic letter of credit based on an irrevocable export letter of credit. In this way the primary exporter can extend his creditworthiness to suppliers of intermediate inputs.

DEBT RECOVERY. Legal systems in developing countries often favor the borrower by making it hard for the lender to foreclose on collateral. Originally, such provisions were intended to protect small borrowers against unscrupulous moneylenders, but today they may adversely affect the ability of state-owned commercial banks to collect on loans. This raises the costs of intermediation and weakens banks' portfolios; as a result the ability of lenders to extend loans to new and creditworthy borrowers is undermined. Creditors often have to sue the defaulting debtor for payment, which in many countries in South Asia, for example, may take several years. Once a judgment has been obtained, the creditor may then have to sue for execution of his claim. Five to eight years may pass from the date of nonpayment to the final recovery of the collateral. Pakistan is among the countries that have recently taken legal and procedural steps to speed this process (see Box 6.4).

Cumbersome recovery procedures have led to new lending arrangements that redress the balance in favor of the creditor. Hire purchase and leasing may have become popular partly because the lender retains title to the asset being financed and can take possession without any legal formalities if the borrower is late in paying. Leasing also owes its popularity to its role in circumventing interest rate controls and taxes. It has often restored access to financing that excessive bank regulation and weak legal systems had blocked.

Company law

Large enterprises have become an important part of modern economic activity in most industrial and developing countries. Today, the largest 100 corporations typically account for between 30 and 50 percent of total manufacturing production in industrial countries. Industrial concentration is often even more pronounced in developing countries.

Box 6.4 Commercial law enforcement in Pakistan

Pakistan's financial institutions have suffered badly from excessive arrears. Matters did not improve when the major commercial banks were nationalized in the 1970s. Enforcement of loan contracts in default was too slow to have much disciplinary effect on borrowers. Often it took five years or longer before the bank could foreclose on mortgaged property.

Recognizing the problem, the government established a system of special banking courts in 1979. In 1984 a corresponding system was established to deal with loan recovery for the newly introduced Islamic financing instruments. Problems remain, however. Debtors can still challenge court rulings at every step, and five-year delays can still occur. More special courts are to be established over the next two years, and their jurisdiction will be narrowed to exclude very small claims. Once a bank has obtained judgment from a special court, it will no longer have to apply separately for execution of the decree.

An institutional innovation of the nineteenth century made this possible: the general incorporation of joint-stock companies with limited liability. Until the 1850s free incorporation and limited liability were viewed with considerable skepticism. General incorporation was prompted by the large capital requirements of railway construction, which could not be met by the small private banking houses.

The new companies called for rules and regulations to protect the interests of shareholders, creditors, and other interested parties, including employees. The resulting structure of control features agents (directors or independent auditors) who monitor management on behalf of the owners; elaborate accounting, information, and disclosure procedures; disciplinary systems that align the interests of managers and owners; and a clear assignment of responsibilities. With hundreds and sometimes millions of shareholders, limited liability became essential. Individual shareholders had little influence over the affairs of the company. They had become "investors," in some ways creditors more than owner-managers. Limited liability shifted more of the risk to other creditors. As a result better bankruptcy and reorganization rules were needed too, so that creditors could take control if the company ran into difficulty. And most countries have enacted labor laws to offer employees some protection against unscrupulous owners and managers.

State or private ownership—does it matter?

An alternative to the joint-stock structure for managing large enterprises is state ownership. Some of the first big industrial enterprises and financial institutions were publicly owned. State ownership is the predominant form of industrial organization in centrally planned economies, and state-owned enterprises account for a substantial part of the economy in many other countries. In a sample of nineteen developing countries in 1984 and 1985, state enterprises accounted for an average of 13 percent of GNP and 31 percent of domestic investment; they were concentrated in capital-intensive heavy industry and utilities such as steel, chemicals, electricity, oil, and gas. Intermediate forms of "ownership" such as cooperatives, mutuals, foundations, and franchises have also become common. State enterprises in some countries are legally constituted as joint-stock corporations; some of these (but not all) seem to operate like private enterprises.

Successful public enterprises such as British Steel, Renault (before its recent difficulties), and Brazil's Empresa Brasileira de Aeronáutica (EMBRAER) are often cited as proof that public enterprises can be as efficient and innovative as private enterprises. Indeed, it is often argued that ownership does not matter as much as the independence and accountability of management and the extent of competition.

In practice, however, the form of ownership goes a long way to determine the environment within which management operates. Lines of authority and responsibility are often blurred in state enterprises. Their chief executives usually take orders from various government agencies, their freedom to reward and discipline employees is circumscribed by rules of seniority and guaranteed employment, and their own compensation is rarely linked directly to profits. Understanding these drawbacks, some governments have tried to create a self-regulating regime for their state enterprises. But the boundary between the government's domain and the market's is ambiguous. Economies of scale, externalities, and scarcity of information cause complications that may prompt governments to intervene.

Bankruptcy and reorganization

For centuries bankruptcy procedures have enabled creditors to recover their resources from debtors who defaulted. The emergence of large corporations, however, called for a new approach. When a company is having difficulty in servicing its debt, reorganizing the enterprise might yield higher returns to its creditors than closing it down and selling its assets. Reorganization might mean rescheduling its interest and principal payments, reducing its interest charges, downgrading the quality of claims against it (for example, by releasing mortgage liens or by swapping debt for equity), or reducing or canceling its debts.

Such a far-reaching modification of the rights of creditors cannot be taken lightly and can be justified only if it is in their best interests—that is, if it will make them (or society) better off than debt recovery through liquidation. Reorganization may also weaken the incentives for good performance, particularly if the present management is left in place. Reorganization becomes more difficult as the number of creditors grows. Rules are needed, for example, to ensure that a few small creditors cannot jeopardize a reorganization plan that is in the interests of the majority.

Few developing countries have well-developed laws and procedures for reorganization. Often the task is delayed and takes place only through ad hoc government intervention. Indonesia's bankruptcy code, for instance, has rarely been used. China and Hungary have recently reintroduced bankruptcy regulations because state enterprises are becoming more independent and the private and cooperative sectors are expanding. Because many developing countries are now trying to rely more on decentralized decisionmaking, market forces, the private sector, and financial intermediation, they too will need to introduce procedures for corporate restructuring that go beyond liquidation and bankruptcy. To ensure that such procedures do not encourage managers to take excessive risks, governments could devise penalties for recklessness and fraud and for concealing the insolvency of a corporation.

Timely and accurate accounts

Because financial claims cannot be fully secured, monitoring and information are essential. In informal financial markets, information is usually obtained as a by-product of other activities of the lender—for example, through his trading with the borrower. For larger organizations, more formal monitoring techniques are necessary, both for internal use to monitor the performance of subunits and for use by outsiders with a legitimate interest in the performance of the corporation. These techniques are management accounting and financial accounting, respectively.

Standardized accounting concepts and principles were developed only after the financial crises of the 1920s and 1930s. Before then, there was no urgent need to standardize the conventions of management accounting: owners and managers set their own rules. But with the emergence of general incorporation and limited liability, standardized information became essential—a point brought home forcefully during the 1930s, when many small investors lost their savings because they trusted inaccurate financial statements.

Governments responded by tightening accounting and auditing requirements in a number of ways. In the United States, for example, the Securities and Exchange Commission (SEC) was created to regulate securities markets and to make the financial process more transparent. The SEC turned to the professional association of accountants to develop accounting concepts (such as fair market value, consistency, accrual, going concern) and detailed rules, or "generally accepted accounting principles," that became binding on the profession. A similar approach was adopted in the United Kingdom and in many Commonwealth countries.

Continental Europe and Japan and several other countries adopted a somewhat different approach. They placed greater emphasis on detailed rules laid down in company laws, usually with particular stress on prudence (historical cost accounting) as opposed to fair value, and on a larger role for the tax authorities in defining accounting rules. In many of these countries, tax accounts and financial accounts must be drawn up on a fully consistent basis.

Because of these and other differences in approach, company accounts cannot be easily compared across countries. For example, companies in Germany, Japan, Korea, and Thailand usually appear highly leveraged (that is, with high levels of debt relative to net worth) when compared with companies in Argentina, Brazil, Canada, or the United States. Most of the difference, however, is due to different accounting conventions. The first group relies more on historical cost accounting, with many assets (especially land) valued at less than their market value, whereas the second group regularly revalues some or all assets. In many countries with high inflation, full revaluation has

become the rule because historical cost accounting becomes virtually meaningless under such conditions. Market valuation can be equally troublesome for assets with drastic, cyclical changes in value (for example, some types of securities, raw materials, and commercial real estate).

Efforts have recently been made to harmonize accounting and auditing practices internationally through the International Accounting Standards Committee and, in a more far-reaching way, within the European Community. The result is a convergence of the Anglo-Saxon and continental approaches, with greater standardization of financial statement formats on the one hand and a greater use of the concept of fair market value on the other.

In developing countries accounting and auditing practices are sometimes weak, and financial laws and regulations do not demand accurate and timely financial reports. Developing an effective accounting and auditing profession is essential for building efficient financial markets, and projects to do this have recently been introduced in Indonesia and Madagascar, for example. Training and education are the main requirements, but appropriate regulation and regulatory bodies are also needed.

Timely accounts are very important for financial institutions. Annual or quarterly accounting might be sufficient for most nonfinancial firms, but financial institutions can lose their risk capital virtually overnight if, say, they hold large open positions in foreign exchange or futures and options contracts. Internal and external financial reporting therefore needs to be much more frequent, with certain kinds of information available to management daily.

Prudential regulation of financial institutions and markets

Procedures for settling private disputes are set forth in most company laws, commercial codes, and special banking acts, but the development of a sound financial system requires additional measures. Prudential supervision by government authorities is warranted for banks and some other financial institutions and markets. Banks hold an important part of the money supply, create money, are the main means of implementing monetary policy, administer the payments system, and intermediate between savings and investments. Problems in one bank can quickly spread through the entire financial system. Bank failures have monetary and macroeconomic consequences, disrupt the payments system, and lead to disintermediation (which decreases the mobilization of resources and the availability of finance for investment).

As financial systems develop, different institutions evolve to take over some activities formerly performed by banks and to provide new services. All these institutions, old and new, are integrated in an increasingly complex financial system. This complexity limits the ability of creditors to exercise effective control and calls for prudential regulation and supervision.

Regulation of banks

Bank supervisors in many developing countries focus on compliance with monetary policy regulations, foreign exchange controls, and economic policy regulations such as those for allocating credit. They pay relatively little attention to the prudential aspects of financial monitoring. For example, in many countries supervisors make no independent assessment of the quality of assets and give scant regard to accounting procedures and management controls. Together with macroeconomic instability and the lack of adequate legislation, this is one of the main causes of bank insolvency.

Governments in developing countries are preoccupied with faster economic growth; they see banks as an instrument for promoting the desired investments. Often, however, these investments are the most risky from a bank's point of view, so the volume of credit extended to them remains less than the governments would like. The government reaction is often to force the banks to extend credit to priority sectors. This policy has been pursued without adequate attention to the risks involved. With the benefit of prudential regulation and supervision, however, governments can obtain information about the consequences of their policies while there is still time to modify them.

The goal of bank supervision, then, is to promote a safe, stable, and efficient financial system. The main task is to prevent bank failures, but this does not mean that financial institutions should not be allowed to fail. Bank supervisors must try to identify problems at an early stage and intervene before the situation gets out of hand. For this reason they have to be organized in such a way that they are constantly aware of developments.

ORGANIZATION. In many developing countries supervision tends to rely predominantly on analysis of bank reports or on bank inspections. Off-site supervision cannot assess risk adequately, and inspections tend to be too infrequent. Effective su-

Box 6.5 Elements of a bank supervision system

An adequate system of bank supervision should allow for both off-site supervision and on-site inspection. The task of the off-site supervisors is to analyze reports of the banks, identify possible problems, and propose remedies. Banks in most countries have to submit monthly balance sheet information for purposes of monetary control. It would make sense to combine the two reporting requirements.

After receiving the reports, the *off-site* supervisors should:

- Check their completeness, accuracy, and consistency
- Check their compliance with prudential ratios and regulations
- Analyze the financial situation of the bank and identify the main changes in financial ratios
- Identify other risks such as foreign exchange risks, interest rate risks, and concentration risks
- Prepare a summary for the management of the supervisory agency and recommend action.

The *on-site* inspectors should check the accuracy of the periodic reports to the supervisor and analyze those aspects of a bank that cannot be adequately monitored by off-site supervision. Inspections, however, should not become audits. They should focus on the bank's main activities and on the potential problems that were identified by off-site supervision. Inspections should assess the quality of assets, management and control procedures, and accounting systems. The inspectors should:

- Study the main credit files (and a sample of smaller files) to assess the lending procedures and the quality of the loans
- Evaluate lending procedures and review minutes of meetings of the credit committee and the board of directors
- Check management information systems and internal controls, especially with regard to the activities of branches and subsidiaries
- Evaluate accounting procedures, especially those for provisioning and interest accrual.

pervision calls for both. Off-site supervisors should analyze reports periodically submitted by the banks, and on-site inspectors should verify their accuracy, obtain detailed information about potential problem areas, and review the elements that off-site supervisors cannot properly assess. Box 6.5 goes into this in more detail.

LICENSING. The purpose of licensing should be to ensure adequate capitalization and sound management, not to limit entry or restrict competition. Bank supervisors should have the authority to screen potential owners and managers to prevent those lacking adequate professional qualifications, financial backing, and moral standing from obtaining a banking license. In many countries restrictions on entry into banking are so severe that they cause oligopolistic practices and suppress competition.

Sometimes entry restrictions are defended by citing the poor quality of the existing banks' portfolios. The supervisors fear that these banks could not withstand competition from new institutions with "clean" portfolios. If portfolios are weak because of government lending directives or drastic adjustment programs, a good case can be made for cleaning up the balance sheets of the existing banks before liberalizing entry. More generally, however, managers and shareholders should be held responsible for past mistakes. If that means losing market share to leaner and more efficient competitors and, in extreme cases, bankruptcy or reorganization, so be it. But liberal entry into financial services should not mean unqualified entry. Several countries with easy entry (Egypt, Thailand, and Turkey, for instance) have experienced problems with unregulated, undercapitalized, and poorly managed banks and other financial institutions.

CAPITAL ADEQUACY. Banks need capital to absorb unusual losses. The need to maintain an adequate capital-to-assets ratio exerts discipline on lending. Regulations should set minimum guidelines for capital adequacy that cover both assets and items not listed on the balance sheet (such as guarantees and lines of credit). Standards of capital adequacy can take account of different degrees of risk by requiring, for example, 100 percent capital for high-risk items such as industrial shares, 10 percent for unsecured loans, 5 percent for secured loans, and so on. The recent agreement among major industrial countries on standards of capital adequacy uses risk weights and might serve as a starting point for others. In many countries financial institutions were significantly undercapitalized

even before portfolio and other losses were recognized. Government-owned banks, in particular, often operate with little capital. When government officials and the public at large believe that state ownership is a guarantee against failure, the management is not subject to the discipline that capital adequacy requirements would provide for a private institution.

ASSET CLASSIFICATION AND PROVISIONING. Banks in developing countries rarely make realistic provisions for potential losses or problem assets. Often they fail to write off or provide for actual losses or to suspend interest on nonperforming loans. As a result their balance sheets and income statements are misleading. Bank supervisors should be able to require banks to make appropriate provisions for loan losses, to write off uncollectible assets, and to suspend interest on nonperforming loans.

LIQUIDITY. In many developing countries banks have to comply with a short-term liquidity ratio. This ratio is often used more as a reserve requirement for purposes of monetary policy than as a prudential measure to guard against lack of liquidity. Liquidity risk arises because banks borrow money at short maturities and lend it at long. The risk is not just that a bank will not be able to repay depositors' money when called, but also that interest rates on short-term liabilities will rise faster than those on longer-term assets. Ratios therefore need to be set and monitored for long-term as well as short-term liquidity.

PORTFOLIO CONCENTRATION. Limits on lending as a percentage of a bank's capital are necessary to prevent the concentration of risk in a single borrower, a group of related borrowers, or a particular industry. Some developing countries set no lending limits at all. In others the limits are set at imprudent levels, in some cases exceeding 100 percent of bank capital. Ghana's central bank had legal authority to set lending limits but until recently did not do so. The resulting concentration of risk eventually led to the technical insolvency of several major banks.

ENFORCEMENT POWERS. In many countries supervisors can impose fines and penalties for criminal acts and violations of specific banking statutes. There may, however, be little they can do to address unsafe and unsound banking practices. Their options are either to cancel the banking license or to do nothing—neither of which is acceptable. Supervisors could be empowered to take certain intermediate steps: impose fines for unsound practices, suspend dividends, deny requests to expand the number of branches or undertake new corporate activities, issue cease and desist orders, remove managers or directors, and hold directors legally accountable for losses incurred through illegal actions and willful contraventions of prudential regulations. The lack of such powers often causes inaction.

RESTRUCTURING. Bank supervisors try to minimize losses by intervening at or near the point of a bank's technical insolvency. Poor information, an inadequate legal framework, and lack of political will often permit banks to stay open, multiplying their losses, even after they have lost their book capital many times over. In many developing countries banks are subject to the same bankruptcy and restructuring procedures as nonfinancial corporations. While bank restructuring is under way, depositors may not have access to their funds. In addition, shareholders may retain an equity interest which they use to obstruct plans to recapitalize and transfer ownership. If supervisors are to dispose of insolvent banks quickly, they must be granted authority to close a bank; to replace its management and directors; to dissolve existing shareholder interests; to purchase, sell, or transfer bad assets; and to merge, restructure, or liquidate as necessary.

AUDITS. In some developing countries the authorities require no external audits of banks. In others audits are performed, but there are no clear guidelines on the standards to be used or on the scope, content, and frequency of the audit program. As a result audits are often inadequate and misleading. Indeed, it is not uncommon for banks that are known to be insolvent to be given clean audit reports. The prudential framework therefore needs to set minimum audit standards and to prescribe the form and content of the related financial disclosures.

POLICY PRIORITIES AND POLITICAL WILL. To be effective, prudential regulation must be backed by a political commitment to supervision and enforcement. The supervisory body must be given clear policy goals, and it must be independent. Too often in developing countries, supervisors are undercut by political interference. Such interference was blatant in the Philippines in the 1970s and early 1980s, when supervisors feared reprisals if

they attempted to discipline bank managers; it happens in a subtler form in many countries. Once aware of the scale of a banking problem, governments often postpone the day of reckoning. When they finally act, the cost of putting matters straight may be far greater.

One sign of political commitment is the amount of resources given to the supervisory agency. If the government means business, it must give the supervisory agency clearly defined responsibilities and then support that mandate with adequate funds for staffing and training. Bank supervisors must be offered good compensation and career prospects if they are to resist corruption and command the respect of the institutions they supervise. If the civil service cannot attract personnel of the required quality, it might be sensible to have banks examined by private auditing firms and to recover the costs through a general levy on banks (with due care to avoid conflicts of interest).

Regulation of other financial institutions

Many of the principles of bank supervision and regulation also apply to other financial institutions, such as finance companies, insurance companies, pension funds, and mutual funds. A vital test in deciding on the extent of regulation is the number and type of creditors. Financial institutions that do not have deposit-like liabilities to the general public need not be regulated as closely as those that do, because their deposits are not part of the payments mechanism and their insolvency is not as costly to the economy. The general provisions of commercial and company laws may therefore be adequate. Conversely, those financial institutions that are like banks in all but name (for example, some investment funds) should be just as closely regulated and supervised (see Box 6.6).

Box 6.6 Investment funds in Egypt

The recent experience of Egypt illustrates the need for adequate regulation and supervision of nonbank financial intermediaries that take deposits from the general public. Investment funds were organized in the mid-1970s to handle remittances from Egyptian workers abroad and the savings of small investors. These Islamic investment companies paid profit-related returns, sometimes as high as 30 percent a year. They were not required to conform to banking regulations and did not come under the supervision of the central bank.

Some of these institutions have faced increasing difficulties in the past two years, and their financial condition has deteriorated. Many had made large initial profits through trade finance not otherwise available to importers or through foreign exchange transactions in the parallel market. Some paid high dividends to earlier depositors out of funds paid in by new depositors. When deposit growth slowed, some could no longer pay the promised high returns. To prevent further deterioration, the government had to step in.

A law regulating the investment funds was passed in 1988. It restricts deposit taking to joint-stock companies, imposes minimum capital standards, and vests regulatory oversight with the Capital Markets Authority.

INSURANCE. Insurance companies are usually heavily regulated in both industrial and developing countries. These regulations have often been introduced in response to failures or fraud. Regulations typically provide for compulsory disclosure of information, government supervision with implicit or explicit guarantees of solvency, oversight of contract terms and conditions, controls on entry, restrictions on investment portfolios, and rules concerning prices or profits. Regulation to promote transparency is desirable, but many of these measures limit competition and efficiency. For example, instead of insisting that a large share of insurance assets be placed in low-interest government bonds, portfolio restrictions should require that risks be adequately diversified. Life insurance and other contractual savings schemes would then be more attractive to savers. Investments in shares and corporate bonds have often been severely restricted, eliminating a potentially important source of long-term capital.

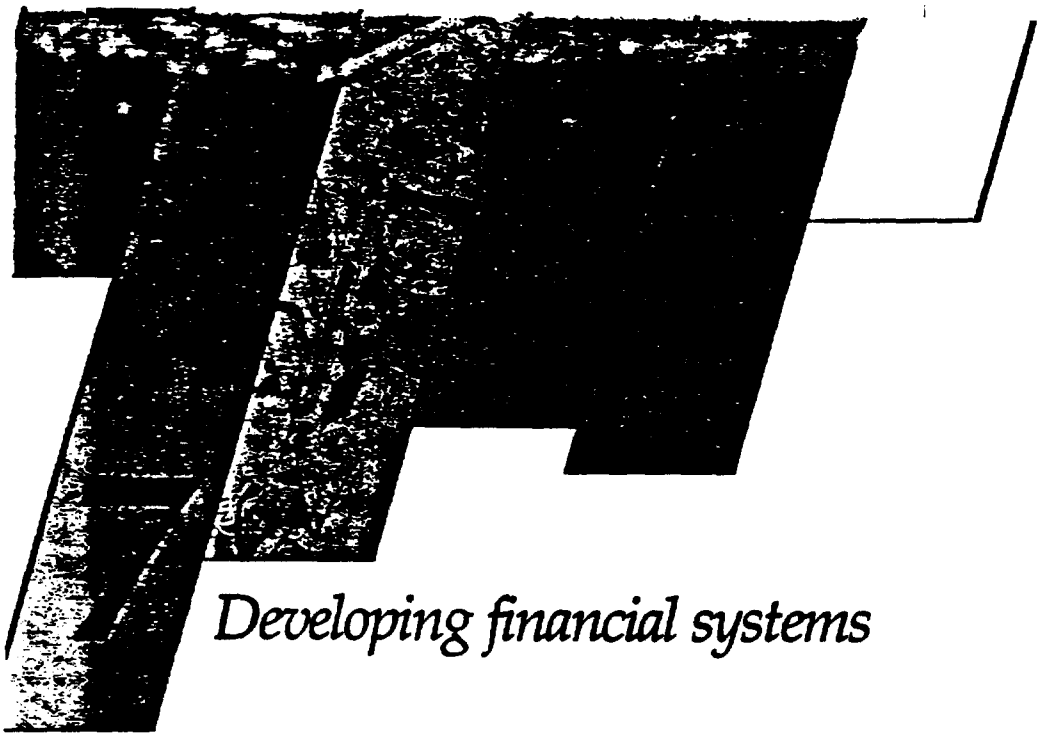
SECURITIES MARKETS. An appropriate regulatory framework for securities is needed to increase investor confidence. Regulation is unlikely to be satisfactory if left entirely to the market. The experience of many countries shows that some government guidance is desirable. In Hong Kong, for example, the stock market collapsed in 1973 partly because of insider abuses. A new securities commission helped to restore confidence. It was able to persuade brokers and underwriters that an orderly market which protected investors was in their own long-term interests.

The regulations need to provide for adequate disclosure of information about companies so that investors can make informed decisions; they need

to license securities intermediaries and to curtail improper activities in the market, especially the use of privileged information by corporate officers and directors for their personal gain (insider trading). These regulations are usually embodied in the company laws that form the legal framework for joint-stock companies.

If securities firms and the securities market as a whole are to perform efficiently, the firms must be profitable and well capitalized and have professionally trained staff. This does not happen automatically in an emerging securities market. The government has a crucial role. If minimum capital requirements are set too high in relation to the size of the market, new securities firms will not appear. But if firms have insufficient capital, they will not be able to take on the risks of underwriting new issues; nor will they be able to work as market makers (that is, to buy and sell shares for their own account) and thus provide liquidity for the secondary market. Brokerage rates, underwriting fees, and so on must be high enough for firms to attract and train staff and still leave their shareholders with an adequate return on capital.

The regulation of companies and securities markets is linked to important social issues. Promoting widespread ownership of productive assets may be one way to forestall greater concentration of wealth and economic power. At the same time, it can provide an income for the elderly at a time when industrialization and urbanization are breaking down the extended family and the traditional transfer of income between generations.



Developing financial systems

What sort of financial systems will the developing countries possess in twenty years? During the past twenty years, internationalization of markets and a common set of forces have pushed the financial systems of high-income countries into rough alignment. The financial systems of developing countries, however, remain quite heterogeneous. Most developing countries have begun to place greater emphasis on market signals, but some governments will continue to intervene extensively in credit allocation and pricing, and some will continue to rely on inflationary financing. As a result their financial systems will remain shallow, with little long-term finance. Economic structures will continue to differ as well, with some countries remaining primarily agrarian, others industrialized, some oriented toward domestic markets and imposing tight controls on capital movements, and others more oriented toward external markets and having fewer controls. Because of these differences in developing countries' economic structures and approaches to development, their financial systems are likely to remain quite diverse over the next two decades.

There are nevertheless pressures that are leading most developing countries to rethink the shape of their financial systems. One is the effort to apply some of the lessons learned from past intervention in financial markets, and another is the need to adapt to the decline in foreign capital inflows. A third is the rapid changes that have occurred in financial technology and banking practice. This chapter considers the evolution of formal financial institutions and markets in response to these pressures. Chapter 8 will turn to the informal markets.

Financing investment

Certainly in the next decade, and perhaps in the next two, the net flow of foreign capital to most developing countries is likely to be relatively small, regardless of how the present debt crisis is resolved. This has important implications for financial sector development. Developing countries will be forced to rely primarily on domestic saving to cover the cost of investment. In the past, most relied heavily on foreign financing, and in many countries external debt exceeds domestic debt. Moreover, practically all long-term credit was provided by foreign loans. The decline in funding from abroad will make living with a shallow domestic financial system and little long-term finance difficult. Unless countries develop their financial systems, would-be investors will have to rely primarily upon retained earnings, and the funding of large projects, particularly ones that require longer-term finance, will be difficult.

Despite considerable differences in level of development and in investment rates, countries are quite similar in the composition of their capital

Box 7.1 The structure of investment and the capital stock

Surprisingly, in relation to national income or GNP, the level and composition of investment (that is, the change in capital stock) and the capital stock itself are quite similar among both low- and high-income countries. Economies with very high rates of investment and rapid growth (such as China, Korea, and Japan) have similar assets-to-GNP ratios, because rapid growth of the capital stock is balanced by rapid growth of output. In the centrally planned economies, assets-to-GNP ratios tend to be somewhat higher, owing to lower productivity and a large volume of inventories. Box table 7.1 presents capital stock estimates for a few countries for which such data are available.

On average, gross investment is about 20 percent of GNP. Among developing countries, however, investment rates vary considerably, ranging from less than 15 percent of GNP in Sub-Saharan Africa to well over 30 percent in China. Machinery and equipment typically account for two-fifths of gross investment, and housing, other buildings, and civil works for one-fifth each. Perhaps one-half of the total is thus invested in assets with a life of fifty years or more, with the rest ranging mostly between ten and twenty years.

Because of substantial differences in asset life, the structure of the capital stock is quite different from the pattern of investment flows: long-lived assets (primarily structures) account for about two-thirds of total reproducible fixed assets, medium-lived machinery and equipment for about one-fifth, and short-lived inventories, livestock, and consumer durables for the remainder. The value of total reproducible assets is typically equivalent to 200 to 300 percent of GNP.

Box table 7.1 Estimates of the net capital stock in selected countries
(percentage of GNP)

Item	*United States, 1978*	*Federal Republic of Germany, 1977*	*Mexico, 1978*	*India, 1975*	*Hungary, 1977*
Total reproducible assets	295	325	209	239[a]	405
Housing	87	106	64	67	73
Other structures	93	117	64	58[a]	135
Machinery and equipment	45	47	43	43	69
Inventories	33	21	20	34	70
Livestock	2	2	4	10	8
Consumer durables	35	33	13	27	51
Land	89	108	50	131	150

a. Adjusted from Goldsmith 1985 to make estimate consistent with those for other countries and with national accounts estimates.
Source: Goldsmith 1985.

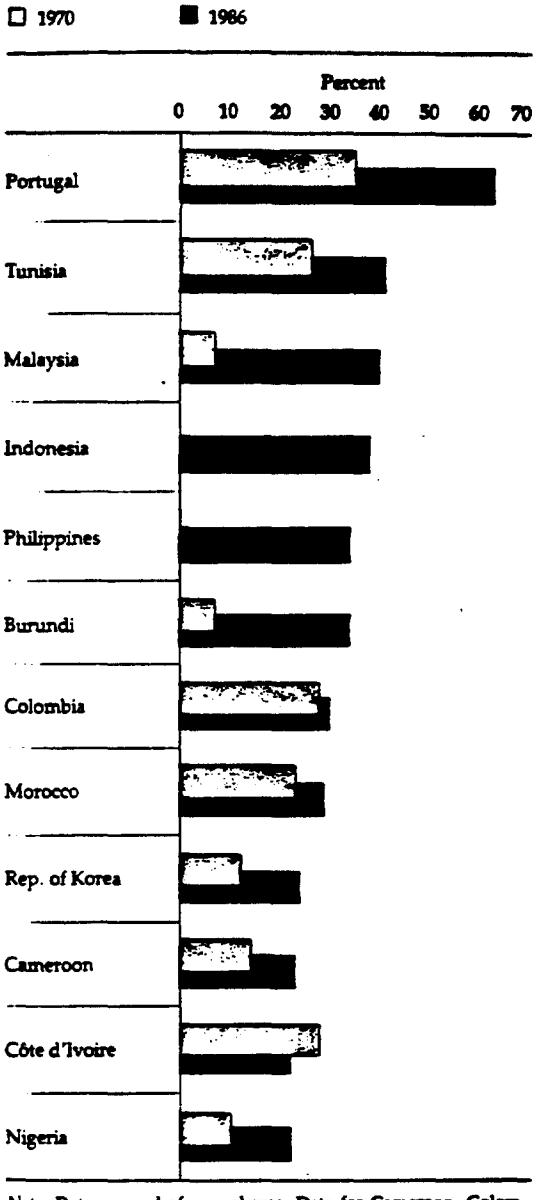
stock and of gross investment flows. The reproducible capital stock is usually equivalent to two to four years of gross national product (see Box 7.1). Long-lived assets, such as housing, commercial buildings, schools, roads, and water supply systems, account for the bulk of physical wealth in all countries. The capital stock of the business sector is surprisingly small in the aggregate. Fixed assets in manufacturing and utilities are each equivalent to about 40 percent of GNP, fixed assets in commerce are equivalent to 10 to 15 percent of GNP, and inventories are equivalent to 20 to 30 percent of GNP. In terms of gross investment flows and the demand for financial services the business sector looms larger than its share of the capital stock might suggest. Its capital stock is constantly being remolded as new machinery replaces old, production and distribution facilities are upgraded, and new plants are built.

Business finance

Many of the financial policies pursued by developing countries during the past several decades were intended to redress perceived shortcomings of domestic financial markets. Two issues have been of particular concern: first, the supply of equity capital and long-term finance and, second, the lack of access to finance for certain classes of borrowers. In formulating policies to address these two concerns, however, countries have paid too little attention to the balance between risk and reward.

PATTERNS OF FINANCE. In the past, developing country governments relied on directed credit, ad-

Figure 7.1 Shares of medium- and long-term credit in total credit outstanding from commercial banks and other financial institutions in selected developing countries, 1970 and 1986



Note: Data are end-of-year shares. Data for Cameroon, Colombia, Korea, Malaysia, Nigeria, and the Philippines refer to commercial banks only. "Credit for equipment" has been used as a proxy for medium- and long-term credit in Korea. Data for 1970 refer to 1974 for Cameroon, average of monthly shares for Nigeria, and 1975 for Portugal; data for 1986 refer to 1985 for Cameroon and Morocco, 1987 for Indonesia, and June 1986 for Nigeria. Data were not available for Indonesia and the Philippines for 1970.
Source: Central bank bulletins and World Bank data.

ministered interest rates, and foreign borrowing to ensure that certain sectors received enough long-term financing. As Figure 7.1 indicates, however, in some countries commercial banks and other financial institutions have begun in recent years to extend more medium- and long-term credit. In other countries, although banks provide little formal long-term finance, they do offer lines of credit and short-term loans that they roll over regularly as long as the borrower is in good standing. This type of financing, acceptable to many firms, is used extensively as an alternative to long-term finance in high-income as well as developing countries. From the viewpoint of some borrowers, however, short-term credit lines are imperfect substitutes for longer-term loans. They entail the risk of nonrenewal, a risk that may lead investors to forgo certain projects.

Neither in theory nor in practice are there simple norms of corporate financial structure. Financial theorists have argued that the debt-to-equity ratios of corporations are irrelevant if capital markets are perfect (see Box 7.2). More realistic theories, which take into account the costs of taxation, information, and monitoring and control, point to a variety of tradeoffs between equity and debt. In practice, no single pattern of corporate finance and control has been found to be best.

It is nonetheless useful to distinguish among firms according to the variability of their earnings. Higher leveraging becomes riskier the more earnings fluctuate. The firms that can best afford to be highly leveraged are large and capital-intensive and have highly predictable earnings—utilities, for example. In fact, modern finance got its start with infrastructure projects such as canals, railways, and (later) public utilities. Today, much of the capital for investment by public utilities in industrial countries is provided by retained earnings, because the basic infrastructure investments have already been made. Thanks to the stability of their income and the long life of their assets, public utilities are usually able to raise what external financing they do need by issuing bonds or other long-term debt.

In most developing countries, utilities and large transport companies have borrowed heavily from domestic banks and from abroad and are now among the borrowers that are unable to service their debts. This does not necessarily mean that they overborrowed, however. Most such companies are publicly owned, and their products are frequently priced too low to yield an adequate return on their huge investments. If prices were set

Box 7.2 Corporate finance in theory and practice

Much attention has been paid in academic circles to identifying the factors that influence corporate financial structure and dividend policies. The seminal article by Modigliani and Miller in 1958 demonstrated that in a world with perfect capital markets a corporation's debt-to-equity ratio is irrelevant to the firm's market value. In such a world the value of the firm is determined entirely by its investment decisions, which can therefore be completely separated from financing decisions. But markets are never perfect, and in practice financing decisions are not irrelevant. Subsequent developments in corporate finance theory relaxed some of the explicit or implicit conditions underpinning the assumption of perfect capital markets.

Corporate taxes and the worldwide practice of tax deductibility of interest payments provide an incentive for debt finance. This incentive is weakened, however, by the direct and indirect costs of financial distress and bankruptcy, which are more likely to be encountered in a highly leveraged company. Information flows are not perfect, and this has an important influence on financing decisions. In particular, managers have better information on a firm's performance and prospects than do outside creditors and shareholders. By maintaining stable dividends, firms help to signal their confidence about future prospects. This may explain why firms continue to pay dividends even if they need additional external finance or if taxes on capital gains are lower than those on dividend income.

Furthermore, since the interests of managers may differ from those of creditors and shareholders, the latter group must incur costs in trying to monitor and affect the way the company is run. Decisions on capital structure will be influenced by the ability of creditors and shareholders to get the information they need in order to exercise control over managers.

Recent theories have provided some plausible explanations for the differences in corporate financing patterns between the bank-based systems of Germany and Japan, on the one hand, and the market-based systems of the United States and United Kingdom, on the other. The two bank-based systems involve greater corporate indebtedness (although the difference is not as large as suggested by reported accounting data). This may be explained by the close relations between banks and industry—that is, by the ability of bankers to influence the decisions of managers.

to yield a higher return, retained earnings could provide most of the investment funds required.

Some large, capital-intensive firms—in steel, cement, or petrochemicals, for example—have a less predictable income stream. These firms cannot afford to be as highly leveraged as utilities and should rely more on equity financing, much of which can come from retained earnings if the firms are profitable. If they are private and large enough to be known to the public, these firms can obtain funding by issuing equities or by finding foreign partners. Where a particular industry accounts for a large part of a country's output, it would be desirable for the country to diversify its risk. It could do so by seeking equity funding abroad or by issuing debt instruments whose payments are linked to the price of the commodity. Foreign lenders would thus bear some of the risk of price fluctuations.

Many industries in this second group borrowed heavily during the 1970s to finance large investment programs. Too heavily as it turned out: substantial overinvestment left many of them unable to service their debts. As a result there has been little investment in these sectors during the 1980s. Care must be taken that firms in these industries do not once again overinvest and become overindebted when additions to capacity become necessary.

To foster sounder corporate financial structures, governments need to reconsider the policies that gave certain classes of firms an incentive to become highly leveraged. Low prices and high costs left many state-owned enterprises dependent on external finance for investment. Subsidized credit, tax biases against equity finance, the limited size of capital markets, and lax or ineffective bankruptcy laws encouraged firms to finance themselves by borrowing rather than by retaining earnings or issuing equity. In some countries the knowledge that the government was likely to help troubled firms made it safer to rely on borrowing. In others the existence of financial-industrial conglomerates in conjunction with weak supervision and regulation of banks worked to the same end.

Increasing the supply of long-term finance—both debt and equity—remains a priority, particularly in inflationary countries and in countries that have depended on foreign borrowing for most of their long-term funding. Macroeconomic stability is essential. Indexation can help to maintain some long-term finance in inflationary economies, but it

Box 7.3 The financial history of a Pakistani firm

Ajmal Hosiery, a family-owned business in Lahore, Pakistan, was established by Malik Ahmad Din in 1947. He began with an abandoned hosiery mill and two obsolete knitting machines. By the late 1950s the firm was well-known across the country.

Malik's original scheme was to let his business grow at a pace that would require no external financing, because he was uncomfortable with the paperwork involved in getting a loan. Moreover, he feared that information given to financial institutions could be used by the tax authorities. The company grew modestly during its first twenty years by plowing profits back into the business. Sales increased from around 50,000 rupees (Rs) in 1947 to Rs1.3 million in 1969.

The company obtained its first bank financing—an Rs50,000 line of credit—in 1969 when it executed its first export order. This venture into the international market was not successful; it cost the company Rs100,000. The company reentered the export market in 1972 but could obtain a line of credit of only Rs200,000 from a local bank. Although there was clear potential for exports, the firm needed working capital finance. In 1973 the State Bank of Pakistan introduced its Export Refinance Scheme, which provided cheap financing to eligible exporters through the commercial banking system. The firm could not exploit the scheme fully because banks thought its collateral inadequate. Nevertheless, the scheme helped the company to reach sales of Rs5.0 million in 1979, by which time its bank credit line amounted to Rs1.3 million.

The firm had always relied solely on internally generated funds to finance investment. Consequently, investment in plant and equipment had not kept pace with sales. In 1976, however, it obtained a long-term loan of Rs1.0 million to expand its capacity; the lender was the Industrial Development Bank of Pakistan.

The company has grown dramatically during the 1980s. It has used the government's enlarged export financing scheme and has also obtained term financing (in 1980, 1984, and 1988) for modernizing its plant and equipment. Sales grew fivefold between 1980 and 1988. In 1989–90 the firm plans to reach sales of Rs90.0 million, a figure three times higher than its 1988 sales of Rs30.0 million and 1,800 times its sales of Rs50,000 at inception in 1947.

is a poor substitute for price stability. Allowing institutions to charge interest rates that reflect the higher risks of longer-term lending will increase its supply, as will improvements in legal and accounting systems that increase lenders' ability to monitor and control their clients. Relatively risky projects should be financed with equity capital, where repayment is linked to profits; long-term loans with fixed returns are unsuitable for such projects.

ACCESS TO FINANCE. Many governments have sought to improve the access of smaller firms to finance, partly for social reasons and partly because such firms are often thought to be the most dynamic part of the economy. Although small-scale manufacturing, service, and commercial firms are generally less capital-intensive than heavy industry or housing and thus have considerably smaller investment needs, they should have access to credit if they can use it more productively than larger borrowers. As Box 7.3 illustrates, credit can allow a small firm to invest and grow.

Because small firms have little name recognition, they can neither borrow abroad nor issue equity. They depend for external funding on trade credits from other firms or on loans from financial intermediaries. Bankers everywhere, however, are reluctant to lend to small borrowers. First, they may find it uneconomical to lend the small sums required. Second, it is difficult to judge the risk, particularly when an investment project is a new venture. Small firms often lack a track record and rarely keep reliable accounts. Third, small borrowers often lack adequate collateral.

In developing countries, bankers' reluctance to lend to small firms has been compounded by other factors. Financial policies have left small firms unable to compete for credit on the same terms as larger firms. Most directed credit programs have discriminated against small borrowers. Interest rate ceilings have prevented lenders from raising interest rates to compensate for additional risk and higher costs. And small firms have less political influence: lenders know that governments are unlikely to intervene on behalf of a failing small firm.

In short, the policies that led to overleveraging by many large firms have also limited access to credit for small borrowers. Changing those policies will improve the flow of finance to small firms. In addition, measures that improve the links between formal and informal financial markets (discussed in Chapter 8) would serve the same purpose.

Financial innovations that secure loans by means

other than collateral are of particular benefit to small firms. By renting buildings and leasing equipment, small firms can acquire the use of assets without borrowing. With the development of securities markets, venture capital is more likely to appear as a source of finance for risky new projects. In the past, governments have relied upon development finance institutions for venture capital, but the risks for them were at least as great as for commercial banks.

MONITORING AND CONTROL. In their efforts to increase the supply of equity capital and long-term finance, governments have paid little attention to the possibility of reducing risk by enabling lenders to monitor and control the use of financial resources. Monitoring can be done by banks where they are the dominant lenders (as in Germany and Japan) or by specialized institutions, such as credit rating agencies and stockbroking firms, where financial markets are more important (as in the United States and the United Kingdom).

The experience of Germany and Japan suggests that high leverage can be compatible with successful industrialization. For such an approach to be effective, lenders must have the confidence of, and a strong commitment to, their borrowers. This in turn calls for the banks to maintain long-term relationships with firms. The banks' involvement may take different forms, such as holding equity positions or having seats on boards of directors, but extensive consultations with managers are crucial. Banks must also have the means to take swift corrective action when necessary—to replace managers, restructure operations, or foreclose on loans if need be.

Close ties between industry and finance have worked well in some countries, but in others, especially in Latin America, they have not. In several developing countries, small groups of businessmen have used the funds of banks under their control to create industrial conglomerates. By eliminating information and control problems, the existence of such groups permitted the financing of some profitable, although more risky, ventures. However, groups have used their control of finance to exclude potential competition. They have captured economic rents for their owners by passing on cheap credits to related firms. And they have rescued and supported fundamentally unviable businesses. When speculative ventures backfired or industrial companies suffered losses, group banks continued to provide funding long after the ailing firms had become insolvent. For close ties between industry and finance to work, regulators must prevent banks from lending imprudently to related firms.

Household finance

Demographic trends will affect the financial systems of developing countries. As the share of the population living in urban areas increases, and as incomes rise, more people will live apart from the rest of their family, and more will live past retirement age unsupported by their children. These changes will increase the demand for credit to finance housing and for certain types of financial assets.

Housing is a major investment in all countries: it accounts for between 20 and 30 percent of a country's capital stock (Box 7.1). In rural areas much housing is built by the owner out of locally available materials; the cash expenditure may be relatively small and spread out over a long period. In urban areas and particularly for middle-class housing, the expense of building or buying a house is large relative to income and incurred all at once. The rapid growth of the urban population of most developing countries will almost certainly lead to a greater demand for mortgage finance. Most families require a loan to buy or build a middle-class house. The need for mortgage finance in many developing countries is demonstrated by the common sight of abandoned, half-completed structures—a significant waste of resources in view of the share of housing in total investment.

Some governments provide concessional finance for housing to preferred borrowers, often civil servants, but others discourage mortgage lending in order to free resources for investment in industry. As urbanization proceeds, it will be important for governments to recognize the scale of housing investment, to improve laws concerning the use of housing as collateral, and to integrate housing finance on a nonpreferential basis with the remainder of the financial system (see Box 7.4).

As more of the population will want and be able to make provision for retirement, there will be an opportunity to develop contractual savings institutions, such as life insurance companies and pension funds. Individuals with greater wealth will wish to hold more diversified portfolios. Investment in housing and contractual savings both provide some diversification, but in a stable macroeconomic environment households are also likely to demand securities with greater yields (and correspondingly greater risk) than bank deposits. In

Box 7.4 Housing finance

The formal financial sector in most developing countries finances only a small share of housing investment. Mortgage credit from the formal sector was 28 percent of all housing investment in a sample of eleven developing countries, compared with more than 60 percent in OECD countries. The difference partly reflects the shallowness of financial systems in developing countries. Years of financial repression not only have minimized the role of the formal sector in housing finance, but have raised housing prices because negative real interest rates favored investments in real assets. In another sample of eleven developing countries the average ratio of house value to annual household income was 5.5, compared with 3.0 in five high-income countries.

Several other factors explain the lack of smoothly functioning markets for housing finance in developing countries. Countries have often given little priority to housing finance. Because housing is a large investment, it requires long-term finance, and in many countries inflation, interest rate controls, and the instability of financial markets have deterred long-term lending of any kind. Inadequate legal systems diminish the value of housing as collateral and hence also diminish lenders' willingness to provide mortgage finance. And policymakers have been concerned that increased finance for housing might drive the cost of housing even higher.

Shelter is a basic human need. Secure ownership of a house can raise the welfare of the household that lives in it. Moreover, when a house is purchased through a mortgage, the buyer becomes, in effect, a contractual saver: the buyer is paying the lender for the right to live in the house while saving for its purchase. And when the title to a house can be easily transferred, the household gains a relatively riskless form of collateral. Furthermore, a housing loan, which is fungible with other household resources, may provide the funds that would permit the household to undertake a productive investment.

a growing number of developing countries, sales to individuals of corporate securities and shares in mutual funds have begun to increase. As macroeconomic stability is restored in other countries, investors' interest in securities will continue to grow.

Building financial institutions and markets

In planning for the future it is important to have a clear and consistent objective for finance. The key objective of the financial system is the provision of financial services at prices that reflect their cost. The financial system can also be used in moderation for other objectives. In the past, however, developing country governments have tried to do too much—using the financial system to finance the government budget deficit, redistribute income, and serve as a tool in implementing their development strategies. Multiple and often conflicting objectives have impaired the financial system in many developing countries.

Financial markets are never perfect. In allocating credit they can make two sorts of mistakes: funding low-yielding projects and failing to fund high-yielding ones. In the early stages of development, developing country governments, fearing that the costs of failing to fund good projects were likely to be high, intervened to direct credit. Perhaps that assessment was sound at the time, but experience has since revealed too many errors of the first kind—funding low-yielding projects. With time, economies have become more complex, information flows have improved, and financial managers have become more skilled. In most countries both sorts of error can be minimized by leaving more decisions to a diverse and competitive financial system that responds to market signals. The primary role of government then shifts to making market signals more meaningful and, in particular, to preventing its own actions from distorting them.

On occasion the government may have a role to play as a promoter of financial institutions and markets in order to create a diversified and competitive financial system. Many high-income and developing countries have used fiscal incentives to favor particular institutions and markets. Such incentives may be justified to encourage financial diversity, particularly if the existing markets are dominated by large banks and are uncompetitive. Fiscal incentives, however, should be used only moderately, should have clear objectives, and should be withdrawn once those objectives are achieved. In the long term, countries should opt for regimes that do not favor one type of instrument or institution over others.

Countries must also choose the range of permissible activities for financial institutions. Banks in many high-income countries are operating increas-

ingly as universal banks, engaging in commercial as well as investment banking activities. Arguments in favor of universal banking include savings in overhead costs, better information about clients, and greater diversification of risks. The arguments against are mostly prudential: universal banking could lead to undue exposure to risk and a concentration of economic power. As discussed in Chapter 6, however, prudential regulation can deal with these drawbacks.

The banking sector

The banking sector in developing countries must confront several difficult issues. The most pressing is that many banks are insolvent and must be restructured. This problem was discussed in Chapter 5. Another is that wide-ranging intervention in the financial sector must gradually give way to systems that provide services in response to market signals. This, in turn, calls for more competition and better management.

INCREASING COMPETITION. Commercial (or deposit) banks hold between 50 and 90 percent of the assets of all financial intermediaries in most developing countries and will continue to be at the heart of their financial markets for the foreseeable future. In many countries these markets are dominated by a few large banks. The lack of effective competition is not so much due to monopolies based on economies of scale as to restrictions on interest rates, on product innovation, on branching, and on the entry of new institutions. Greater freedom for banks to respond to market signals, to choose their own customers, to set interest rates, and to determine the location of branches would stimulate greater competition. The creation of new banks and other institutions should be constrained only by the prudential regulations discussed in Chapter 6. Competition also means allowing failed institutions to go out of business. Allowing foreign institutions to open branches, start joint ventures with a local institution, or provide specialized services from abroad can be another source of competition.

Although economies of scale are not great in finance, it may not be possible in small economies to ensure a competitive market for every financial product. A few commercial banks supplemented by a postal savings bank may be all a small economy can support. Even in larger economies, financial markets are often uncompetitive. In these it should at least be possible to promote competition in big product markets, such as wholesale banking (loans to larger borrowers) and deposit taking in cities. This can be done, even when the creation of another big commercial bank would not be justified, by encouraging the development of specialized intermediaries. A postal savings bank, for instance, would extend financial services to new clients and foster competition for deposits; finance and leasing companies would spur competition in the market for loans.

To improve competition and efficiency, some small countries have opened their markets to foreign banks or have encouraged joint ventures between foreign and domestic institutions. Many small and medium-size countries could buy the specialized financial services they need (such as reinsurance, swaps, and forward contracts) from abroad. Small, specialized institutions and foreign competition can force even big oligopolistic banks to behave competitively—although not necessarily across the full range of financial services.

As the demand for financial services grows, countries will need to encourage the development of nonbank financial intermediaries and securities markets in order to broaden the range of services and to stimulate competition and efficiency. Some countries have already made considerable progress toward more diversified financial systems. In Malaysia, for example, a wide variety of institutions and markets are operating in an environment of macroeconomic stability. Brazil and other Latin American countries have had some success in institution building, although high and volatile inflation continues to undermine financial development. In recent years several developing countries have broadened their money and capital markets and created new intermediaries, such as leasing companies and contractual savings institutions. Most countries, however, are still at an early stage of financial development.

IMPROVING MANAGEMENT. Poor management has contributed to banks' difficulties in many countries. A 1988 study of bank failure in the United States concluded that management weaknesses, especially among smaller banks, were an important factor in 90 percent of the cases analyzed. Improvements must be made in the skills of management and in the banks' internal systems, particularly if the banks are to survive in the more competitive markets of the future (see Box 7.5). Many management tasks are similar to those of bank regulators and supervisors, as discussed in Chapter 6. Indeed, banks with large branch net-

Box 7.5 Bank modernization: Indonesia's experience

Indonesia began to deregulate its financial sector in 1983 and enacted a second set of measures in 1988. These signaled—at least potentially—a fundamental shift from a highly protected state banking oligopoly to a broadly competitive financial market. In a competitive environment, state banks would need to improve service, productivity, product innovation, and marketing skills. They would also need to introduce better risk management, because competitive pressures would narrow lending spreads and increase balance sheet volatility.

Bank Negara Indonesia 1946 (or BNI) is the largest of Indonesia's five state commercial banks, which together accounted for 71 percent of commercial bank assets in 1987. BNI's board of managing directors reacted to the changing environment by adopting an ambitious modernization program with the support of an international consulting firm. This program was given top priority from its inception in 1983 to the end of 1988.

The program had an institutional component and a technology component. The institutional component included an attempt to identify business opportunities following deregulation; a reorganization to refocus the bank on its marketplace priorities, reinforce risk management, and speed management decisions; manpower management programs to improve the evaluation, deployment, development, and motivation of staff; and a comprehensive revamping of the bank's procedures for managing its assets and liabilities. The project was accompanied by a massive effort to train staff.

The technology component was the full-scale automation of the bank's retail and wholesale functions. In preparation for automation, BNI greatly simplified its procedures. To attract and retain the necessary technical expertise, it paid higher salaries.

It is too soon to judge the overall success of BNI's reforms. BNI's competitors have begun or announced similar programs of their own.

works internalize a considerable part of the supervisory function.

The internal systems of banks in developing countries have some common problems. Many banks are operated without the benefit of a formal planning process. Financial plans and budgets may not exist, and little is done to control costs. As a result institutions react to, rather than anticipate, changes in the external environment. This makes them vulnerable to sudden change.

The information available to management is neither timely nor complete. At one bank in Nepal, unreconciled differences in interbranch accounts have existed for years and are equal to the whole of the bank's capital. Without good information, it is difficult to take corrective action on credit extensions, problem loans, or off-balance-sheet risks. Commercial banks in many countries have lax accounting and auditing procedures and continue to accrue income long after loans are nonperforming and recovery has become doubtful. Sometimes new lending is used to conceal debt servicing problems; overdraft facilities are particularly vulnerable to such abuse.

Poor management is most often reflected in improper lending. A lack of written lending policies makes it more difficult to manage risk; without written policies, senior managers find it hard to control the lending of their middle managers. Excessive concentration of risk is common. Too many loans to one borrower, an affiliated group, or borrowers in one industry means that the quality of those loans could be jointly damaged by a single factor. Banks in Texas are an example of excessive risk concentration. When the price of oil was high, Texas banks were among the nation's most profitable; when the price fell after 1982, they sustained large losses, and several of the leading banks failed.

Excessive lending to related firms has proved a serious problem in Chile, Kenya, Turkey, and other developing countries. In Spain, the Rumasa group contained twenty banks and more than 700 companies and used the twenty banks to finance the related firms. When the firms experienced difficulties, the banks became insolvent. In the aftermath of the crisis, it was discovered that 400 of the firms were phantom companies created to borrow money, conceal the use of funds, and maintain the appearance of financial health.

Poor risk selection is the source of many problem loans. This includes advancing an excessive proportion of the required capital without demanding an adequate infusion of the borrower's own funds. Speculative loans based on the appreciation of asset prices can also be dangerous. In Malaysia, a fall in property prices and a rise in the debt servicing costs in the early 1980s adversely affected loans to

those speculating in real estate. In Kuwait, a collapse in the securities markets, together with the system of settlement by postdated checks, created serious problems for banks that had extended credit against securities and real estate.

One of the most important tasks of management is to train and motivate staff. The most successful international commercial banks appear to be those with the best in-house training programs, where top managers train and assess future managers. Commercial banks in developing countries should draw on the experience of banks in other countries in devising training programs for their own staff. Countries such as Guinea, Hungary, and Korea have established joint venture banks with foreign commercial banks in order to transfer skills more rapidly (see Box 7.6).

Accountability is a problem for many banks in developing countries because organizational structures are overly complicated and responsibilities are poorly defined. To improve accountability, commercial banks in high-income countries are making greater use of independent profit centers. Each branch is managed as a profit center, as are other units supplying services such as leasing and consumer credit. Profit centers are judged and rewarded on the basis of the profits they generate. Separately managed cost centers (for example, check processing) have to be judged on the basis of unit costs because there is no way for the market to evaluate their services. Only the head office or certain major subsidiaries qualify to be investment centers and thereby have a say in the use of profits. Credit ceilings are used to limit the authority of branch managers and to prevent undue loan concentration on the books of a branch. Large loans require approval at higher levels and are carried on the books of the head office. Internal prices permit the efficient transfer of resources without undermining the profit incentive of each branch. The profit center approach has much to recommend it. In practice, however, it is complicated and requires skill and experience to work well.

Nonbank financial institutions

In most developing countries, nonbank financial institutions (finance companies, development finance institutions, investment banks, mutual funds, leasing and factoring companies, insurance companies, pension funds, and so on) are a relatively small part of the financial system. Countries such as Brazil, India, Jordan, Korea, and Malaysia, however, do have a large nonbank financial sector. Sometimes, stringent bank regulation or favorable tax treatment gives nonbank intermediaries a strong competitive edge. In Korea, for example, finance companies have grown rapidly since 1982 largely because they have greater freedom than banks in setting interest rates.

Box 7.6 Banks in Guinea

Like most African countries at independence, Guinea had a commercial banking sector that was dominated by a few foreign banks. In 1960 it established the Bank of the Republic of Guinea as a socialist monobank. This was later divided into four specialized banks, each dealing with one function or a single category of customer. The management of the banking system was centralized, and the four specialized banks were, in practice, departments of the central bank—that is, the government. Credit was allocated in accordance with five-year plans. (Credit to the private sector was prohibited during 1965–79.) The banks confined themselves to providing working capital for state enterprises, which in most cases meant financing their recurring losses. By 1985, 80 percent of the banks' loans were irrecoverable. The banks were grossly overstaffed with badly trained employees and managers. Discrepancies in interbank claims amounted to 10 percent of their combined balance sheet.

A change of government and a new development strategy in 1984 gave a larger role to market forces and private sector initiative. The central bank was strengthened with foreign technical advisers, the specialized banks were liquidated, and a currency reform and a large devaluation were implemented. Three new commercial banks started business, with foreign participation. Foreign workers now account for about 7 percent of staff, but their number will be gradually reduced as nationals finish their training. The total personnel of the new system is a quarter of the old. Intermediation margins have initially been high, because there has been little competition among the banks, and the demand for credit has expanded rapidly as the economy has recovered. The banks also say that their nonperforming assets are substantial (one-third of their portfolio), so further improvements in the legal framework for loan recovery may be needed.

DEVELOPMENT FINANCE INSTITUTIONS. The most common type of nonbank intermediary in developing countries is the development finance institution (DFI). Most are public or quasi-public institutions that derive much of their funding from the government or from foreign assistance. Originally, they were intended to provide small and medium-size enterprises with the long-term finance that the commercial banks would not supply. During the 1970s that mandate was broadened to include the promotion of priority sectors. Using government funds, DFIs extended subsidized credit to activities judged unprofitable or too risky by other lenders. In practice, the DFIs found it difficult to finance projects with high economic but low financial rates of return and remain financially viable at the same time. The DFIs' difficulties have been discussed in Chapter 4. Today many of them are insolvent. If they are to remain in operation, they will have to be restructured.

DFIs face competition from commercial banks, leasing companies, and other sources of long-term and equity finance. The procedures of other institutions are often speedier and less bureaucratic. Moreover, commercial banks offer much more than just long-term loans. If DFIs were to charge market rates for their services, many would soon lose their customers. Where other institutions offer competing services and the existing DFIs are financially and institutionally weak, the best course is to close the DFIs or merge them with sounder institutions. There is no reason to close DFIs that can mobilize their own funds and are profitable at market interest rates—although it might be sensible to merge them with commercial banks, which thereby would gain expertise in long-term financing.

Monitoring and control of borrowers has posed particular problems for DFIs. Because they provide mostly long-term loans, they do not have the same day-to-day contact with customers as commercial banks. And the narrow specialization of DFIs has made it difficult for them to diversify their risks; they have been particularly vulnerable to fluctuations in the business cycle. Merger with commercial banks would help to solve both problems. Alternatively, DFIs might expand their range of services within the constraints of their institutional capabilities and professional skills. Activities potentially suitable for DFIs include consulting and leasing; the skills involved are similar to those required by DFIs' existing activities.

The operations of DFIs need to be strengthened in the ways already outlined for commercial banks. The DFIs that are to remain in the public sector need professional boards of directors, trained management, and competitive salaries. They also need to place greater emphasis on loan appraisal and recovery.

To attract more funds from the public, DFIs need to charge market rates on their loans. Borrowing long-term funds will be feasible only if there is a market for long-term finance (this is discussed further below). Some DFIs have acquired equity holdings. Selling the shares of firms that have become profitable could free resources to finance new ventures and increase the supply of securities in local capital markets. To the extent that DFIs continue to lend foreign resources, better management of foreign exchange risk will be necessary. In many countries clients of DFIs and, in turn, the institutions themselves were badly affected by sharp currency devaluations. If foreign exchange risk is to be passed on to borrowers, loans should go only to those with foreign exchange revenues or hedging opportunities.

Past experience has shown that DFIs cannot achieve all of their objectives and remain financially viable. If they are to lend for socially attractive but financially dubious purposes, they should do so as agents of the government with no risk to themselves. In some countries they have used managed funds to this end.

LEASING COMPANIES. Smaller and less well-established enterprises find leasing companies an attractive source of long-term finance. By leasing plant and equipment, small firms can avoid the requirements for collateral that often prevent them from obtaining long-term finance for a direct purchase. Of course, leasing depends on the ability to repossess leased assets (in fact, as well as in principle) and on the existence of markets for used equipment. The share of leasing in capital formation (excluding building and construction) in selected developing countries ranges from 0.5 percent in Thailand (1986) to 8 percent in Korea (1985) to 14 percent in Malaysia (1985). This compares with shares of 8 percent in Germany, 9 percent in Japan, and 20–28 percent in five other industrial countries.

Governments can encourage leasing by ensuring that tax systems do not discriminate against this type of financing and by amending laws that are unclear or unfavorable (as they are in Thailand). The more successful leasing companies in develop-

ing countries have been joint ventures between national institutions (commercial as well as financial) on one side and overseas leasing companies or bank groups with experience in leasing on the other.

VENTURE CAPITAL COMPANIES. Venture capital is temporary start-up financing in the form of equity capital or loans, with returns linked to profits and with some measure of managerial control. Venture capitalists expect losses on some ventures to be greater than with traditional financing, but they invest because they think that greater than normal returns on others will more than make up for those losses. Venture capital is ideally suited to projects involving uncertainty, poor information, and lack of collateral. It is therefore an alternative to finance from DFIs. It is clearly not suitable for every country, however. It requires an entrepreneurial class and an environment conducive to private sector initiatives. A source of long-term investable resources is also necessary. And an active secondary market—either a secondary stock exchange with less demanding listing requirements or an adequate network of business contacts—is essential so that investments can be sold.

CONTRACTUAL SAVINGS INSTITUTIONS. Contractual savings institutions (life insurance companies, occupational pension schemes, national provident funds, and funded social security systems) have long-term and generally predictable liabilities. They are potentially good sources of finance for investment in corporate bonds and equities. In high-income countries these institutions are the main suppliers of long-term finance. They provide savers with opportunities to diversify risk and with the benefits of investing in a portfolio selected by professional investors.

A major impediment to the development of contractual savings as a source of long-term corporate finance has been the preemptive use of these funds by government. In many countries—Brazil, Colombia, Ecuador, India, Kenya, and Malaysia, for instance—governments require contractual savings institutions to invest a significant part of their

Box 7.7 Pension funds as a source of term finance

Compulsory pension funds have contributed significantly to the supply of long-term investment funds in Singapore and Chile. In Singapore the Central Provident Fund receives exceptionally high mandatory contributions from employers and employees. Such contributions rose to 50 percent of salaries in 1984, before being temporarily reduced to 35 percent in 1986. Funds are mostly invested in government bonds, but employees are now allowed to use their provident fund savings to buy housing. At retirement, employees receive either a lump-sum payment equivalent to their contributions plus the accumulated return on the assets of the fund or an annuity determined by their life expectancy at retirement. The accumulated resources of the provident fund are now equivalent to about 65 percent of GNP—a substantial amount of very long-term savings (with average maturity between twenty-five and thirty years), which will continue to grow.

Chile restructured its pension system in 1981. Contributions are compulsory but are privately managed by competitive firms. Employees can choose among plans and switch at their discretion. Thus managers who perform better can expect to gain accounts. Compulsory contributions are set at 10 percent of salaries. Benefits based on life expectancy are determined at retirement; the minimum pension is 85 percent of the legal minimum wage, or about 40 percent of the average wage.

In the first eight years of the new system, the total value of assets grew to about 18 percent of GDP. Two-thirds of the funds are invested in government securities, one-quarter in mortgage bonds, and the rest in shares and other investments. Initially the earnings on assets were very high (owing to high real interest rates), but they are now about 4–5 percent in real terms.

The fraction of the portfolio invested in equity shares was negligible until 1985, because companies that had a dominant shareholder did not qualify for pension fund investment. Only with the denationalization of a number of large state enterprises (mainly utilities) and some further relaxation of prudential standards has it become possible for the pension managers to invest in corporate equities. Investment in corporate equities is likely to remain a small part of assets, not because of regulation, but because securities are in short supply. Even after the denationalization program, the value of all corporate stock is only about 25 percent of GNP; the value of pension assets will grow to about 100 percent of GNP as the system matures.

The main issue for both funded and pay-as-you-go social security systems is the rapid increase in life expectancy. This will require adjustments in the contribution rates, retirement benefits, or the retirement age.

resources in government securities or programs with low returns in the social sectors. (Sometimes contractual savings institutions hold government securities because they lack alternative investment opportunities.)

Although a government with a deficit needs funds from a source other than the banking system, it does not necessarily need long-term finance. Furthermore, the government's legitimate concern with the soundness of the assets in which pension funds invest need not preclude investment of those funds in the private sector. Governments in high-income countries have enacted prudential rules for pension and insurance investments, and these rules allow pension funds to invest in private sector activities. Chile and Singapore have moved in recent years to allow the pension authorities to invest in other than government securities (see Box 7.7).

Because pension and insurance institutions are likely to be relatively large and therefore able to afford professional management, these managers are able to play a role in the monitoring and control of the firms in which they invest. Governments can encourage the industry to develop by creating a regulatory framework that seeks a proper balance between safety and real returns and by fostering greater competition.

Securities markets

Well-developed securities markets enlarge the range of financial services. Short-term money markets provide competition to the banks in supplying credit to larger corporations, and under appropriate conditions capital markets can provide long-term finance to government and large firms.

MONEY MARKETS. The development of securities markets usually starts with trading in a short-term money market instrument, often a government security. Other money market instruments are interbank deposits, bankers' acceptances, certificates of deposit, and commercial paper issued by nonfinancial corporations. Money markets provide a noninflationary way to finance government deficits. They also allow governments to implement monetary policy through open market operations and provide a market-based reference point for setting other interest rates. Furthermore, money markets are a source of funds for commercial banks and other institutions with limited branch

Box 7.8 Capital markets in India

In the 1950s India's capital markets helped to mobilize financial resources for the corporate sector. The importance of these markets then diminished, because subsidized credits were available from commercial and development banks, equities had to be issued at a discount substantially below market value, the capital market lacked liquidity, and investor safeguards were inadequate.

A reform of the Foreign Exchange Regulations Act in the early 1970s limited the expansion of foreign-owned and foreign-controlled companies. In response, many companies decided to become Indian companies. This led to the issue of substantial quantities of company shares at low prices. The market's revival continued in the 1980s, as various measures were introduced to stimulate both demand and supply. Incentives for equity and debenture issues included reducing the corporate rate of tax for listed companies and fixing the permitted interest rate for debentures above that for fixed deposits but below that for bank loans. The government also authorized the use of cumulative, convertible preference shares and equity-linked debentures and gave generous fiscal incentives to investors.

The growth of the Indian capital markets has been impressive. Equity market capitalization on the Bombay exchange increased from $11.8 billion to $19.4 billion between the end of 1980 and 1987; average capitalization ratios remained roughly equal to 6.5 percent of GNP. The number of listed companies on all exchanges increased from 2,114 in 1981 to 6,017 in 1987. New issues of debentures also multiplied. However, there were also abuses, such as the use of misleading prospectuses and insider trading. In addition, the processing of new issues, which were heavily oversubscribed because of their low prices, was plagued by delays in share allocation.

In April 1988 the Securities and Exchange Board of India was established to oversee and regulate the markets. In August 1988 a credit rating agency was established to grade capital issues. In January 1989 proposals were published regarding the appointment of market makers offering bid-and-asked quotations, the responsibility of stockbrokers for vetting companies before listing, the opening of stockbroking to banks and other financial institutions, and the creation of a second-tier market for smaller enterprises, with less onerous listing requirements. The measures were intended to improve market liquidity and transparency and to provide adequate protection to investors.

Table 7.1 Equity market indicators, 1987

Country	Average market capitalization[a] (percentage of GNP)	Turnover ratio[b] (percentage of average capitalization)	Number of companies listed
High-income countries			
Japan	92	93	1,912
United Kingdom	80	72	2,135
United States	58	93	7,181
Germany, Fed. Rep. of	21	161	507
France	18	56	650
Developing countries			
Jordan	60	15	101
Malaysia	58	23	232
Chile	27	11	209
Korea, Rep. of	19	111	389
Portugal	10	44	143
Zimbabwe	10	4	53
Thailand	9	114	125
Mexico	8	159	233
Brazil	7	43	590
Philippines	7	62	138
Venezuela	7	8	110
India	6[c]	19[c]	6,017
Greece	5	18	116
Pakistan	5	9	379
Nigeria	4	1	100
Colombia	3	8	96
Turkey	3	6	50
Argentina	2	16	206

a. Average market capitalization is a five-quarter average of the total value of listed stock, based on year-end data, assuming constant exponential growth during the year.
b. Turnover ratio is the value of stocks actually traded as a percentage of the average total value of listed stock.
c. Bombay exchange.
Source: IFC.

networks, including foreign banks and leasing and factoring companies. By enabling large corporations to issue short-term securities in the form of commercial paper, money markets make the corporate loan market more competitive and reduce the market power of large commercial banks. Measures to promote the growth of money markets have been among the most successful financial reforms in high-income and developing countries alike in the 1980s.

One such measure is to issue government securities at market interest rates. The reluctance of finance ministries to pay market rates on their debt is usually the biggest obstacle to the development of money markets. Governments also need to remove regulatory obstacles, such as the rules that prevent banks from issuing certificates of deposit or corporations from issuing commercial paper. The publication of clear rules of conduct for market participants is essential.

CAPITAL MARKETS. Capital markets provide long-term debt and equity finance for the government and the corporate sector. By making long-term investments liquid, capital markets mediate between the conflicting maturity preferences of lenders and borrowers. Capital markets also facilitate the dispersion of business ownership and the reallocation of financial resources among corporations and industries.

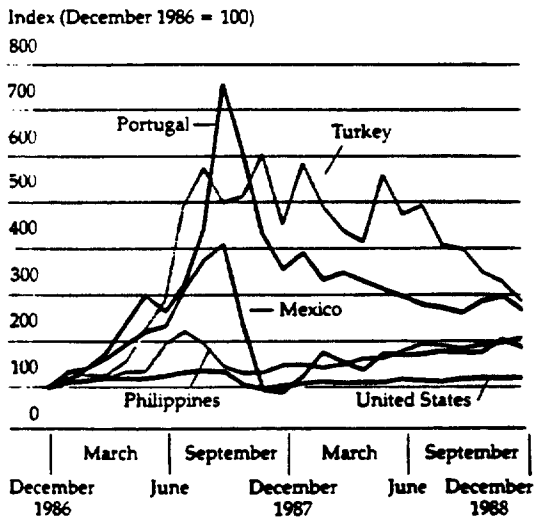
In mature economies, new share issues have been overshadowed in recent years by the retirement of existing equity. In the United States and the United Kingdom, as a result of mergers and takeovers and the spread of share repurchase programs, net new equity finance has been negative for several years. In earlier periods, however, securities markets were far more important as a source of finance. From 1901 to 1912, for example, new stock issues provided 14 percent of corporate financing in the United States. In several developing countries, including India and Korea, the securities markets have raised impressive amounts of new equity and bond finance in recent years (see Box 7.8).

Several developing countries have made great

strides in recent years in establishing and invigorating equity markets. Such markets now exist in more than forty countries. Indeed, the market capitalization of stock exchanges (that is, the total value of listed shares) is a greater proportion of GNP in Jordan and Malaysia than in France and Germany, and India's stock exchanges list more companies than the stock markets of any other country except the United States (see Table 7.1). In many countries, however, equity markets remain small. Only a few countries have active corporate bond markets; they include Canada, India, Korea, and the United States.

The supply of equities has been limited by the reluctance of owners of private companies to dilute their ownership and control by issuing stock or to comply with requirements to disclose information about their operations. The availability of less expensive debt finance has also discouraged equity issues. Some countries—for example, Korea—have provided considerable tax incentives to encourage corporations to go public. In Jordan, any firm seeking limited liability must offer a substantial percentage of its shares to the general public. Chile requires all limited liability companies of a certain size to make the same financial disclosures as publicly listed firms. In the past, demand for securities has been inhibited by the lack of investor confidence. In the future, much of the demand is likely to come from institutional investors.

Figure 7.2 Stock indexes in selected developing countries and the United States, 1987 and 1988



Note: For the developing countries, the stock index is the IFC index of total returns in U.S. dollars; for the United States, it is the Standard and Poor's 500.
Source: IFC 1988 and 1989.

A primary reason for the underdeveloped state of capital markets in many developing countries is the absence of an appropriate legal, regulatory, and tax framework. In some countries new shares have to be issued at par value, which makes them unattractive to companies if the market value of their shares has appreciated significantly. In other countries the tax-free status of time deposits or government and public enterprise bonds lessens the appeal of private corporate instruments. Far more important in developing countries, however, is lax enforcement of corporate income taxes. This makes it possible for closely held corporations to avoid taxes by showing very low accounting profits; publicly traded corporations cannot hide their profits without hurting investor confidence.

A common problem in securities markets, especially early in their development, is the danger of a speculative boom followed by a sharp decline. Such crises have affected markets in Brazil, Hong Kong, Korea, Mexico, the Philippines, Singapore, and Thailand. Large increases and declines in prices also affect securities markets in high-income countries, but they can be much more pronounced in young markets. The Wall Street collapse of October 1987 was far less abrupt than the collapse of many smaller markets (see Figure 7.2).

Countries with a relatively large business sector and middle class should encourage the development of securities markets. Fiscal policies that discriminate against equities should be changed. Governments also need to define the operational scope of underwriters, brokers, dealers, merchant banks, and mutual funds and to encourage the establishment of credit rating agencies. Privatization of state-owned enterprises can be another stimulus to securities markets. Privatization has been one of the forces revitalizing Chile's equity market in recent years. In France, 167 state enterprises and subsidiaries were divested from late 1986 through early 1988, and their shares were taken up by more than 13 million individuals. As a result the capitalization of the Paris stock market increased by an amount equivalent to 6 percent of GDP.

Encouraging foreign portfolio investment is another way to raise demand for securities in developing countries. The increasing role of institutional investors means that foreign portfolio

investment might grow substantially. Prices in several emerging markets have shown a low or negative correlation with price movements in the United States and Japan and thus offer foreign investors an opportunity to reduce risk. During 1975–87, equity markets in six developing countries outperformed the market in the United States, and two of them (Chile and Korea) outperformed Japan.

In capital-exporting countries, regulations on foreign portfolio investment limit the extent to which contractual savings institutions can invest abroad. In developing countries, concern over volatile flows of money and increasing control by foreigners has prompted a variety of restrictions and disincentives. Foreign portfolio investment is usually passive, but the concerns of developing countries can in any case be met by such means as the closed-end country fund, whose shares can be traded but not redeemed. More than thirty developing country funds, most of them closed-end, have been floated in emerging markets since 1980. Since issue, the market value of twenty-five of them has increased by 86 percent (as of August 1988).

Priorities for reform

Building a financial system more responsive to the needs of lenders and borrowers will require substantial improvements in the macroeconomic, legal, and regulatory environments. Developing countries also need to broaden the range and improve the efficiency of their financial institutions and markets. Much can be achieved by removing obstacles to the development of different instruments, by adopting a system of regulation by function rather than by institution, and by strengthening the management capabilities of individual institutions.

To operate efficiently, financial institutions and markets have to be guided primarily by market forces rather than government directives. Competition needs to be strengthened by encouraging the entry of new and innovative providers of financial services, by phasing out interest rate controls and high levies on financial transactions, and by stimulating the development of money and capital markets.

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

TO: Economic Growth Training Workshop Participants

SUBJECT: **FSDP BUY-IN SOW'S EXAMPLES**

DATE: September 1995

The following list name the FSDP buy-in SOW's included in the Financial Sector Day course material to serve as a resource 'tool' in the design of FSDP buy-in SOW's:

- Rural Credit Study (Ethiopia)
- Financial Markets Project Evaluation (Indonesia)
- Rural Economic Policy Reform Assessment (Niger)
- Central Bank of Egypt Implementation of Financial Reform Activity
- Long-Term Advisor to the Prague Stock Exchange
- Financial Sector Development Strategies (Egypt)

320 TWENTY-FIRST STREET, N.W., WASHINGTON, D.C. 20523

Attachment 1

ETHIOPIA RURAL CREDIT STUDY

I. BACKGROUND

With a population of 55 million, Ethiopia is among the largest countries on the African continent, but it is also one of the poorest with an estimated per capita income of $120. Illiteracy is estimated at 85% (probably even higher for women).

Some 90% of the population is involved in agriculture and as a sector, agriculture contributes 50% to the Ethiopian economy. Under the Marxist regime economic growth stagnated, and agriculture only grew at 0.1% per year in the 1980s, 2.9% below population growth. This led to declines in incomes and nutritional levels, and led to dramatic increases in food aid imports. Ethiopia's structural food deficit is estimated to be approximately one million metric tons, very close to its current import capacity of 1.2 million metric tons. If agricultural production conditions were to significantly worsen, it is conceivable that Ethiopia's food needs could expand to 2.8 million metric tons.

Ethiopia is currently in a critical stage of transition, moving away from a Marxist government to a more democratic one, and making progress in changing from a command economy towards a more open market economy. At the same time, USAID's program in Ethiopia has been changing from one of emergency relief to one of long-term development interventions. One of the major concerns for the country is the size of food importations via the international community, as well as the potential effect of such large quantities on the Ethiopian agricultural production sector. Donor organization's thinking is increasingly moving from the supply of emergency food assistance to one of addressing the root causes of Ethiopia's food security problem.

The state of agriculture in Ethiopia leaves much to be desired. Small holder farmers have suffered 17 years of neglect and top-down imperatives of how, what and how much to produce. They have had limited access to information on improved technologies and inputs, and agriculture is still very much carried out with a subsistence approach and mentality. As population has increased, farming activities have extended on to more fragile land areas and productivity levels have declined, even as farmers continue mining their natural resource base. However, there is sufficient evidence of potential to significantly increase yields and production of Ethiopia's agriculture to believe that intervention in this sector could lead to dramatic increases in food crop production, decreasing or eliminating the food gap.

The lack of rural banking services is believed to be one of the major constraints to increasing the productivity of rural input suppliers, farmers, agricultural processors, and traders in Ethiopia. USAID's proposed new program in the agricultural sector, Ethiopian Resources for

Agricultural Development (ERDA) has, as its purpose, to increase production and productivity of selected domestically produced food grain crops, and has selected the East Wellega zone of Oromiya Region to use as a pilot test area for field level activities. Several attempts have been made to determine the role of credit in the agricultural production system (which includes the full range of activities related to agricultural inputs through to grain output marketing), and to what extent credit is a constraint to increasing agricultural productivity in Ethiopia. There are still many critical questions related to the Ethiopian rural financial market system which remain unanswered.

Agriculture Cooperative Development International (ACDI) conducted a rapid assessment of the current state of Ethiopia's rural financial markets and the informal and formal credit systems which provide credit to rural entrepreneurs from the farming, processing or wholesale/retail trading sectors. While the report has many recommendations, these are based on a somewhat limited rapid appraisal and are not specific enough for USAID to ascertain what the most critical problems that need to be addressed nor the steps or mechanisms to act on many of these. Two subsequent teams were fielded tasked to identify primary constraints to agricultural productivity and develop specific recommendations for potential ERDA interventions both in the policy arena as well as field oriented, farmer and entrepreneur level activities to address the identified constraints. Rural banking services were not addressed in sufficient detail in either of these reports.

USAID/E believes that rural banking services are an important key to increasing agricultural production and rural incomes, and through this procurement, is requesting detailed assessments, recommendations and a plan of action for what USAID/E might be able to achieve in the banking services sector. The Ethiopian government is currently developing results from a task force on rural credit, and while the results have not been finalized, USAID has been told that there are currently two strategies emerging. The first is to use the India model of setting up several regional development banks, which would have capital from the government, perhaps private banks (though this would be difficult since there is at present only 1 newly operational private bank in Ethiopia) and from donors. The second proposal is to allow the National Bank of Ethiopia (NBE, the central bank) to strengthen its capabilities in regulation and oversight, and to allow experimentation with various models for rural banking service delivery.

II. PURPOSE

The purpose of this procurement is to determine the degree to which the lack of rural banking services is a constraint to achieving increased agricultural production and productivity in Ethiopia. The consultants will specifically address questions relating to what the needs for banking services are of various actors in the agricultural sector, in terms of size of the potential demand by this population for such services, the types of services needed (short term credit, long term credit, savings etc.), and developing recommendations for what kinds of financial

institutions could best meet the expressed needs. Currently, USAID/E is focussing on groups including farmers, traders, input/output retailers, wholesalers, who are involved directly or indirectly in agricultural production and presently do not have access to rural banking services except on a limited basis (government production credit scheme, informal sector, family). The purpose of the study will be to identify specific actions that could be taken to sustainably increase access to banking services by these groups.

It is expected that the results of this consultancy will be shared with the government and based on the new rural banking policy it will have developed, identify if there are aspects of the report, both at the policy agenda level as well as at the field level of activities in East Wellega, that can be incorporated into the ERDA activity.

III. SCOPE OF WORK

The tasks described in this scope of work will be performed by a team of two expatriates and two Ethiopian professionals, with expertise in rural banking services and rural financial market development, regulatory/legislative frameworks for viable rural financial markets, and in developing practical solutions and recommendations for setting up viable and sustainable systems to supply banking services to farmers and microentrepreneurs in rural areas. This team will be responsible for addressing the following questions and areas dealing with the rural financial market in Ethiopia.

1. What are the legislative and regulatory prerequisites in order to develop sustainable rural financial market in Ethiopia? This should identify the requirements and institutional configurations for establishing and sustainably running non-bank financial institutions (such as credit and savings activities, the establishment of savings and loan activities in the existing cooperative system, and the establishment of Grameen-type savings and lending organizations). Legal and regulatory requirements will also be identified for the establishment of community or rural banks in Ethiopia. Recommendations will be practical and implementable.

2. For rural banking to develop and flourish, the regulatory system must be able to grow and develop the appropriate skills. Is the National Bank of Ethiopia (NBE) ready institutionally to undertake changes and experimentation in the rural banking field? What investments in NBE would need to occur to maintain appropriate oversight responsibility over rural banking. What type of operational changes would be required. What would the financial impact of these changes be? If the consultant team recommends that the NBE needs technical assistance, is this finding strongly endorsed and accepted by top level NBE officials?

3. Now that USAID has selected a specific region, East Wellega in which it will focus pilot activities, the team will identify what the banking services needs are of the various groups (small holder farmers, input retailer, wholesalers)with whom ERDA will work. The team will also

develop recommendations for the types of institutions that would be best able to provide the kinds of banking services needed by the various groups in the zone, keeping in mind that the objective of the ERDA program is to sustainably increase agricultural production, with a strong emphasis on private sector providing whatever services are needed to achieve the increased production. For example, early indications are that while there may be no overt discrimination or prohibition against private sector retailers and wholesalers entering the market, these groups are not able to provide formal credit to their customers, unlike the parastatals who can provide government credit to their customers. This is particularly problematic in input supply marketing. Therefore in answering these sets of questions, the consultants should develop recommendations on how to level the playing field to encourage more private sector entry into input marketing through increasing access to banking services.

4. Some earlier work suggests that collateral can be a major constraint to accessing formal credit. The team will evaluate the current collateral requirements for loans related to the agricultural sector (farmers, traders, retailers, wholesalers) and develop alternative collateral mechanisms (such as use of inventory as collateral) to increase access to formal credit by these groups. These mechanisms should be practicable by the financial institutions that would be using them.

5. Currently, government agricultural credit is very restrictive. It is channeled through two state banks to service cooperatives who in turn on lend to their members. Thus the only persons who have access to this credit are members of service cooperatives who have not defaulted. The credit can only be used for the purchase of fertilizer (although there is some indication that improved seed can also be bought). The credit can only be used with the parastatal which supplies fertilizer. Are there possible interventions that USAID/E through the ERDA program could do to broaden this line of credit? Is the government (and the banks) willing to allow farmers to use this credit for broader purposes? Is the government (and the banks) willing to allow retailers access to credit so that farmers could purchase directly from private sector suppliers which would have a credit facility with the banks? What would need to change to allow this?

6. Collection of loans has been problematic in the past two years. The government banks rely on local government officials to enforce collection of their loans. They do not appear to have adequate staff to perform collection, nor strong incentives to do so since the provision of agricultural loans to the service cooperatives is dictated by the central government. What are some actions that could be taken to strengthen the banks' collection systems and incentives? These recommendations should be discussed with Ethiopian government officials to determine their acceptability.

On the private sector side, collection is also a problem. One of the reasons private sector retailers are unwilling to provide inputs on credit to farmers is the lack of enforcement authority

for collection of loans. To what degree is this a problem? What are some strategies and actions that could be taken to provide this kind of authority or legal recourse for such retailers? How difficult would implementing such changes be?

7. The ERDA program is willing to consider setting up a loan guarantee fund to ensure the availability of credit to East Wellega and to test this mechanism for future expansion in Ethiopia. What are some of the pitfalls the Mission should be aware of in the setting up and running of guarantee funds, and how could the Mission design a loan guarantee to avoid these? Is the Ethiopian government, state banks, and private banks favorable to donor guarantee funds for agriculture credit? Where should it be located (central bank, CBE, DBE, or a private bank)? What would be a reasonable amount for such a fund? Would the holding bank allow interest to be earned on it? How could that interest be used (for example to fund the training and functioning of bank field agents)? What would the percent of guarantee be? Would this be decreased over time? How long would the fund need to function? What would its primary objectives be (for any agricultural loan? targeted to certain farmers)? Once the time for the guarantee has expired, what would the funds be used for?

8. The only existing formal credit system for agriculture is run through the service cooperatives. Should the ERDA program consider working with credit through the service cooperatives? Why or why not? If so, what criteria should be used to select service cooperatives to work with in East Wellega? How long should ERDA work with service cooperatives - that is, should the program work with them only until other alternative mechanisms are up and running? What interventions should ERDA focus on regarding service cooperatives? One proposal is to work with service cooperatives to establish savings and loan facilities in them. Does the service cooperative legislation allow this kind of activity? Is this a viable activity? How should this be set up? What would the service cooperative management structure for this look like? What would the necessary preconditions be to set this up in a service cooperative? What would be required from the project to support the establishment of this? What other aspects of service cooperatives should ERDA support?

9. Are market interest rates presently being used by the government credit programs (run through the Commercial Bank of Ethiopia, the Development Bank of Ethiopia)? If not, how likely is it that the government will establish market interest rates for its lending activities? Is the rate currently in use sufficient to encourage rural lending? If not, how high would the rates need to be raised in order to cover costs? Related to establishment of interest rates, what are the pros and cons of establishing differential interest rates? Some Ethiopian officials propose to use lower interest rates for agricultural loans due to the extreme poverty of the majority of small farmers so that they would have access to credit. The banks on the other hand believe they cannot cover costs at these lower rates. Is it possible to target subsidized interest rates for agricultural credit? How could this be done in East Wellega? How could such subsidization be targeted to the desired groups? Describe a system whereby such subsidy is clearly tracked

and quantified in order to provide the Ethiopian government accurate information on the cost of such a subsidy program.

10. The central bank has expressed willingness to experiment with different mechanisms for rural credit delivery in Ethiopia. One model that is favorably mentioned is the Grameen bank model. What are the pros and cons of the Grameen bank model for Ethiopia? Could this be a viable alternative for providing farmers with credit? How might this be structured and set up in East Wellega? Could this model be used for agriculture input retailers? The government is has also contemplated using a regional development bank approach such as that used in India. How could this work in Ethiopia? What are the pros and cons of this model? What other models might be appropriate for Ethiopia to consider given the existing conditions? For example, rural credit unions, saving and loan association and/or rural/community banks? What would it take (time, funding, changes in legislation, etc) to set up each of these institutions?

11. There are numerous NGOs in Ethiopia who have credit components in their activities; some also have savings components with their credit activities. Each NGO has its own philosophy and its own approach to how it provides credit. ACDI recommended that the Ethiopian government develop national standards for NGO programs, including the use of market rate interest rates, mandatory development of a savings component and others. Is this recommendation valid? Is it necessary for the healthy development of the rural financial market in Ethiopia?

12. ACDI recommended that the DBE and CBE branches in certain target areas be allowed on an experimental basis to operate as autonomous profit centers. Can this recommendation be implemented under current legislation? Are the banks and the government willing to undertake this kind of experiment? Is this viable option in East Wellega? There was also a recommendation that the 2 banks consider using mobile agents to provide banking services to more remote areas. How has this model worked in other countries? Has this been a cost effective method of providing banking services to more remote areas in other countries? How could it be structured to work in Ethiopia?

13. For all the above questions, the consultants must ensure that their recommendations are clear and that priorities are provided in terms of which recommendations are the most important to act upon, and which could provide the most cost effective impact. Wherever training is recommended, specific description of the areas in need of strengthening, a detailed description of what the training will be and for which agency and department, is required. If technical assistance is recommended, the team must determine that this is requested by the agency for which the TA is being recommended. There must also be a detailed description of how much, what the general tasks will be and what skills are to be transferred to Ethiopians by the TA.

The expatriate and Ethiopian rural financial markets experts will be responsible for all tasks relating to the needs assessment for rural banking services (#3), alternative rural banking systems

(#5, 8, 10), alternative collateral systems (#4), loan collection problems (#6), loan guarantee mechanisms (#7), interest rates (#9), NGO credit schemes (#11) and questions of experimenting with formal banking structures (#12). In addition, the Team Leader will ensure that the issues in #13 are addressed by all team members and are incorporated into the written report.

The rural banking regulatory and legislative experts will be responsible specifically for points #1 and 2 above, and additionally will be responsible for all regulatory and legislative aspects that are relate to the other questions raised above.

IV. Qualifications of Team Members

A. Team Leader/Rural financial markets expert - Expatriate

- PhD in business, finance, banking or a related field;
- Minimum 15 years professional experience in rural financial markets in developing countries. The candidate must have field experience, preferably in Africa, and have skills in developing creative solutions at both the field level implementation and at the policy level that are practical and acceptable to host country officials.
- 5 years minimum of experience in positions of team leadership and/or supervisory or management positions.
- Strong writing skills and computer literacy in word processing required.

B. Rural financial markets specialist - Ethiopian

- Masters degree or higher in business, finance, banking or a related field;
- Minimum 10 years experience in the field of rural credit and banking in Ethiopia, with in-depth understanding of past experiences in credit in Ethiopia. Good knowledge of the existing banking system, particularly in the agricultural sector.
- Strong writing skills and computer literacy in word processing highly desirable.

C. Rural credit regulatory and legislative expert - Expatriate

- Graduate degree in law, preferably with emphasis in banking, business or finance;
- Minimum 10 years professional experience in banking regulation and legislative frameworks governing banking systems in rural financial markets.
- Experience in developing countries working on legislation and regulatory frameworks required.
- The candidate must have field experience, preferably in Africa, and have skills in identifying problems and developing creative solutions for reforms in the regulatory framework and developing recommendations at the policy level that are practical and acceptable to host country officials.

- Strong writing skills and computer literacy in word processing required.

D. Rural credit regulatory and legislative expert - Ethiopian

- Graduate degree in law is desirable, with emphasis in banking legislation and regulatory frameworks.
- Minimum 10 years experience in banking legislation and regulatory frameworks governing Ethiopia's rural banking and credit programs. Good knowledge of the banking sector, banking reforms, and current Ethiopian government policies on rural banking legislation.
- Strong writing skills and computer literacy in word processing highly desirable.

IV. DELIVERABLES

The team will provide USAID/E with a report with 2 major sections: analysis and recommendations for rural banking interventions under the ERDA activity; and analysis and recommendations for the current banking regulatory and legislative framework.

Recommendations in the report will be detailed. Any recommendations for training will provide information on what kind, to address what expressed needs, and to build what kind of skills for the identified institutions. Each concerned agency's agreement to these will be noted. Recommendations concerning technical assistance will also be detailed to provide information on how much, to what agency, for what purpose and length of time. Agency agreement must be indicated.

The report will not exceed 40 pages in length, and will have an Executive Summary at the beginning, not to exceed 4 pages. The Executive Summary will contain a description of the purpose of the study, provide summarized analyses and findings and list the recommendations. Five (hard) copies of the draft document will be submitted to the Deputy of ANR for review and comments. Ten (hard) copies of each final document plus an electronic copy on Word Perfect 5.1/5.2 on diskette will be provided to USAID/Ethiopia within 2 weeks of receiving mission comments. One hard copy and an electronic copy of each document in Word Perfect 5.1 on diskette will be provided to the FSDP Project Officer in the Global Bureau.

V. REPORTING RESPONSIBILITIES

The team will be under the direct coordination of the expatriate Team Leader/Rural banking expert. The Team Leader will be under the technical direction of the Deputy of USAID/E Agriculture and Natural Resources Office. The Team Leader will report on the team's progress on a weekly basis as feasible to the Deputy ANR.

VI. LEVEL OF EFFORT AND TIMING

The team will carry out the scope of work over a period of 4 weeks. It is estimated that field work will begin on/about October 15 and end on/about November 15, 1995.

Position	Arrival/Dep. Dates	Total Length of Consultancy
1. TL/Rural Credit - Expat	10/15/95 - 11/15/95	4 wks. (24 work days)
2. Rural Credit - Ethiopian	10/15/95 - 11/15/95	4 wks. (24 work days)
3. Banking Reg./Leg - Expat	10/15/95 - 11/15/95	4 wks. (24 work days)
4. Banking Reg./Leg - Ethiopian	10/15/95 - 11/15/95	4 wks. (24 work days)

During the team's presence in Ethiopia, a six-day work week is authorized for all team members.

VII. METHOD OF PAYMENT

The contractor will be reimbursed after submission and approval of vouchers (SF 1034) to USAID/Ethiopia's Controller's Office. Final payment will be made when USAID/E is in receipt of an acceptable final report. The USAID/E designated Liaison Officer for this procurement is Margaret Brown.

VIII. LOGISTICAL SUPPORT.

The contractor will be required to rent a vehicle for any field travel. Rental rates are approximately $125/d including vehicle and driver. At least some members of the team will be expected to travel East Wellega (approx. 300 kms. west of Addis Ababa). The contractor will also be expected to pay salaries and provide per diem expenses for local professionals accompanying the expatriate consultants. Per diem for local professionals is $20 per day outside Addis Ababa. Approximately 12 days per diem for local professionals should be budgeted. Ethiopian professionals shall be fully paid in cash prior to the departure of the Team Leader. The contractor will be expected to arrange and pay for workspace.

Attachment 2

PIO/T TRANSMITTAL MEMORANDUM

TO: Carolyn Eldridge, USAID/Ethiopia Contracts Officer

FROM: Martin Hanratty, USAID/Ethiopia

SUBJECT: Request for Issuance of Delivery Order and Justification and Approval for Use of External Resources for Advisory and Assistance Services

A. REQUEST

1. I recommend that you negotiate a Delivery Order under the Financial Sector Development Project (940-0025) from the Global Bureau Office of Economic Growth. for the services described in the attached PIO/T No. .

2. This is a USAID/Ethiopia funded PIO/T. The USAID/Ethiopia Project Officer who will administratively approve contractor voucher requests for payment is Margaret Brown, Office of Agriculture and Natural Resources, USAID/Ethiopia.

3. The required services should start in October 1995 with the exact timing to be arranged in consultation with the USAID/Ethiopia Project Officer.

4. The person to be contacted concerning this request is Margaret Brown who can be reached at USAID/Ethiopia at 251-1-610-666.

B. REQUIRING OFFICER CERTIFICATIONS

I certify that to the best of my knowledge:

1. The required work is not a fragmentation of a known long-term requirement for the services of the recommended contractor.

2. No USAID employee or other individual resource, such as experts and consultants or personal services contractors is available on a timely basis to perform the required work.

3. No USAID employee has recommended the use of any individual under this buy-in who was not initially located and identified by the contractor.

C. JUSTIFICATION AND APPROVAL FOR PROCURING ADVISORY AND ASSISTANCE SERVICES

1. Justification

a. Need and Utilization

The services defined in the Scope of Work of this PIO/T relate directly to USAID/E's design of the Ethiopian Resources for Agricultural Development (ERDA) activity. The purpose of this PIO/T is to conduct an assessment of the Ethiopian financial markets with specific questions pertaining to ERDA's role in this sector. The resulting analysis will identify specific actions that USAID/E will need take to address problems in the rural banking component of the ERDA activity.

b. Review of Prior Work

Three teams have attempted to address the issue of rural credit delivery in Ethiopia. The first study, by ACDI, was conducted before the specifics of the ERDA activity were know, and the study concentrated on a geographic area different from where ERDA's pilot field activities will take place. The ACDI study addressed much broader issues which will provide this particular study with important basic information, but did not look at specific options, costs and necessary actions to address problems of banking services access and use by specific groups.

The second set of reports looked at the credit situation specific to ERDA, but arrived at sometimes conflicting conclusions. One report presented only partial information concerning the regulatory framework and concluded that no interventions at the policy level would be necessary. Subsequent discussions with NGOs have revealed certain regulatory problems. The second report provide no information on alternative mechanisms for channeling banking services to potential rural users. USAID/E has subsequently identified some major questions relating to, for example, the use of loan guarantee funds, the adequacy of the regulatory framework and capacity of the central bank to handle experimentation in rural banking services delivery systems, and questions raised by the government itself concerning the use of targeted subsidized interest rates for farmers.

c. In House Capability

Current USDH staff at the Mission do not have the time or the full range of expertise required for this work. Limitations on time for the Global and Africa Bureaux staff prohibit the use of any of these full time for the periods of time required to do the

assessment. Both USDH and FSN staff have, in addition to this task, other on-going responsibilities that require significant portions of their time.

2. **Approval**

I approve the requested work and the use of persons other than USDH employees in the performance of this work.

BY: _____

TYPED NAME: Walter North, Acting Mission Director

DATE: _____

Attachment 2

Draft: MBrown, ANR; 8/22/95
Clearance:
MHanratty, ANR
BDouglass, PRM

Attachment 2

Salaries

Rural credit expat:	@ $500/d @ 24 days @ 2.121 multip.	$25,452
Rural credit leg./regulatory expat:	@ $500/d @ 24 days @ 2.121 multip.	$25,452
Rural credit Ethiopian:	@ $250/d @ 24 days @ 2.121 multip.	$12,726
Rural credit leg./regulatory Ethio:	@ $250/d @ 24 days @ 2.121 multip.	$12,726
Sub-total		$76,356

Travel & transport

2 round trip from US	2 @ $5000	$10,000
Internat'l perdiem	2 @ $200	$ 400
In country perdiem expat	2 @ $168 @ 28 days	$ 9,408
In country perdiem Ethiopian	2 @ $20 @ 15 days	$ 600
In country car rental and fuel	$140/d @ 15 days	$ 2,100
Sub-total		$22,508

Other Direct Costs

Office workspace rental (or upgraded hotel room equivalent)	$500	$ 500
Communications, courier	$400	$ 400
Visa/medical exams, medevac ins. (expats)	$400	$ 400
Misc. other direct costs	$836	$ 836
Sub-total		$ 1,600

TOTAL	$101,000

ATTACHMENT NO. 1

SCOPE OF WORK
FINANCIAL MARKETS PROJECT (497-0360) FINAL EVALUATION

1. Activity to be Evaluated. The Financial Markets project (FMP) which was authorized on August 30, 1988. The current project assistance completion date (PACD) is March 1, 1995. Life-of-project grant funding from USAID is $14.6 million; the total host country contribution, from both public and private sources, is $4.9 million; therefore total funding is estimated at $19.5 million.

2. Purpose of the Evaluation. The purpose of this evaluation is to provide the Government of Indonesia (GOI) and USAID/Indonesia with an assessment of the impact of the Financial Markets project. The emphasis of the evaluation will be to analyze the relationship between the availability of debt and security instruments to the success of Indonesia's poverty alleviation policies. The analysis should be broad enough to consider the effect of improvement in financial markets on the lower income populace through facilitating economic reform and continued rapid economic growth. This evaluation will review what has taken place in the Indonesian financial sector since this project intervention was initiated, systematically collect information about the extent to which this intervention made a difference to the economic development of Indonesia, suggest what problems remain, and speculate about alternative designs for similar programs or projects in the future. The intention is contribute to more informed future decisions, rather than to try to arrive at definitive conclusions that FMP led to specific results which would not have occurred in its absence.

3. Background. The FMP was designed as a response to the GOI's desire to develop well-regulated, efficient, and active financial markets, particularly capital and money markets. Improvements in the depth and efficiency of capital and money markets were assumed to lead to increases in the availability of domestic and foreign investment capital. It was recognized that a strong capital market could be important for the privatization of state-owned enterprises through the public sale of securities in financial markets. Privatization was also seen as a means to broaden and deepen Indonesian capital markets by increasing the supply of marketable securities.

The goal of the FMP is to increase the availability of long-term investment capital by supporting open financial markets. The project purposes are to increase the number of debt and equity securities and commodity contracts available to investors, to increase the transparent trading volume of these instruments, and to improve the efficiency of the public sector through restructuring and/or privatization of the ownership and management of state-owned enterprises.

Increased investment in capital assets was seen as crucial for Indonesia's continued economic development and, in turn, contributing to this country's poverty alleviation policies. If investment does not expand significantly, Indonesia will not realize the sustained economic growth necessary to employ its large and growing

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population, many of whom are still living in poverty. In order to mobilize the necessary investment, Indonesia has been relying on foreign borrowing and investment, but also has to continue to stimulate domestic savings. Public sector savings can be increased through raising taxes, reducing or eliminating price subsidies, and increasing the operating efficiency of governmental agencies. Increasing private sector savings requires continued deregulation of business activities. An important step to be taken is to increase both sectors' savings and investment in order to further develop Indonesia's financial markets.

FMP contains a Capital Market component implemented through a host-country contract with Price Waterhouse; a Money Market component implemented through a host country contract with Deloitte Touche Tohmatsu International; and a Privatization component funded through a "buy-in" to the Price Waterhouse contract managed under the centrally authorized Privatization and Development project. All three components will be considered in this evaluation.

4. Statement of Work. This evaluation will address the following questions:

a. Has the FMP achieved its goal, purposes, and outputs?

b. What people-level impact has FMP had on contributing to the GOI's extensive poverty alleviation policies, as well as poverty alleviation itself? What are the interrelationships, if any, between financial markets development and poverty alleviation?

c. Have project inputs, including host country contributions, been used effectively?

d. What are the lessons learned from the FMP? Are its activities sustainable? How relevant is the project in the context of USAID's overall strategies for sustainable development?

e. What is the impact of the achievements of the FMP on Indonesia's financial markets, the GOI's restructuring and privatization program, and overall economic development?

f. Have increases in investment and savings occurred by increasing the types of securities available? If so, has the development of financial markets increased the level of equity finance relative to debt finance and has this stimulated the development of small and new businesses?

g. Are there indications that the flow of funds from investors to users of funds has become more efficient?

h. Has financial market development lead to increased economic stability?

i. Has privatization contributed to the deregulation of the public sector?

j. Have FMP activities had any impact on the more equitable distribution of financial sector resources?

k. Are there positive or negative effects resulting from the project that were completely unanticipated?

5. Specific Evaluation Tasks.

a. Before departure for Indonesia, expatriate teams members should familiarize themselves with the literature of Indonesian financial market development. USAID/Indonesia will supply the following documents: FMP Project Paper, Project Paper Supplement, and Approval of Authorized Amendment No. 2; "Assessment of the Financial Markets Project," September 1992; Midterm Evaluation, October 1993; and the most recent Annual Workplans and Quarterly Reports for each of the three components.

b. The evaluation team leader will draft a workplan and submit it to the FMP project officer within three days of the beginning of the evaluation in Indonesia.

c. The evaluation team will conduct evaluation activities, including regular weekly briefings to USAID staff and GOI counterparts and preparation of the final report, over a three-week period in Indonesia. The draft final report will be submitted to the FMP project officer before the evaluation team leaves Indonesia.

d. USAID/Indonesia will then have 15 days to comment on the draft final report before the evaluation team leader submits the final report within 30 days after leaving Indonesia.

6. Methods and Procedures. Interviews should be conducted with a number of people involved in the current project and/or Indonesia's financial markets. These should include USAID personnel; representatives of project contractors and consultants; GOI counterparts, including the Ministry of Finance, BAPEPAM, BAPPENAS, and Bank Indonesia; private sector experts, participants, and beneficiaries; academic experts; and other donors.

Research should include USAID documentation, contractors' reports, and any other books, reports, and articles deemed relevant.

7. Evaluation Team Composition. The team should consist of an evaluation specialist, a financial specialist, and a financial research specialist.

Evaluation Specialist/Team Leader: A social scientist with a Ph.D., field research

experience, and an economic or financial background is needed for the evaluation specialist position. This person should have considerable experience in evaluating economic development projects. The evaluation specialist will be responsible for managing the evaluation team and producing all evaluation documentation, including the final report.

Financial Specialist: The financial specialist should have extensive experience in the financial sector, have prior experience with financial sector development in developing countries, and possess wide exposure to numerous facets of financial sector issues. A minimum of fifteen years experience in the financial sector obtained through high-level assignments is required.

Financial Research Specialist: This person will be a local-hire who will be responsible for gathering data regarding Indonesia's financial markets, privatization activities, and general issues of financial sector development and economic development. He or she must be fluent in Indonesian and English. A strong background in financial market development is required. This person will obtain data and research materials relevant to the evaluation.

8. Reporting Requirements. The team will prepare, in the field, a draft final report which addresses the questions in item 4 above, and which corresponds to USAID's required format for evaluation reports. The following sections must be included in the final evaluation report:

a. Executive Summary
   - Purpose of activity evaluated
   - Purpose of the evaluation and methodology used
   - Findings and conclusions
   - Clear and succinctly stated lessons learned, both regarding project design implications and broad action implications
b. Project Identification Data Sheet
c. Table of Contents
d. Body of the Report, including sections on:
   - purpose and study questions
   - the economic, political and social context of the project
   - description of the project
   - team composition and study methods
   - findings and analyses of the study concerning the evaluation questions
   - succinctly stated conclusions drawn from the findings (including lessons learned and policy implications)
   - recommendations based on the study findings and conclusions.
e. Appendices, including:
   - a copy of the evaluation scope of work
   - the project log frame

Attachment B
PIO/T No. 940-0025-3-50001

STATEMENT OF WORK

(note: elements of this SOW specifically for this PIO/T are redlined)

The following is the overall Statement of work for a sector assessment to be done as part of the USAID/Niger Economic Reform and Microenterprise Program (ERMP).

GEMINI (DAI) is involved in the overall design of the program, and participating in this effort with their own funding. The work they have done on rural financial institutions will provide quality input for the assessment. Also participating is the Financial Services Development Project, (FSDP), whose personnel have exceptional understanding of the most important aspects of our efforts. Their work would be especially useful in the area of structural constraints within the financial sector, and complement that of GEMINI in structural constraints to microenterprise development. GEMINI's sectoral analysis methodology should be particularly useful in assessing overall constraints within the microenterprise sector. A USDA RSSA Officer for the Africa Bureau's Office of Sustainable Development will also participate as the Agricultural Marketing Specialist.

This PIO/T funds the participation of FSDP. Though the entire SOW is important to the work of the FSDP the relined portions show the specific elements which belong to FSDP.

Microenterprise is a key part of our strategic plan and results package, and is described by the mission's strategic objective no. 2 As follows:

"Improve access to markets especially through use of improved, decentralized financial services."

We refined the language of S.O. No. 2 in concert with a broad consultative process which is still underway, and which has been a leading part of our re-invention/reengineering efforts. We garnered this input from informal customer surveys conducted by focus group members during field trips.

Statement of Work

1. Given Niger's extreme poverty, and limited institutional framework, and in the present setting of rapid advances in democratic reform, USAID/Niger's goal is broad. Led by Nigerians within the framework of AID/W strategy directives, USAID/Niger has framed our goal statement as follows: "a political, economic and social environment that empowers all Nigerians to achieve

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sustainable improvements in the quality of their lives".

2. Vision for economic reform and microenterprise development: Economic development must be led by development of the non-governmental sector: private for profit business sector (both formal and informal) and civil society, i.e. NGOs, civic groups, associations, credit unions, cooperatives, etc. We have found during the last several years that several of our projects are having positive impacts on these groups and individuals. These projects are succeeding at both sectoral and local level and through general policy reforms which affect the entire country. We are convinced that expanding and improving on these successes will bring about significant improvement in the quality of life of our customers who live or work in those areas where we will be concentrating in the future. We are confident that by planning in an even more collaborative fashion with all our customers and partners, and by developing synergy with other sectoral programs as well as with other donors, our success will be even greater.

3. Purpose

The purpose of this assessment is to appraise the growth potential of the rural sector in Niger and to determine key constraints and the means of overcoming them in order to achieve USAID/Niger's Strategic Objective No. 2. (SO2), and to analyze options for activities to achieve SO2.

4. Elements of Sector Assessment

a. General Scope of Work: Upon arrival in-country, the assessment team (A-Team) will review the Strategic Plan for the Mission. A Team Planning Meeting (TPM) will be conducted to obtain agreement between members of the A-Team and SO2-Team over a feasible implementation plan for the scope of work. The TPM process will be done in consultation with clients to assure their agreement with the implementation plan and the products it will produce. The A-Team will then assess the Mission's three decentralized financial institution (DFI) projects in light of research recently conducted under the GEMINI project, focussing on self-sufficiency issues. It will also review the Mission's two economic reform projects and, in particular, the evaluations done for these projects. A-Team members will meet with customers, partners, and their representatives during this initial assessment work. The A-Team will subsequently perform analyses necessary to support the vision for the SO2 articulated above, and identify key results required to achieve SO2 and constraints which much be relieved to achieve the results. The A-Team will use prior studies the assessments of the DFI projects, their analysis of constraints and opportunities in the rural sector to appraise the potential for growth in this sector in Niger. In a final phase of work the assessment team will provide conclusions on its soundness and as appropriate make

recommendations for implementing the strategic plan for achieving SO2, including a conceptual outline of activities which would lead to the plan's successful implementation.

b. Review of reference documents: some of the most useful reference documents for conduct of the assessment work are as follows:

i. USAID/Niger draft strategy plan;

ii. Gemini rural financial institutions and economic reform research draft report;

iii. Previous USAID/Niger evaluation reports (especially for recent PAM and NEPRP evaluations;

iv. Studies and reports prepared by NEPRP and PAM;

v. Progress reports and other documents pertaining to DFS projects, especially the report on developing a sustainable institution from the CARE/Niger BRK lending facility, the impact study of credit unions in Niger, and the plan of action for development of an accredited financial establishment by CLUSA.

vi. Financial analyses and assessments from the French, FED, IMF, IBRD, and local sources;

vii. Analyses and review of the rural producers, informal sector and of micro-enterprise linkages to growth and development (specifically to Niger, and more generally, in the sahel) done by IFPRI.

Review of documentation will require TDY time with Africa and Global Bureaus, and IFPRI in Washington D.C. and in Paris for discussions with personnel of the Club du Sahel and with French researchers.

c. Review committee: This consists of the Expanded SO2 team and includes the National Director for Analysis, Economic Studies and Public Finance or designated representative, directors of each of the three US PVOs involved in DFS delivery, the Director of the Center for Exterior Commerce, the President of Niger's Businesswomen's Association, the Head of the Credit Department of the Bank of Africa, the REDSO/WCA Economist (virtual member), the REDSO/WCA ADO (virtual member), the Africa Bureau Economist (virtual member also assessment team member) and the Mission SO2 expanded team as well as the USAID Director or designee.

d. Assessment team personnel: The assessment team will consist of a macroeconomist experienced in financial sector

adjustment in developing countries undergoing structural reform programs, an agricultural production specialist with experience in assessing the growth potential of agricultural production, a micro-economist specializing in decentralized financial institutions, a private sector microenterprise specialist, and an agricultural marketing specialist. One or more of the consultants should be well experienced with gender issues in the analysis and design of development programs for microenterprise, DFS, and/or sectoral adjustment programs. All consultants should have a minimum of 2-years of relevant experience in developing countries, and be able to work professionally in the French language.

The first two consultants (macroeconomist and ag production specialist) will be provided by the Financial Sector Development Project; the second two (microeconomist and microenterprize specialist) will be provided by the GEMINI project; and the fifth will be provided by the AFR/SD.

Support/logistics personnel: the Mission will provide one individual experienced as a TPM facilitator, a locally hired Economist, Representative of Civil Society, as well as logistics and administrative assistance.

i. A-Team leader: the A-Team leader will not be a discrete position. The individual selected as team leader will be the individual consultant best qualified to fill this role in addition to his/her technical role. Experience in successfully leading teams conducting similar work will be the primary consideration in selecting this individual, along with experience in integrating gender concerns in similar assessments, although the latter work could be done by another A-Team member.

(1) The responsibilities of the A-Team leader will be as follows:

(a) Completing negotiation on-site of details of the implementation plan (within first three days of arrival in-country);

(b) Assigning, evaluating, and coordinating analyses by other experts;

(c) Drafting, editing, presenting and correcting and completing the final report;

(d) Ensuring that gender issues are considered and resolved by the A-Team;

(e) Determining the appropriateness of the

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Mission's vision in relation to the reality of the access by women to financial sector services and to markets.

(f) Determining results, conditions and activities required to ensure that women will receive at least 50 percent of the benefits of individual programs designed to achieve SO2.

(g) Determining the illustrative activities or sectoral adjustments which will lead to the desired results.

(2) A-Team leader qualifications

(a) Minimum of ten years of professional experience, including at least 5 years in sectoral assessments and evaluation of financial services or microenterprise development, preferably in francophone West Africa;

(b) Successful leadership of several similar assessment teams;

(c) Demonstrable skills as a writer and editor;

(d) Profession experience in integrating gender issues into sector assessments and evaluations.

ii. Macro-economist

(1) Responsibilities

(a) Assessing the appropriateness of the mission's vision in view of the realities of the Nigerian and CFA financial sector environments;

(b) Determining intermediate results required to ensure that the financial sector environment is conducive to achieving SO2.

(c) Determining the illustrative activities or sectoral adjustments which will lead

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to the desired results.

(d) Improving the consistency between the USAID/Niger plan for achieving SO2 and Niger's obligations under agreements with Breton Woods Institutions.

(e) Assess the potential impact of alternative macro economic policies and monetary policies that may be pursued by the government of Nigeria on the attainment of SO2.

(2) Qualifications

(a) Minimum five years professional experience in financial sector assessment preferably in francophone west africa. Experience in trade and macro monetary analyses highly desirable.

(b) French S3/R3 minimum; and,

(c) Proven skills in written and verbal communications.

iii. Agricultural production specialist

(1) Responsibilities

(a) Determine the validity of the Mission's vision in relation to the realities of the rural production potential in Niger especially from the point of view of existing and potentially viable technical packages, from both the biophysical and the agro-technical points of view;

(b) Determine intermediate results required to insure attainment of SO2 objectives in terms of natural resources management as well as technical and financial inputs required; and,

(c) Determine the illustrative activities (continued or new) or sectoral adjustments which will lead to desired results under SO2.

(2) Qualifications for agricultural production

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specialist

(a) Minimum of five years of profession experience in applied agricultural research and extension including both natural resource management techniques and other agro-technical packages for semi-arid cropping systems;

(b) Professional experience, preferably in West Africa, in the conduct of agricultural or rural sectoral assessments; and,

(c) French language skills at minimum S3/R3 level

iv. Micro-economist

(1) Responsibilities

(a) Determining the appropriateness of the Mission's vision in relation to the realities as regards sustainability and viability of financial service delivery projects in Niger;

(b) Determining intermediate results that must be achieved in the financial sector for overall attainment of SO2; and,

(c) Determining the illustrative activities and sector adjustments which will lead to desired results under SO2.

(2) Qualifications

(a) Minimum of five years of professional experience in decentralized financial services delivery, preferably in francophone west africa;

(b) French language at FSI S3/R3 minimum; and,

(c) Proven analytic skills and knowledge of west african, and particular sahelian, private sector issues.

v. Private sector specialist

(1) The responsibilities of the private sector

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specialist will be as follows:

(a) Determine the appropriateness of the Mission's vision in relation to realities of Niger's private sector environment;

(b) Determine results required to ensure that the microenterprise business environment and customer skills are conducive to the achievement of SO2;

(c) Determine illustrative activities (continued or new) and sectoral adjustments which will lead to desired results under SO2.

(d) Analyze the linkage between the formal and micro-enterprise/informal sectors (to the degree that they are separate and distinct), especially as related to financial markets and women's access to credit;

(e) Analyze linkages between Niger's informal sector and how business opportunities in it are affected by formal and informal sector markets in Nigeria; and,

(f) Analyze and evaluate private sector institutions, particularly as pertains to micro-enterprise, and to include gender issues.

(2) Qualifications for private sector specialist

(a) Minimum of five years of professional experience in private/microenterprise sector assessments, preferably in francophone west africa.

(b) French language skills at FSI S3/R3 minimum; and,

(c) Proven analytical skills and knowledge of west african, particularly sahelian, private sector issues.

vi. Agricultural marketing specialist

(1) Responsibilities

(a) Determining the validity of the Mission's vision in relation to the realities of the marketing environment and local capacity, particularly as regards agricultural cooperatives;

(b) Determining intermediate results required to insure attainment of SO2 objectives for both input and output markets in agriculture;

(c) Determining the illustrative activities (continued or new) or sectoral adjustments which will lead to desired results under SO2; and,

(d) Assess and evaluate the role of Nigeria's agricultural trade/commercial policies on Niger's agricultural markets and potential effect of success in attaining objectives for under SO2.

(2) Qualifications for agricultural marketing specialist

(a) Minimum of five years of profession experience in the marketing of agricultural inputs and products in west africa, particular as relates to micro-enterprise and farmer cooperatives;

(b) Professional experience, preferably in west africa, in the conduct of sectoral assessments for agricultural marketing; and,

(c) French language skills at minimum S3/R3 level

vii. Local consulting firm economist

(1) Responsibilities

(a) Facilitating the work of the entire assessment team by provision of needed documentation and reports, relevant local information, and contacts with government of Niger and private sector individuals important for the assessment;

(b) Determining conditions required to

assure that local partners are committed to achieving SO2, and identify results expected to flow from this commitment; and,

(c) Advise the entire assessment team on new or continued activities and sectoral adjustments required to achieve SO2.

(2) Qualifications

(a) Minimum five years of professional experience in Niger in conducting economic and sectoral analyses;

(b) Professional experience in the design and implementation of micro-enterprise and decentralized financial intermediary programs highly desirable;

viii. Local Representative of Civil Society

(1) Responsibilities

(a) Assuring the work of the entire assessment team takes into consideration the new emerging "social sector", i.e. NGOs, associations, community and village associations, women's groups, mutuals, cooperatives, etc. by provision of needed documentation and reports, relevant local information, and contacts with members of such groups who are important for the assessment;

(b) Determining conditions required to assure that local partners are committed to achieving SO2, and identify results expected to flow from this commitment; and,

(c) Advise the entire assessment team on social sector activities and sectoral adjustments required to achieve SO2.

(2) Qualifications

(a) Minimum three years of leadership experience in the social sector in Niger;

(b) Professional experience in conducting

development/sectoral analyses;

(c) Professional experience in training in the social sector highly desirable;

ix. Support/logistics personnel (two persons): The support and logistics personnel are not part of the study team as such, but their services are necessary to allow the team to concentrate to the maximum extent possible on their respective professional assignments. The following two support personnel will be required for the assessment:

(1) Facilitator: s/he will facilitate the team planning meeting, beginning as leader, and gradually turning leadership over to the A-Team leader; and,

(2) Expeditor: s/he may be recruited from Mission staff, or hired locally. S/he will be responsible for the following tasks:

(a) Search out, gather, reproduce, and distribute documents related to the work of the assessment team;

(b) Facilitate all in-country travel arrangements for the A-Team;

(c) Assure qualified secretarial services that can provide quick and accurate typing, and photocopying services;

(d) Source all required office supplies in a timely manner;

(e) Work in close collaboration with the facilitator and the local hire economist to assure that all logistical arrangements as required; and,

(f) Perform other tasks as required which contribute for the smooth conduct of the assessment.

e. Schedule: The U.S. Consultants should be briefed by the desk officer in AFR/WA and relevant Global Bureau officers prior to departure. They will be provided with as many background documents as available to be able to begin studying them for a week before leaving the U.S.

The assessment team will conduct its work in Niger over a period of four weeks. A Team Planning Meeting will be conducted during the first two days in-country. During the TPM, individual members will review the overall scope of work, provide assessments of their individual strengths as related to the scope of work, review relevant documentation, define and plan activities to be undertaken, refine terms of reference of the work, assign tasks with individual responsibilities, and assure team consensus for the entire assessment implementation plan.

Week one: Team Planning Meeting, presentation of detailed implementation plan and schedule to review committee. Interviews conducted with ERMD staff, program, design and implementation, and management officer. Meetings conducted with officials of the GON and PVO implementing agencies. Interviews with selected returned participants, Mission staff, and project officers, and other donor agencies. Preparation of field trips and customer surveys as appropriate.

Week two/three: Field trips and customer surveys. Participation in SO2 Workshop (August 16-18, Park W) to interview each sub-group and share preliminary findings.

Weeks four: Analyses and preparation of restitution/consensus mini-retreat. Retreat with review committee and other focus group members and customer representatives to provide restitution of findings and develop consensus on findings and recommendations of report.

After field trip: Clean Draft of report will be prepared by team in U.S. and emailed to USAID NLT two weeks after leaving Niger.

USAID will provide comments by email within two weeks of receiving the report, and the COP for the team will deliver final report in french and english NLT two weeks after receiving USAID comments.

Reports: The report will be published and delivered to USAID/Niger within two weeks of receiving USAID comments of the draft: 40 copies in french and 10 in english. Five english copies will be delivered to AID/W backstop officer for distribution in Washington.

STATEMENT OF WORK

CENTRAL BANK OF EGYPT
IMPLEMENTATION OF FINANCIAL REFORM ACTIVITY

I. PURPOSE

The purpose of the Implementation of Financial Reform Activity (IFRA) is to provide the Central Bank of Egypt with technical assistance and training to help implement reforms supported by the U.S. Agency for International Development's Sector Policy Reform programs. This purpose will be achieved through technical assistance in banking supervision, research, indirect monetary control and modelling, and an education and training program for the Central Bank of Egypt that supplements what has previously been planned in the World Bank coordinated Banking Sector Reform Technical Assistance Program (BTAP).

II. RELATION TO USAID'S SECTOR POLICY REFORM PROGRAM

IFRA will be conducted under the Technical Support for Sector Policy Reform (TSSPR) project. TSSPR assists the Government of Egypt (GOE) to achieve its economic reform program, specifically those sector policy reforms related to the Sector Policy Reform (SPR) programs. The SPR goal is to achieve rapid, sustainable economic growth which benefits the great majority of the people, by promoting the transition to an outward oriented, competitive, private market economy. In order to achieve the financial markets subgoal which is to encourage savings and efficient channeling of financial resources to the private sector within a stable fiscal setting, policy reform measures aim at: a) increasing competition; b) ensuring financial system solvency while facilitating privatization; c) activating the capital market to promote productive private investment; and d) ensuring a stable fiscal setting.

Various SPR measures have affected a large number of areas which are within the regulatory responsibilities of the Central Bank of Egypt (CBE). One specific SPR requirement was to develop banking supervision manuals which document what central bank examiners should do to conduct both onsite and offsite inspections. The CBE has taken the first step in this process by documenting current procedures. The first component of IFRA will provide technical assistance to review the prepared banking supervision manuals, recommend improvements, and help incorporate the recommendations.

The SPR has required a number of other innovations in the banking industry including a study of new financial instruments which should help improve the functioning of capital markets, and thus encourage productive private investment. Similarly, the SPR has succeeded in opening the domestic banking industry to foreign banks and expediting branch banking which increases competition in the financial markets. The SPR will attempt to transfer a number of joint venture banks to private sector control.

The Executive Development Program (EDP), which is the second component of IFRA, will help the CBE staff to understand fully the intent of SPR supported reforms, and hence better implement them. The EDP will include, *inter alia*, courses on corporate finance and financial instruments, and on monetary policy instruments. These courses would introduce CBE and, possibly, other banks' staff to the new deregulated financial sector environment. They would improve their understanding of the role of the private sector in the financial sector and thereby facilitate the transformation towards a private sector driven economy. Financial instruments courses would introduce staff to these products and to capital market concepts, which would allow CBE to conduct monetary policy in a liberalized setting.

The third component of IFRA relates to research and indirect monetary control needed to support CBE operations in deregulated foreign exchange and financial markets. Because of the impact of SPR measures, such as the widespread reductions in import bans and tariffs, and the transition towards a private sector driven, market oriented economy, CBE's earlier experience in regulating the financial system would need to be both broadened and deepened. The proposed technical assistance will deepen the CBE staff understanding of the economic implications of the reforms that are necessary if the CBE is to successfully make the transition to an institution capable of effectively conducting monetary policy in a market oriented economy.

III. BACKGROUND

The GOE embarked on an economic reform program in 1991 which encompasses financial sector development. USAID has supported this effort through its SPR programs. In pursuing these programs, the GOE successfully implemented a number of financial sector policy reform measures. These policy reforms included: liberalization of interest rates; introduction of a treasury bills market (and thus a shift towards indirect monetary management); adoption of prudential regulations; amendment of the banking law; introduction of a new capital market law and executive regulations; unification of the foreign exchange markets; liberalization of the exchange rate; and introduction of foreign exchange bureaus.

In response to these reforms, the CBE has had to adjust rapidly to meet the demands placed upon it by the banking and financial sectors. Namely, CBE has started to improve prudential regulations and supervision, develop an Indirect Monetary Control department, create a new banking institute and enter into a program of wider technical assistance to develop its role, skills, structure, efficiency and image. The World Bank-led Banking Sector Reform Technical Assistance Program (BTAP) is supported by a number of donors, including the European Union, Overseas Development Administration (U.K), Germany and USAID. The

BTAP consists of nine elements: (1) an organizational study of the CBE; (2) a CBE automation strategy study; (3) strengthening of CBE's banking supervision function; (4) strengthening of CBE's foreign reserves management; (5) strengthening of CBE's Indirect Monetary Control; (6) strengthening of CBE's research function; (7) payment system modernization; (8) bank privatization; and (9) strengthening the Banking Institute. The first six elements will support performance and capacity improvements within CBE, whereas the remaining elements relate to the banking sector as a whole.

IV. INSTITUTIONAL ANALYSIS

An extensive institutional analysis for CBE has been conducted by Coopers and Lybrand and published in May 1994 in a report titled, "Central Bank of Egypt - The Future and the Way Forward." The purpose of the report is to provide recommendations for the modernization of CBE. One important conclusion that the report makes is that training of CBE personnel "is urgently required to improve CBE operational efficiency...an essential driving force and pre-requisite for the overall reform of the Egyptian financial sector."

The report suggests that CBE will need to focus on three major themes for improvement, namely improvement of monetary policy, making supervisory functions more effective, and broad based performance improvement. IFRA components relate to the three major themes recommended by the report. BTAP activities, which will build on the foundation provided by IFRA, will expedite the achievement of the following CBE strategic objectives. Achievement of these objectives will be an important contributing factor to achievement of SPR goal for Egypt. The strategic objectives developed in the Coopers and Lybrand institutional analysis are as follows:

a. design and implementation of measures for achieving greater autonomy in the making and implementation of monetary policy;
b. conduct of core central banking activities and share of additional responsibilities;
c. development of strong technical skills;
d. improvement of its efficiency and controls by more effective management, the redesign of its work methods and the use of computer technology in priority areas;
e. introduction of modern human resource policies;
f. movement towards a new corporate culture;
g. improvement in working conditions to be better than average for all staff and adoption of firm plans for a new head office in Cairo with all departments in the same building; and
h. improvement in its internal decision making by the enhancement of its management information system and the use of computer technology.

V. SCOPE OF WORK

In support of SPR goal, subgoals, objectives and measures, the contractor will work closely with CBE officials and staff to assist them understand the new, liberalized environment created under the economic reform program, including the SPR. Primary assistance will be in the following three areas:

* Banking Supervision;
* Executive Development Program (EDP); and
* Research and Indirect Monetary Control.

TASK A: BANKING SUPERVISION

One SPR financial sector measure requires the Central Bank of Egypt to review its supervisory regulations and procedures relating to off- and on-site bank examination and inspection, and to produce a manual of revised procedures. The technical assistance provided under Task A will help the CBE implement that measure.

The Statistics and Follow-Up Division of the Banking Control Department is responsible for prudential offsite monitoring of the banking system. Banks are required to submit a variety of prudential and statistical returns to the Statistics and Follow-up Division on a regular basis. The returns, taken together, form the basis for analysis of trends in the banking system for monetary policy-making purposes.

Onsite examinations are the responsibility of the Inspection Division. At present, banks are being inspected only once every two years, which is considered too infrequent. The examinations also need to become more forward-looking.

The CBE has introduced several other important regulations designed to limit and control the risks that banks undertake. These regulations include the application of the capital/asset ratio levels according to the Basle guidelines, asset classification and provisions for loans and investment losses, and the suspension of interest on non-performing assets. SPR measures of 1992 and 1993 required the increase of the capital asset ratio to follow these guidelines.

In support of the goal, subgoals, objectives and measures of the SPR programs, the contractor's primary task will be to review the prepared manuals, the underlying system of bank supervision regulations and provisions, and assist in the revision of the Banking Supervision Manuals. Their work also may require assisting CBE staff in related analytical methods and identifying future assistance needs.

In conducting this task, the contractor will provide the following expertise:

1. OFFSITE MONITORING SPECIALIST - 1.5 PERSON-MONTHS

In support of the SPR goal, objectives, and subgoals, the Offsite Monitoring Specialist's task will be to critically review the prepared manuals and the system of offsite monitoring and surveillance procedures and assist in revising the Banking Supervision Manual, although the specialist's work may also require assisting CBE staff in related analytical methods and identifying future assistance needs. The specialist in the offsite monitoring and analysis of banks will work in this area, completing the following tasks:

(a) review the prepared manual and work to date on developing more responsive analytical methods and procedures;
(b) make recommendations to improve the offsite Banking Supervision Manual;
(c) based on discussions with CBE staff concerning these recommendations, re-draft sections of the manual related to offsite monitoring;
(d) provide assistance on the analytical methods related to offsite monitoring; and
(e) identify further assistance needs.

In addition to the job qualifications listed in section VI below, the offsite monitoring/bank analysis specialist will have a significant practical experience in offsite monitoring and surveillance at one of the developed countries central banks and preferably similar experience in a developing country central bank.

2. ONSITE EXAMINATION SPECIALIST - 1.5 PERSON-MONTHS

In support of the SPR goal, objectives, and subgoals, the Onsite Examination Specialist's task will be to critically review the prepared manuals and the system of onsite examination and inspection and assist in the revision of the onsite examination and inspection Banking Supervision Manual, although the specialist's work may also require providing assistance to CBE staff in related analytical methods and identifying future assistance needs. The onsite examination specialist will complete the following tasks:

(a) review the prepared manual and progress to date on updating onsite examination analytical methods and procedures;
(b) make recommendations to improve the onsite Banking Supervision Manual;
(c) based on discussions with CBE senior staff concerning these recommendations, re-draft written examination procedures and the Banking Manual sections on onsite examination;

(d) conduct orientations in basic examination skills such as asset evaluation and the classification of assets; liquidity, asset and liability management; evaluation of management; analysis of earnings and capital; assessment of internal controls; and the evaluation of internal and external audit activities;

(e) since Egypt does not currently use a rating system for categorizing the condition of banks, familiarize the Egyptian supervisors with the CAMEL rating, a widely used rating system that focuses on capital, asset quality, management, earnings and liquidity; and

(f) identify further assistance needs.

TASK B: EXECUTIVE DEVELOPMENT PROGRAM

In order to achieve the SPR goal of supporting the implementation of Egypt's economic reform program, significant training is required. The SPR measures are creating a new, liberalized environment. For the CBE to manage effectively in this new environment, the staff needs sufficient training so that they understand the theory behind the SPR reforms as well as some of the practical aspects of regulating the new, market-driven organizations.

The contractor will review SPR measures with special emphasis on the policy measures concerning: a) interest rates; b) allowing foreign banks to operate fully in the domestic banking system; c) increasing the capital adequacy levels of banks; and d) conducting a study on new financial instruments. After considering the intent of the financial sector policy measures, conducting training needs assessment, and depending on the composition of the class (which in most cases will include key CBE staff and other bankers), the contractor will design, develop and conduct an Executive Development Program that directly addresses the trainees' needs. The length of the EDP is expected to be about twelve months. The contractor will submit a training needs assessment and a training plan, that covers both in-country and foreign training and visits, with associated cost estimates within eight weeks from the commencement of IFRA. The training needs assessment and plan have to be done according to the guidelines of Handbook 10 and Mission-order 10-1 and to be approved by the USAID Project Officer.

In assessing training needs, the contractor will consider, in addition to training benefits to staff, staff who have capacity to absorb and make use of training. In addition to designing and conducting training programs in these areas, the contractor will identify specific support for trainees for the period following completion of their training programs. The EDP training component will include on-the-job, local, and limited foreign and observation training to familiarize trainees with the experience of other countries. Foreign and

observation training has to be approved by USAID. Other EDP opportunities for trainees may include conferences, exchanges, academic offerings or reverse invitations to experts external to CBE. The number of trainees is estimated to be 60 persons.

It is anticipated that the EDP will broaden bankers' knowledge and develop their capabilities in areas such as basic finance, financial markets, foreign exchange operations, privatization of banks, banking supervision, portfolio management and settlements/accounting, and open market operations.

In conducting this task, the contractor will provide the following expertise:

FINANCE INSTRUCTORS - 10 PERSON-MONTHS

The Finance Instructors will provide courses largely for CBE staff, though other bankers or finance professionals may participate if spare capacity exists. It is anticipated that during the program, three, one-week modules on finance will be offered quarterly covering: (a) money and capital markets; (b) fixed income securities; and (c) foreign currency markets. In addition, one-week modules on specialized market topics will be offered.

The instructors will:

(a) assess training needs and develop a training plan, covering both in-country and overseas training and visits, together with the associated cost estimates within eight weeks from the start of IFRA;
(b) develop instruction material and overhead slides according to the specifications of the course, quantitative problems to support the material, and course books containing instruction material and supporting documentation;
(c) select supporting literature including articles or texts;
(d) instruct the course; and
(e) evaluate the trainees level of understanding of the modules.

In conducting these tasks, the contractor will provide the necessary equipment and media, such as a projector and a video display if one is needed.

In addition to the job qualifications listed in section VI below, the Instructors should have an academic background in finance and economics and relevant market experience.

TASK C: RESEARCH AND INDIRECT MONETARY CONTROL

SPR measures have moved Egypt towards greater deregulation of interest and exchange rates. In particular, SPR measures have, among other things, helped introduce new investment instruments and institutions into the financial markets, remove controls on interest rates on corporate bonds, change the tax treatment of interest, and facilitate the entry of foreign banks into Egyptian markets. Ongoing activities under SPR, such as the study on new financial instruments will further change the economic environment. The shift from the use of direct controls for regulating credit growth to the use of indirect instruments has already taken place. There is still a need to support this shift. Such a shift also will support the development of an efficient inter-bank market and an efficient secondary market for debt securities.

The result of these changes is that the CBE is operating in an entirely new environment. In order to anticipate the results of their actions, and effectively implement reforms and regulate markets, it is critical that the CBE strengthen their research and indirect monetary control activities. Additional and improved research and indirect monetary control will allow them to anticipate problems associated with the implementation of policy reforms, and prevent them from arising rather than having to continually react to problems which arise.

Improved research could assist in the development of medium- and long-term economic policies which reduce uncertainty and increase confidence in the Government's policies and enhance macroeconomic stability. Confidence and stability are crucial for the effectiveness and success of growth policies needed to accelerate growth rate in the economy.

Enhancing research and indirect monetary control capabilities of CBE involve developing their policy formulation and forecasting skills, and open market operations tactics. After completing a training needs assessment, the contractor will provide training assistance to the concerned departments under this task to support CBE's changing role. The contractor may also provide limited amount of commodities that support the conduct of its task in this component and other components as well. Commodities under IFRA are expected to include: 13 computers, 3 printers, reference books and materials, course materials, CD-ROM based databanks, and closely related software. The contractor will help the CBE to maintain an economic data base and prepare long-term forecasts for monetary policy input.

Specifically, the contractor will complement other donor efforts at upgrading CBE Research, IMC, and other departments' staff capabilities in:

Task C.1: Policy Formulation

C.1.1 the design and operation of an automated economic and financial data base which should be compatible with current or planned CBE computer systems and readily accessible to multiple users;

C.1.2 macroeconomic framework analysis i.e. modelling. This includes activities such as training needs assessment and training plan that includes secondment of appropriate staff to work in relevant areas of foreign central banks (or, where appropriate, research institutes), and participation in overseas short-term courses in indirect monetary control; and

C.1.3 development of a survey of expectations and business confidence, the data from which would be used in policy formulation.

Task C.2: Forecasting and Tactics

C.2.1 improve the CBE's capability to analyze the effects of its actions in controlling the nation's money supply and intervening in foreign exchange markets. As a result of this activity, the CBE should be better able to anticipate the effects of a change in policy or monetary action on the economy, the money markets, and the foreign exchange markets. This assistance should be closely coordinated with the work the CBE is undertaking with its own resources to modernize its overall accounting function; and

C.2.2 assessment of training needs followed by training plan that includes staff secondment to foreign central banks to gain practical experience in constructing forecasts and using forecasts to develop tactics for open market operations.

In conducting this task, the contractor will provide the following expertise:

1. MACROECONOMIC ADVISOR AND TEAM LEADER - 12 PERSON-MONTHS

The Macroeconomic Advisor will assist the CBE by providing expert assistance to develop a rigorous intellectual and operative framework for macroeconomic analysis with particular emphasis on monetary policy. This effort will further the SPR goal of achieving rapid sustainable economic growth by helping the CBE to take actions and implement reforms which will foster private sector development in a liberalized environment.
This will include:

(a) the development and the maintenance of computerized economic and financial database accessible to multiple users, if necessary;
(b) the development of a rigorous quantitative framework within which the research, indirect monetary control, and other concerned offices/departments can analyze macroeconomic developments and generate forecasts of economic variables in Egypt with particular reference to monetary policy;
(c) the assessment of training needs and development of training plan with associated cost estimates, followed by staff training to strengthen the macroeconomic analysis and monetary policy decision making abilities of the relevant departments; and
(d) the conduct of seminars on indirect monetary control and related financial and monetary programming.

In addition to the job qualifications listed in section VI below, the Macroeconomic Advisor should have an extensive experience in macroeconomic analysis and policy making, database development and quantitative macroeconomic modelling. The Advisor should be familiar with the International Monetary Fund's financial programming approach and indirect monetary control.

2. ECONOMIC SURVEYS EXPERT - 3 PERSON-MONTHS

To move forward the SPR goal, objectives, and subgoals, the Economic Surveys Expert should provide assistance to the CBE to add information on expectations and business confidence to the data base. Within one year from the commencement of IFRA, the Expert will:

(a) recommend the type of information to be collected in the survey, the group(s) of people or organizations to be surveyed and the method of delivering and collecting the survey;
(b) design a survey form suited to Egypt;

(c) train CBE staff on the analysis of the survey results;
(d) assist in conducting the first survey and analyze and evaluate its results;
(e) produce a report on the results of the survey; and
(f) based on data and findings of the first survey, recommend, if necessary, revisions/changes of types of information and data.

In addition to the job qualifications listed in section VI below, the Economic Surveys Expert should have significant experience in the design, conduct and analysis of economic surveys.

VI. PERSONNEL

The contractor team will consist of foreign and/or Egyptian experts, each of whom, unless otherwise stated, will have at least 5 years of practical experience in financial markets, financial economics, finance, foreign exchange trading, money and capital markets, banking, or central banking. Each team member will have a minimum of a masters degree in economics, monetary economics, financial economics, money and banking, or finance. An additional two years of experience in human resources training at financial institutions, preferably in developing or Middle Eastern countries, is desirable. Preferably the contractor will have full working fluency in Arabic as well as English (e.g. an FSI ranking of 4/4 in each language). The contractor's home office will provide support following Handbook 10 guidelines for trainees and staff sent abroad under IFRA.

The contractor must submit to the USAID project officer a copy of biodata sheets for all personnel for approval prior to the commencement of IFRA. All personnel selected must coordinate with other donors providing complementary assistance under the Banking Sector Reform Technical Assistance Program.

In addition to the above expertise, the consultant team shall provide the following expertise:

1. LOCAL BANKING EXPERT - 1.5 PERSON-MONTHS

A local banking expert will provide assistance under each of the above tasks (A, B, and C) to the team of expatriate experts. Specific assistance will be provided under the banking supervision task. The expert should have at least 10 years of experience in central banking with significant amount in the banking supervision area. The expert should have a minimum of bachelor degree in commerce, economics, finance, or business administration.

2. SHORT TERM ADVISORS

A number of short term advisors (6 person-months), international or local, may be needed to provide assistance to CBE in any of the components or on other related matters. The advisors may include experts from the U.S. Treasury, U.S. Federal Reserve Board or regional Federal Reserve Banks.

VII. DELIVERABLES

A. TECHNICAL ASSISTANCE

The contractor will submit to USAID/Egypt five copies of users' guides on the following topics (submission dates to be agreed to by the contractor and USAID within 60 days of start of activity):

(a) revised sections of the onsite and offsite banking supervision manuals;
(b) a computerized economic and financial database accessible to multiple users;
(c) a quantitative framework for analyzing macroeconomic developments and generating forecasts of economic variables with particular reference to monetary policy; and
(d) survey of expectations and confidence.

B. REPORTS

In addition to providing copies of course outlines to each of the trainees in each of the programs described above at least one week prior to the start of those programs, the contractor will also submit the following reports:

(a) a preliminary workplan for completing the IFRA three tasks (A, B, and C) two weeks after the start of the activity;
(b) CBE's needs assessment, and training plan that covers both in-country and foreign training and visits, with associated cost estimates within eight weeks from the start of the activity;
(c) course outlines for each of the programs/modules mentioned above within sixteen weeks from the start of the activity; and
(d) commodities procurement plan within sixteen weeks from the start of the activity.

The preliminary workplan, training needs assessment, and training plans have to be approved by the USAID project officer with input from the USAID Training Office. Overseas training and visits have to be approved by USAID.

C. COMMODITIES

The contractor will conduct commodities needs assessment which covers commodities, computers and printers, and database software for Research and Indirect Monetary Control Departments. Commodities include reference books and materials, CD-ROM based databanks. Computer equipment and printers amount to 13 computers and 3 printers. Database software is to be used for the economic and financial database required for the policy formulation task (C.1.1).

In providing the computer equipment, printers, and the software, the contractor will produce a procurement plan within sixteen weeks. The procurement plan will lay down the specifications of the commodities, an implementation schedule for ordering, purchasing, and shipping commodities, and the administrative mechanisms to be used in administering the plan. The plan must be approved by the USAID project officer and the Contracts and Procurement Office(s), and cleared by the Information Resources Management Project Support Group.

VIII. REPORTING

The contractor will report to the Associate Director of the USAID/Cairo Economic Analysis and Policy (EAP) Directorate and/or his designee(s) - the Project Officer, and a joint USAID-CBE follow-up committee. CBE members on this committee will be appointed by CBE Governor or the Deputy Governor. The contractor will hold a monthly presentation for both CBE senior officials as well as the EAP Office on progress of work under this activity.

IX. LEVEL OF EFFORT AND TIMING

The team should begin its work in June or July 1995. This activity is expected to be completed in 16 months.

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ILLUSTRATIVE BUDGET

ITEM	DAYS	RATE ($)	TOTAL ($)
A. LABOR			
Macroeconomic Advisor	313	331	103,603
Economic Surveys Expert	78	331	25,818
Finance Instructors	260	331	86,060
Offsite Monitoring Spec.	36	331	11,916
Onsite Examination Spec.	36	331	11,916
Local Banking Expert	36	150	5,400
Short Term Advisors			200,000
Total Labor Costs			**444,713**
B. Multiplier			**498,523**
C. Travel, Per Diem, and Insurance			
International Travel	15	4,000	60,000
Per Diem	880	134	117,920
Travel/Per Diem (Trainees)			75,000
Transportation			9,000
Insurance			5,000
Subtotal			**266,920**
D. Commodities			
Computers	13 units	4,000	52,000
Printers	3 units	3,000	9,000
Commodities for Research and Indirect Monetary Departments. (Includes reference books and materials, CD-ROM based databanks. Subscriptions to be paid by the CBE.)			30,000
Subtotal			**91,000**
E. Training materials/supplies			**50,000**
F. Contingencies			**105,416**
GRAND TOTAL			**$1,456,572**

STATEMENT OF WORK

I. BACKGROUND

The Czech Republic began aggressive economic reforms several years ago while a constituent member of Czechoslovakia. These reforms were directed at the creation of a market economy. They included large-scale privatization of state enterprises, financial liberalization and an opening of the economy. These changes accompanied liberalization of the political system.

Privatization of state enterprises in Czechoslovakia was achieved through the distribution of vouchers to citizens. This opened the potential for every adult Czech to become a shareholder, although most individual holdings are presently indirect, through large investment funds.

A key institution supporting economic reform and the creation of a market economy is the stock exchange. A well-functioning exchange's major contribution to the economy is the information it generates about the performance of quoted companies. Another extremely important function is that a stock exchange permits ordinary citizens to participate as shareholders in the increasing returns that should accompany reliance on the private sector as the primary source of productivity and creator of wealth. Finally, a stock exchange contributes to the financing of enterprise and encourages venture capital investment by providing an exit mechanism for initial investors in successful firms.

The first stock exchange in Prague was established in 1871 and functioned until 1938. After 55 years of interruption, the Prague Stock Exchange (PSE) reopened on April 6, 1993. The PSE is a joint stock company which currently has 53 members. Its rules are modeled after the Paris stock exchange. Its Articles of Incorporation are supplemented by ten other documents specifying its rules and regulations, providing listing requirements, specifying fees and arbitration procedures, and regulations governing a guarantee fund associated with the exchange.

The RM-System has also been an important player in the development of the Czech capital market. To a certain extent, it represents a competition to the Prague Stock Exchange. It is a joint stock company affiliated with the computer network company PVT. Basically, the RM-System is a framework for over-the-counter securities trading and functions as a logical continuation of voucher privatization. Hundreds of registration offices all over the country make transactions directly to any investor without bookmakers or other intermediaries. Trading in the RMS occurs on an occasional basis when a sufficient number of orders have accumulated, as opposed to the three sessions weekly of the PSE. The advantage of the PSE is that similar institutions exist all over the world. It is not certain if the RMS will survive.

The PSE is currently the largest of the two stock exchanges in the Czech Republic. Nearly 1,000 companies are quoted on the PSE. A steady increase in trading volume frequently involves $5-10 million in volume traded in the thrice-weekly session.

The Ministry of Finance (MoF) is responsible for regulation of securities markets, and a separate regulatory body may be established for this purpose. Legislation relating to this function includes The Securities Act, The Stock Exchange Act and The Investment Companies and Investment Funds Act. Despite the relatively healthy trading volumes, the PSE faces a number of real and potential problems. These include the regulation and supervision of the brokerage community, resolution of potential conflict-of-interest problems among fund managers, brokerages and banks (frequently owned by the same institution), processing the increased trade volumes, re-evaluation of the listing and reporting requirements for companies, professionalization of the PSE staff, etc.

Proper and effective functioning of the PSE is an important priority in Czech economic reform and stabilization. Its successful operation is also consistent with priorities of the United States Agency for International Development (USAID), which include economic growth and popular participation in development.

USAID has been providing short term technical assistance to the development of the financial sector of the Czech Republic, including the Prague Stock Exchange, through short term consultancies provided under the Financial Services Volunteer Corps. While these short term consultancies have been well received by the PSE, it is apparent that a longer term advisor is needed. This need was communicated by PSE officials to USAID representatives on several different occasions this year. USAID was specifically requested to provide a long-term advisor (2 years) to not only assist PSE in the development of a long-term strategic plan for the growth and development of the PSE , but also help design and implement a game plan for needed reforms.

Since this requirement is for two years and funding under Project 180-0014 terminates September 1995, ENI/EUR/P proposes to buy-in to the Office of Emerging Markets, Bureau of Global Programs (G/PRE/EM) Financial Sector Development Project Phase II. The five year, financial development contract with KPMG/Peat Marwick, which was fully competed, provides USAID missions worldwide and bureaus the opportunity to quickly access expert technical assistance to support financial sector reform. .

II. OBJECTIVE

The objective of this buy-in to the Financial Services Development Project II is to assist in the development of the Prague Stock Exchange to international standards. The buy-in will provide both long term and short-term technical assistance to the Prague Stock Exchange. Both components will develop identifiable indicators of performance and benchmarks of success through quarterly workplans for the long-term advisor and individual indicators/benchmarks for each short-term assignment.

III. SCOPE OF SERVICES FOR TECHNICAL ASSISTANCE

A. Level of Effort

The contractor will provide (a) a Long-Term Advisor (LTA) for 24 months and (b) short-term consultants for up to 8 months over a 24 month period.

B. Coordination and Reporting Requirements

The Long-Term Advisor (LTA) will work with the Chairman of the Prague Stock Exchange or his designee. The LTA will draft monthly progress reports and a final report encompassing the specific areas mentioned below. These reports will be provided to the Chairman and General Secretary of the Exchange, to the USAID representative in Prague and to the Project Officer in Washington DC. The LTA will arrange and coordinate short term technical assistance through FSDP II and other assistance providers such as the Financial Services Volunteer Corps to assist with specific priorities for the development of the Prague Stock Exchange.

The LTA will coordinate closely with the USAID Representative in Prague and with the USAID Project Officer in Washington, D.C. The LTA will brief the USAID Representative on a regular basis; short term consultants will brief the USAID Representative upon completion of all assignments.

C. Specific Tasks

1- Long Term Advisor

a- Help develop and implement a strategic plan for the PSE

The Long-Term Advisor will work directly with the Chairman and management of the PSE to assist the development and implementation of a strategic development plan for the PSE. This plan will be based on a diagnosis of present performance, a review of regulations, an analysis of PSE management structure and technical resources, and the identification of risks facing PSE in its efforts to build an efficient market. This background material will permit the identification of realistic objectives and the preparation of implementation plans. The LTA will assist in building confidence in and consensus to support the strategic plan and guide its implementation.

The central objective for the development of PSE (or of any other world-class exchange) is development of an efficient market. This objective is achieved by creation of liquidity and provision of transparency. Liquidity and transparency can be achieved through specific institutional measures, which could be addressed in the strategic development plan. Such measures could include the steps required for: 1) introduction of continuous trading; 2) timely and accurate clearing and settlement

of trades; 3) development of options and futures, other new products, and the listing of foreign securities; 4) protecting the market against fraud, insider abuse and other forms of manipulation and abuse; 5) development of regulatory and self-regulating structures; 6) managing relations with issuers, including listing and disclosure requirements; 7) cultivating retail clients, including development of marketing strategies and educational programs; 8) other measures for creating liquidity, improving price formation and providing transparency; 9) adequate staffing of the Exchange; and 10) admitting new members to the Exchange.

The LTA will submit the following deliverables:

1) An initial workplan submitted 45 days after arrival.

2) A strategic plan accepted by the PSE.

3) Quarterly progress reports assessing the development, implementation and modification of the strategic plan.

4) Final report within thirty days following the end of the project evaluating PSE's progress towards achieving its strategic plan.

b- Help identify and coordinate short-term technical assistance assignments

The Long-Term Advisor will assist management of the PSE to identify short-term technical assistance priorities that would contribute to the development of PSE. The LTA will coordinate these tasks and ensure that they are consistent with the priorities of PSE management. This assistance will be accessed through the FSDP II buy-in and from other sources such as the Financial Services Volunteer Corps.

Deliverable- Quarterly work plans on projected technical assistance requirements identified and planned

2- Short-Term Technical Assistance (SSTA)

The Long-Term Advisor will collaborate with organizations such as the Financial Services Volunteer Corps in accessing and coordinating short-term technical assistance. These assignments would deal specifically with components of the strategic development plan. Scopes of work for specific assignments would be developed by the advisor in consultation with and with the approval of PSE management. Examples could include but would not be limited to such areas as promotion and use of disclosure to increase investor confidence and interest, including suggestions regarding the extent and frequency of disclosure; promotion of fair and effective order execution; assistance with the mechanics of price discovery and settlement systems and procedures; assistance in market protection mechanisms, including systems for monitoring trades, internal and external

regulation and supervision; and assistance in the development of new products and attracting new investors.

Deliverables- 1) Monthly reports by the LTA on technical assistance tasks completed/on-going. These reports will contain a review of progress, constraints in implementing technical assistance recommendations and recommendations to address those constraints and issues.

2) Short-term task reports: Short-term advisors will prepare their own reports. Drafts will be submitted prior to their departure from Prague. Final reports will be submitted before an advisor is paid in full under his or her contract.

IV. BENCHMARKS

A. Official endorsement by the PSE of a strategic plan and timetable for achieving identifiable objectives;

B. Memoranda documenting specific actions taken by the PSE to achieve its strategic objectives identified in the plan.

V. DELIVERABLES

Preparation of reports identified in section III above will be the responsibility of the LTA. Copies of each report should be sent to the USAID Project Officer in Washington and to the USAID Representative Office in Prague.

These deliverables, listed above, include:

Strategic development plan acceptable to the PSE
LTA monthly progress reports
LTA quarterly work plans
LTA final report
Short-term task reports by short-term advisors

VI. OTHER CONSIDERATIONS

The Long Term Advisor, to be funded through a buy-in under the USAID-financed FSDP II, would be engaged by The Policy Economics Group of KPMG Peat Marwick (PEG), the contractor implementing FSDP II. The advisor would be selected by PSE, which would also provide a) an office in the PSE building, and b) bilingual secretarial support.

The LTA would have access to insider information and must therefore work on a confidential basis in collaboration with the management of the Prague Stock Exchange. The

LTA should undertake no investments in Czech securities directly or indirectly and should not disclose any sensitive information to KPMG Peat Marwick or to others not having a need to know.

The candidate most attractive to PSE should visit Prague for an initial 15-30 day introductory assignment. During this period the Advisor would be briefed on the task and would work with the senior management of the Exchange to develop a work program. This introductory assignment would also allow the Exchange to evaluate the Advisor's suitability for a longer assignment. At the end of the initial 15-30 days the candidate would leave Prague and the Exchange would indicate whether the individual is acceptable. If found acceptable, the Advisor would return to Prague within three weeks for the duration of the assignment, which would run for a remaining period of between 18-23 months.

VII. KEY PERSONNEL

The ideal candidate would be a professional with a strong background in U.S. capital markets. An understanding of regulatory frameworks in important. Exposure to clearing, settlement and depository systems would be helpful. The advisor would be independent, flexible and able to work closely with senior management. Given the nature of the assignment the advisor would have high communication skills, patience, and ability to appreciate and work with different individuals with different perspectives an backgrounds.

It is understood that the advisor cannot be expert in all topics, but would be expected to identify problem areas for further work by other consultants and experts to be drawn in on a temporary basis. Also, it is understood that the advisor would be an "advisor", and not a policy maker. This professional would offer options and ways of approaching problems with the understanding that decisions would rest with PSE management. This requires a sensitivity in the advisor to local customs, pride, and management styles.

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Scope of Work

Egyptian Financial Sector Development Strategies

(Buy-In under FSDP II)

I. Introduction:

Egypt is undergoing a comprehensive economic reform program. In the financial sector, the Government of Egypt (GOE), since 1991, has, *inter alia*: deregulated interest rates and introduced treasury bills market, consolidated its multiple foreign exchange regime and unified the parallel foreign exchange markets, introduced foreign exchange dealing bureaus, allowed foreign banks to operate in local currency, strengthened banks prudential regulations and supervision, and recapitalized its four major public sector banks. GOE has amended its banking and credit law, and also issued a new capital market law. Recently, a couple of banks established two close-ended mutual funds which were overly subscribed.

The structure of Egypt's financial sector is dominated by the banking sector. Four major public sector banks account for nearly three quarters of total deposits. In addition, these state-owned banks together with other public sector companies hold stake in other joint-venture banks. The securities market is still rudimentary. The insurance sector is also dominated by public sector companies. The social security scheme is extensive. Both it and the insurance companies submit percentage of their reserves, by law, to the GOE's investment organ - the National Investment Bank (NIB). Also deposits accepted by the extensive network of post offices are channeled to NIB. The NIB ,in turn, channels them to government and, until recently, public sector projects which rarely, if ever, pay back investments.

An array of more developed financial institutions and instruments are needed to help the economy in its transition to a full fledged private sector driven economy. For example, at the institutional level the market lacks leasing companies, clearing and settlements systems, and building societies. Basic-type financial instruments - shares, government bonds, and treasury bills - are available in the market, while other instruments, such as forwards, options, and futures are lacking.

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II. Purpose:

The purposes of this study are to:

a) propose immediate actions that could increase the flow of funds to the private sector;

b) identify new financial instruments for the Egyptian financial market; and

c) develop medium- and long-term strategies for GOE and USAID/Egypt to assist financial sector development in Egypt which consider: i) qualitative and/or quantitative risks and returns for their introduction, and ii) intervention sequence and priority factors.

GOE strategy should be based on its reform program and the gradual integration into the world economy while USAID strategy should be based on the Mission's country strategy.

III. Statement of Work:

A consultant team with extensive knowledge and experience in financial markets in both emerging/developing and developed economies will be contracted to conduct the study. The team shall work with officials from different institutions, including the Ministry of International Cooperation, Social Insurance Authority, the National Investment Bank, the Capital Market Authority; Central Bank of Egypt; Ministry of Economy; Egyptian Insurance Supervisory Authority; Insurance Companies; Business and Investment, and branches of Foreign Banks; Ministry of Transportation and Communication; and the private sector. The team will also work with a USAID internal task force which will help to establish contacts that would facilitate the core team's access to information for the purpose of producing and monitoring the progress of this activity. The consultants should conduct the following tasks:

A. Evaluation of Economic and Financial Reform and Activities since 1991

A.1 review GOE, USAID, and other donor activities involving the Egyptian financial sector;

A.2 review the following documentation:

- i) The World Bank's 1993 financial sector study titled "Financial Sector for Adjustment and Growth" and document changes that have been implemented;
- ii) Documents on the "Financial Framework", "Legal and Judicial Framework" and the "Small and Microenterprises and Rural Development" themes of the Private Sector Development Conference;
- iii) Bentley's report, "Egyptian Legal and Judicial Sector Assessment;"
- iv) Bechtel's Financial Instrument Study

A.3 inventory the financial sector activities of other international multi- or bilateral donors in Egypt, including the Banking Sector Reform Technical Assistance Program;

A.4 evaluate the progress that has been done in the financial sector since the World Bank's study;

B. <u>Propose Immediate Actions to Increase Flow of Funds to the Private Sector</u>

B.1 propose immediate actions that could increase the flow of funds to the private sector, such as encouraging flow of funds from the social insurance system, postal savings, and insurance companies to the private sector. The increased flow of funds should be at non-subsidized terms and conditions appropriate to the Private Sector Investment activities than those presently available in the banking system, such as longer term maturities, grace periods, fixed and/or variable interest rates, hedging...etc;

C. <u>Examine Enabling Environment for the Introduction of New Financial Instruments</u>

C.1 explore the introduction of new financial instruments not picked up by the financial instruments study, examine any legal or regulatory constraints to their introduction, and propose action plans to introduce them to increase the depth, breadth and activity of the markets;

D. <u>Develop an Action Oriented Financial Sector Development Strategy</u>

D.1 review progress on USAID's Securities Market Development Project and the Bechtel's Financial Instruments Study mentioned above;

D.2 evaluate the effectiveness of the following financial and quasi-financial institutions in relation to their capacity to serve GOE and USAID financial sector objectives, specifically encouraging the flow of funds to the private sector, and to efficiency:

i) The National Investment Bank,
ii) The Post Office, and
iii) The Capital Market Authority;

D.3 identify areas in these institutions and authorities in which reforms and innovations are strategically needed;

D.4 recommend action oriented strategies, and specific projects or activities for GOE and USAID to support financial sector development in Egypt; and

D.5 identify new interventions and areas of research in the financial market.

IV. Deliverables and Reports:

Deliverables:
The consultant shall submit a workplan for review and approval of USAID internal task force within one week after arrival of the international team. The consultant will also conduct weekly meetings with the task force to brief them on progress of work, and hold a presentation on the findings of the activity before submitting a draft report.

Reports:
The output of this study will take the form of two reports. The first report should contain the action plan for increasing the flow of funds in the private sector. The second report should contain the action oriented financial sector development strategy and would include USAID specific appendix that propose specific projects or activities for intervention.

The consultant team shall give a presentation on key findings and submit a draft of the executive summary (for each of the two reports) (20 copies) in the last week of work in Egypt. The consultant will send a draft final report (20 copies) within 2 weeks of departure from Egypt, and a final report (20 copies) two weeks after receipt of USAID comments. All reports will be in English, produced using Wordperfect 5.2, and accompanied with a 3.5 HD diskette media form.

V. Staffing:

The consultant shall fill a team consisting of a core group recruited in the United States and internationally, and local specialists assembled to assist and complement the core group during its work in Egypt. Most of the core group will require about 6 working days period for preparation in Washington or elsewhere, up to 24 working days in Egypt to conduct its investigations and produce a draft report, and 6 working days to finalize the report in Washington or elsewhere.

The core team should include expertise recruited abroad in the following areas:
a) economic reform programs
b) financial markets
c) financial laws and regulations
d) contractual savings institutions
e) term credit

The local team should include expertise on:

a) financial markets
b) financial institutions and regulations
c) contractual savings institutions
d) Egyptian postal savings system

In addition the local team shall include interpreter(s) and/or translator(s), and a secretary.

There is scope for changing the mix of international and local specialists listed above, depending on availability and recruitment results.

The core and local teams will report regularly to the USAID internal task force.

VI. Level of effort and Timing:

The team should begin its work by mid-March 1995. The target delivery date for the team's reports is 60 days following commencement of its work, or in May 1995.

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Estimated Budget

Item	Daily Rate	Days	Total Cost
A. LABOR			
International Team:			
Economist and Team Leader	443	39	17,277
Financial Market Specialist	332	18	5,976
Legal Specialist	443	24	10,632
Contractual Savings Instit. Specialist	332	30	9,960
Portfolio/Investment Manager	332	18	5,976
Sub Total			49,821
Local Team:			
Financial Market & Regulations Advisor	105	18	1,890
Legal Specialist	105	24	2,520
Contractual Savings Instit. Specialist	105	24	2,520
Institutional Advisor	105	18	1,890
Secretary	60	24	1,440
Int/Translator	100	24	2,400
Int/Translator	100	24	2,400
Sub Total			15,060
TOTAL LABOR COST			**64,881**
B. MULTIPLIER			**72,732**
C. TRAVEL, PER DIEM, AND INSURANCE			**40,000**
D. OTHER EXPENSES			**6,000**
E. CONTINGENCIES			**66,387**
TOTAL COST			**250,000**

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Economic Growth Center Training

Financial Sector Development

Summary of Key Messages

September 19, 1995

This paper was prepared by Elisabeth Rhyne, with input from J. D. von Pischke, Richard Rosenberg, Juan Buttari, James Coates and Barry Lennon. The views expressed are the author's, not those of USAID or the people who provided input. The first few pages draw heavily from Financial Systems and Development, The World Bank, 1990, and "Financial Markets Development", A.I.D. Policy Paper, August 1988.

OUTLINE OF CONTENTS

I. Functions of Financial Markets

II. The Policy and Regulatory Framework for Financial Development

- A. Macroeconomic Policies
- B. Interest Rate Policies
- C. Government Controls on the Financial Sector
  - 1. Financial Repression
  - 2. Prudential Regulation and Supervision
- D. The Legal Underpinnings of Financial Markets

III. Financial Intermediation: Savings and Credit

- A. Savings Mobilization
- B. Credit Markets -- Product Innovation and Expanding the Frontier
  - 1. Risks and Costs
  - 2. Specialized Credit Markets
  - 3. Informal Credit Markets
- C. Capital Markets
- D. The Market for Funds Transfer
- E. Financial Institutions and their Development

IV. USAID's Role in Financial System Development

- A. Statement of Principles
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Economic Growth Center: Training

Financial Sector Development
Summary of Key Messages

I. Functions of Financial Markets[1]

Effective financial markets are indispensable to sustained economic growth and increased standards of living. A financial system provides services that are essential to economic development and useful to all segments of society -- households, businesses and government. The functions of financial systems are as follows:

- The use of a stable, widely accepted **medium of exchange** reduces the costs of transactions, and thus makes trade possible (both domestic and international).

- Financial assets with attractive yield, liquidity and risk characteristics encourage **mobilization of resources** making savings available for investment.

- An efficient financial system evaluates alternative investment proposals and **allocates resources** to activities that will provide the highest rate of return for the use of the funds. Providing saved resources to those with productive uses for them raises the income of saver and borrower alike.

- Well-designed financial instruments can be used to **spread risks** in a way that enables economies to manage shocks and take on promising risks.

- Efficient financial markets facilitate **wider ownership of assets**, giving a larger number of citizens an opportunity to participate in the growth of the economy and to diversify their assets and liabilities.

Without financial services an economy would be confined to self-sufficiency or barter. Separating the timing of consumption and production would be possible only through

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[1]This paper was prepared by Elisabeth Rhyne, with input from J. D. von Pischke, Richard Rosenberg, Juan Buttari, and Barry Lennon. The first few pages draw heavily from Financial Systems and Development, The World Bank, 1990, and "Financial Markets Development", A.I.D. Policy Paper, August 1988.

storing goods (as opposed to storing financial assets). Investments would be financed only by individual savers or closely-knit groups of individuals.

A financial system's contribution to the economy depends upon the quantity and quality of its services and the efficiency with which it provides them. As financial systems evolve, they improve along two dimensions:

- **Depth.** A commonly used indicator of financial depth is the ratio of broadly defined money to GDP. A low ratio suggests that the financial system is a poor mobilizer of funds and that relatively few people have access to the market. The economy is not making the most of its endowment. Shallow financial markets are easily disrupted or manipulated.

- **Efficiency.** Efficient financial markets are good at a) selecting high return invesments (they allocate efficiently) and b) providing their services at a low overall cost (they operate efficiently).

Financial sector development is primarily concerned with achievement of greater depth and efficiency.

II. The Policy and Regulatory Framework for Financial Development

A. Macroeconomic Policies

Government has a crucial role in facilitating financial market development by providing a favorable macroeconomic setting.

- Control of inflation allows financial assets to maintain their value and facilitates the operation of price mechanisms (interest rates). It also reduces risk by lowering uncertainty about future value.

- Fiscal balance ensures that government does not absorb too large a share of potentially available resources ("crowding out"), and reduces reliance on the kind of external borrowing that fueled the international debt crisis.

- Realistic exchange rates facilitate participation in international financial markets and trade and discourage capital flight.

Progress in financial sector development is greatly hampered whenever any of these conditions are absent.

B. Interest Rate Policies

Interest rates are the crucial prices that allow financial markets to function fairly. Low to moderate real rates of interest are conducive to economic growth -- they offer savers adequate incentive to save, but provide a reasonable hurdle rate for borrowers making investments (so that low-return investments are not funded). Thus, low interest rates are "good". However, low interest rates that truly benefit an economy must be the result of sound macroeconomic conditions and efficient financial markets. They cannot be achieved through legislation or regulation.

When governments directly control interest rates, keeping them lower than markets would otherwise, a number of negative consequences result:

- Returns to savers are artifically low; the amount of savings mobilized shrinks.

- Facing thin margins, financial institutions cannot provide a wide range of financial products because the become overly risk averse and unlikely to innovate.

- Credit is rationed to the customers that can be served at the lowest risk and lowest transaction cost, or who have the most influence in the financial and political systems.

Under these circumstances, neither depth nor efficiency grows.

During the late 1980s and early 1990s many governments removed interest rate controls. However, it is generally recognized that interest rate decontrol must be carried out carefully, in sequence with other aspects of financial liberalization, particularly exchange rate liberalization, and with responsible fiscal management, to avoid causing macroeconomic imbalances that can lead to more serious financial stress.

C. Government Controls on the Financial Sector

Governments control financial markets in different ways and for different reasons. These reasons include the desire to stabilize the economy, to dispense patronage, to protect consumers, and to extract funds through taxes and loans. Economic stabilization is

achieved through controls on interest rates and government borrowing and lending in financial markets. Patronage is given through preferential interest rates and access and by turning a blind eye to loan recovery. Consumers are protected by deposit insurance, licensing requirements imposed on institutions and individuals working for financial intermediaries, market segmentation, intervention in crises, and disclosure requirements in financial instruments and institutions.

Key focus areas in financial development are government's role in financial repression and in prudential regulation and supervision.

1. Financial Repression

Governments have often used their power to manipulate the flow of financial resources in self-interested ways. Interest rate ceilings on deposits and loans, combined with inflationary rates of monetary expansion are the most important policies creating financial repression. Other policies adding to this repression are exchange controls, certain taxes, directed credit policies and heavy reserve requirements. Such policies cripple the progress of financial systems by restricting the amount of funds available or by restricting the range of services that can be provided. Financial repression has been a major contributor to financial crises in many countries, while in others it has merely served to keep most people from having access to the benefits of financial services and to lower rates of economic growth.

2. Prudential Regulation and Supervision

By contrast, prudential regulations are designed to preserve the stability of the financial system and to protect depositors in the financial system. Most importantly, they provide a framework for maintaining the soundness of individual financial institutions and reduce the risk that failure in one financial institution will spread throughout the financial system.

A strong framework for bank regulation will address: licensing to ensure adequate capitalization and sound management; capital adequacy (the ratio of capital to total assets should be at least 8 percent by international standards); portfolio quality (risk classification, provisioning for expected losses and diversification); liquidity ratios (short term assets and cash as a percentage of total assets); limits on the sizes of loans to any one client; and prohibitions on insider lending.

In addition, bank supervisors need to have adequate powers to enforce these regulations. These powers must be flexible enough to provide sanctions before problems reach a crisis level. For example, supervisors might impose fines, suspend dividends, remove

managers or directors, etc. before a major intervention such as restructuring or merger becomes necessary.

To be effective, prudential regulation must be backed by a political commitment to supervision and enforcement. The supervisory body must be given clear policy goals, and it must be independent. Too often, in both developed and developing countries, supervisors are undercut by political interference. One way for governments to demonstrate commitment to adequate supervision is to provide adequate resources to the supervisory agency and invest in high quality staff and training.

D. The Legal Underpinnings of Financial Markets

Legal codes and regulations governing property rights, contract enforcement, and valuation of assets are essential prerequisites to the development of modern financial institutions and instruments.

Without clear property rights, individuals will not easily offer their assets in financial transactions. Rules must be clear regarding: title to and transfer of property, use of assets as security for loans, procedures for claiming collateral, and sharing ownership of assets. The effects of weak property rights legislation are felt at all levels of the financial system. For ordinary women, property laws often result in their exclusion from formal credit markets. For money markets, particularly in civil code countries (as opposed to common law countries), the legal framework makes innovation difficult and thus slows development of new types of securities.

Accounting, property valuation, financial disclosure and audit standards provide the base of information that helps two parties (be they individuals or institutions) to agree on the value of assets. Legislation governing such standards should be clear and in line with international practice. Because such standards are used in processing many financial transactions, they must be widely understood and practiced -- and that in turn calls for major investments in training and capacity development.

III. Financial Intermediation: Savings and Credit

A. Savings Mobilization

Savings determines the rate at which productive capacity, and hence income, can grow. Well-developed financial markets offer a variety of short and long term instruments that enable savers to select the combination of risks and returns they seek. In the aggregate, households are net savers while businesses are net borrowers. Many non-financial factors

(e.g., income growth, age of individuals, cultural attitudes, macro/political stability) affect the savings rate. It is not clear whether financial factors greatly affect the savings rate, but it is clear that financial factors can influence the extent to which savings are placed in the financial system rather than held in kind. Savers are influenced by several key factors: **liquidity, ease of access (convenience), real rate of return, and safety.**

Governments can support savings mobilization by ensuring that interest rates charged to borrowers are not restricted, by providing adequate financial sector regulation and supervision, and, when carefully designed and limited, through deposit insurance. Financial institutions can encourage savings by developing savings instruments tailored to the preferences of various market segments.

Savings services are particularly important to low income households, who have often not had access to savings instruments that fit their particular constraints. Evidence strongly affirms that the poor in developing countries save, often in kind or through informal mechanisms. The limitations of such savings mechanisms, together with the value of bringing savings into the financial system mean that there are significant benefits to be captured by offering low income people savings services through financial institutions. The Bank Rakyat Indonesia (BRI), a government-owned bank, has operated a stunningly successful savings mobilization program since 1985. Credit unions and postal savings banks in some countries have also mobilized funds successfully from low-income populations.

For those at middle and upper income levels, the development of insurance and pension funds provides a vehicle for long term savings, and, as noted below, contributes to the ability of financial systems to offer longer term credit.

Emphasis on savings is also healthy for the development of financial institutions. Some observers believe that saver-dominated financial institutions tend to show steadier growth in assets, lower loan delinquency, greater efficiency and longer term financial viability, while borrower-dominated financial institutions tend to show higher rates of loan delinquency, slower growth, and frequent liquidity problems, particularly when they rely on external sources of funds.

B. Credit Markets -- Product Innovation and Expanding the Frontier

Financial markets tackle the easiest problems first. Thus, short term loans to large, well-known borrowers and purchases of government securities appear before long term mortgage markets or loans to consumers. Because of this tendency, less developed financial systems tend to serve mainly the elites, and provide limited support to long term

productive investment. **Thus, credit market development can be viewed as a process of extending the frontiers of the financial system to serve the majority of the population and to support longer term transactions.**

1. Risks and Costs

To extend the frontier, financial markets must find ways to deal with several sets of risks and costs.

- **Credit risk.** Ensuring that borrowers will repay loans is the central problem in credit markets. Techniques for reducing credit risk include: collateral-based lending; keeping loans short term so that major changes in business prospects are unlikely; project appraisal and cash flow assessment. Generally, the means banks have found to reduce credit risk involve gathering additional information on borrowers, and this process adds costs. Breakthrough innovations involve ways to reduce credit risk at lower costs, e.g., credit reference bureaus and the motivational techniques (peer pressure and positive incentives) used in microfinance.

- **Liquidity risk** -- the risk that depositors will demand funds at a time when the financial institution's assets are tied up in assets that cannot readily be sold, thus rendering the bank insolvent. Liquidity risk is a major barrier to long term lending, because savers typically want to place their funds for short periods while borrowers want to amortize the costs of investments over as long a period as possible. Therefore, financial institutions face pressure to borrow short and lend long, jeopardizing their liquidity. Innovations in money markets that allow banks to move money quickly (interbank funds markets; secondary markets that sell to insurance companies and pension funds) are important in reducing liquidity risk and enabling longer term lending. Thus, while money markets may appear to be far removed from final borrowers, they play a key role in enabling borrowers to get more and longer term credit.

- **Interest rate risk** -- the risk of loss due to unexpected changes in price. For example, interest rate increases can leave a financial institution paying too much for funds while it remains unable to increase the income received from longer term loans and other assets. Thus, interest rate risk again contributes to a preference by banks for short term lending. Interest rate risk can be passed to borrowers through floating rate loans, but this can contribute to higher credit risk if borrowers suddenly find they cannot afford higher debt service.

- **Information costs.** Closely related to credit risk are the costs incurred in determining the creditworthiness of borrowers and their proposed investments and in tracking the repayment status of loans. For small and micro borrowers these costs can become prohibitive, which has led microfinance to adopt techniques from the informal sector that involve motivation to repay and immediately verified selection criteria in place of information gathering. At the corporate level, financial disclosure by businesses seeking to raise funds through bond or stock markets makes relevant information available to the public, often with the certification of public bodies such as a securities and exchange commission. Information costs that cannot be reduced are passed to borrowers through the interest rate, and thus, competition among institutions is an important force for reducing such costs.

- **Transaction technology costs.** The costs of processing individual transactions are particularly important for the highly competitive funds transfer services and for lending to small business, microenterprise and consumers. Technological advances such as those brought by computers, credit cards and the like, have helped reduce these costs. However, in the poorest countries, the value of such techniques may be limited by the quality of communications infrastructure and the cheapness of labor relative to equipment.

2. Specialized Credit Markets

If financial systems are to serve the majority of the population, they must develop products tailored to several key markets, each with its own set of risk and cost attributes.

- **Small Business.** Small business is a particularly difficult market segment because few shortcuts to costly information-gathering have been found other than high collateral requirements. Small businesses cannot be treated in a standardized fashion (as can microenterprises or consumers), but loan sizes are too small to leave room for extensive analysis. Techniques particularly important for expanding small business lending include: credit reference bureaus, clear collateral legislation, leasing, and factoring.

- **Microenterprise and Poverty Lending.** Poor, self-employed people were long believed to be unbankable -- bad credit risks, costly to serve, lacking in collateral, unable to pay market-determined rates of interest. Recent experience in microenterprise programs has shown the error of these beliefs. The new microfinance techniques, adapted from the informal sector, use peer pressure and positive incentives to motivate repayment, charge full-cost recovery interest rates, and streamline delivery systems to lower costs.

- **Agriculture.** Agricultural activities provide livelihoods for large segments of the populations of developing countries and animate their rural economies. However, agricultural credit is a difficult area. Farmers face great variations in crop yields and commodity prices (high risk, much of it not easily diversified) and the dispersion of rural populations raises the costs of providing financial services. One partial solution is general rural finance, focused on enterprises with lower risk covariance than agriculture; another is lending through intermediaries such as marketing companies. Deeper financial markets in rural areas increase the availability of financing for farmers.

- **Housing Finance.** The twin problems in housing finance are the high cost of housing relative to household income streams and the fact that for most people investment in housing does not generate the income needed for debt service. Mortgage markets cope with these problems by amortizing payments over a very long period of time, in return for claims on housing that holds its value over many years. Mortgage market development requires many prerequisites: strong property rights legislation and property appraisal systems, stable financial sector conditions, sources of long term funds for savings, and, generally, a large number of salaried home buyers. Where these are lacking, microfinance techniques may be useful -- and may fit well with the characteristics of informal housing -- incremental, built by owners, and used for productive purposes.

3. Informal Credit Markets

In many parts of the developing world, particularly rural areas, services through formal financial sector intermediaries are not available. In such settings, and even where some formal services are available, all or much financial service delivery occurs informally, through input suppliers, merchants, moneylenders, friends and family. The informal mechanisms are tailored to the specific parties involved, and may involve interlinkages with other markets (as does supplier credit, for example).

As informal markets serve a valuable function, they should be allowed to operate, and even encouraged. While few methods have been devised to link directly from formal to informal mechanisms, it is believed that formal financial deepening, particularly in rural areas, may enhance informal mechanisms by increasing general liquidity. Due to the important limitations of informal mechanisms, however, (low risk diversification, frequently high cost, confined area for intermediation), there are potential advantages to the introduction of formal financial services that can overcome these shortcomings.

C. Capital Markets

Capital markets include stock markets and other corporate equity markets; bond markets, both government and corporate; and commodity markets. These markets work through securities whose value is readily agreed upon by all parties, so that they can be bought and sold quickly. **Requirements for the development of any aspect of the capital market are: 1) a sufficient supply of potential issuers and buyers to make a market worthwhile; 2) clear, enforceable contract rules governing ownership and sale of securities and their underlying claims; 3) widely accepted standards for valuing the securities; and 4) a market system that actually handles the transactions.**

Government securities are typically the first element of the capital market to be developed, as government's promise to repay is generally stronger than that of private corporations, and as government debt is easily standardized. Government securities markets lay the foundation for development of other money and capital market instruments by creating a foundation interest rate that helps market participants price risk, and by creating a mechanism to bring market participants into contact with each other.

The conditions for the development of corporate equity markets are frequently lacking in developing countries, particularly in terms of the number of prospective buyers and sellers and the legal underpinnings (for example, credible corporate disclosure requirements) needed to make capital markets work. It is often possible to create stock exchanges that serve a small number of companies and cater to wealthy investors. However, broader economic benefits come from capital markets only when they are reasonably deep. Development finance institutions were created in many countries to compensate for the absence of capital markets as a mechanism for financing long term corporate investment. However, these institutions have generally failed, due to fundamental flaws in their design.

In the short and medium run, the problem of long term corporate finance often has no obvious solution. **In the absence of the appropriate conditions for stock market development, most business equity comes from informal sources (extended family,**

business associates, retained earnings). Even in developed countries like the United States a very large share of business equity is still informally supplied. This observation suggests that good savings instruments and shorter term banking services can substantially, albeit indirectly, support business growth.

An important reason to consider capital market development is its close relationship to privatization. Without capital markets, privatization tends to be limited to private placement in the hands of local elites or foreign investors. Privatization through vouchers spreads ownership widely but is only effective if the market for vouchers has been carefully designed. Recent experience in Russia, the Czech Republic and Poland, among others, has shown voucher privatization to be possible but very difficult to structure well.

D. The Market for Funds Transfer

As noted above, the most basic function of financial systems is providing a medium of exchange. Efficient funds transfer services allow businesses to interact across great distances and national borders and allow individuals to use income earned in one place to support family members elsewhere. Such services are often well developed for urban elites, and foreign exchange. They are attractive to banks because they can be fee-based, and carry low risk. Throughout the Eastern Europe and NIS region, transfer services have been nearly non-existent, raising costs even for large businesses. However, progress has been quick in developing such services during the 1990s. Extending funds transfer services to the rural areas of very poor countries could make a significant contribution to rural welfare. At present, many rural residents lose large portions of their earnings in the transfer process (through both time and money), and cannot readily access distant markets. Funds transfer is primarily a technology issue. Recent technological developments should lead to progress in this area in coming years.

E. Financial Institutions and their Development

In many developing countries the financial system is dominated by one or a few large government-owned banks, which hold most of the assets of the financial system. Often these banks are insolvent, holding large portfolios of non-performing loans. Local private banks are often small and weak. International banks, while stronger, typically cream off the best business, including much of the foreign exchange business. **One of the key tasks in financial sector development is, therefore, to move the financial system toward a more effective constellation of institutions, through restructuring or privatizing government banks and laying the groundwork for development of healthy private banks.** Public bank restructuring embodies many difficult challenges:

- Restructuring government banks may require downsizing, installing new

management and governance, creating positive incentives, and redefining business products. Such fundamental institutional overhauls are never easy.

- Workout of bad debt requires the government to acknowledge large losses, a politically difficult task.

- Government must find a way to revamp institutions, for example by injecting fresh capital, without inviting subsequent failures (moral hazard).

- Government banks often have a mandate to reach frontier-type clients. When these banks are restructured, the lack of outreach by the financial system to such clients becomes more apparent, and the pressure to restore outreach may be strong.

While restructuring/privatization of public banks proceeds, the foundations must be laid for private bank development. Without a sound foundation, private banks too often have small deposit bases, dangerously low capital, corruption, insider lending and scams. Designed to serve the interests of shareholders, such banks offer few products and those mainly serve urban elites. When such an image prevails, a vicious circle undermines confidence in the viability of private sector banking, causing decision makers to turn back to public sector banks as solutions.

Government relates to private banks largely through the prudential supervisory authorities, using the framework of the banking law and bank regulations. This is where government should begin in seeking to develop private banks. It is often difficult to recognize the importance of strengthening supervision in systems dominated by public banks, which are typically not rigorously supervised, but developing supervisory capacity is a long process, and in some sense is a prerequisite for the entry of sound investors into the banking arena. Government must be particularly careful to give private banks a "level playing field" by withdrawing from monopoly positions that have often been given to government banks. For example, in some countries, government banks carry the government's implicit (or explicit) deposit guarantee, while private banks have none. Ideally, both should attract deposits on the basis of the soundness of their balance sheets.

IV. USAID's Role in Financial System Development

A. Statement of Principles

USAID supports the development of deep and efficient financial markets, affirming the contribution of the financial sector to economic growth. Within financial sector development, USAID pays particular attention to laying the groundwork for broad-based financial systems that serve the majority of the population, including low income people, and especially women. In pursuing these aims, USAID supports a financial system where markets are free of distortion, where independent financial institutions compete fairly with each other to provide better services, and where transactions occur at market-determined rates of interest and other terms.

B. USAID's Role in the Policy and Regulatory Framework

1. Political Will

Problems in financial markets are most often the result of a failure of political will. Before embarking on a significant program of assistance in mainstream financial sector reform (e.g., policy liberalization, bank restructuring/privatization, central bank reform, development of banking supervision), USAID should identify clear political will in support of reform, or at least a highly-placed and politically strong base for developing that will.

2. Macroeconomic Prerequisites -- "First Generation Reforms"

Before embarking on a significant effort in financial market development, USAID should evaluate current macroeconomic conditions, and be prepared to postpone involvement until reasonable stability is reached. In some cases, however, financial reform will be an integral part of an overall stabilization plan.

Elimination of financially repressive policies and achievement of basic financial sector liberalization should be considered "first generation" steps. Included in the first generation are the following: macroeconomic stability, interest rate deregulation, reduction of directed credit, strengthening of basic banking legislation and supervision, and the disentanglement of the financial system from government budgets (including the restructuring or privatization of state-owned banks and the elimination of government subsidies provided through the financial sector). These steps need to be secured before significant progress can be expected on "second generation" steps (e.g., development of sound institutions, markets and instruments).

3. Working with Multilaterals

USAID is unlikely to be a dominant force in financial market reform, given its constrained resources. This generally means that USAID must coordinate such activities with multilateral organizations, particularly the World Bank and InterAmerican Development Bank, which are seen as having the lead in this area. USAID should evaluate the plans of the multilaterals and determine whether it wants to support the basic thrust or perhaps seek to influence the shape of the plans. Decisions should be based on evidence of host country commitment to reform, as well as on judgments regarding the soundness of the multilateral's plans.

4. USAID Comparative Advantage: Provision of Specialized Technical Assistance

USAID can often make its maximum contribution to financial sector reform through the provision of specialized expertise. USAID has an advantage over multilaterals in the agility with which it can supply technical assistance. Moreover, U.S. expertise in the financial sector is widely recognized, respected and sought. Through well-placed technical assistance, USAID can be very supportive of a reform plan, or can offer a valuable second-opinion to counterbalance the voice of multilateral institutions.

However, a common pitfall is the presumption that the U.S. way of conducting the financial sector is the only way. Avoiding this pitfall is an essential consideration in the many countries where financial systems are based on laws/principles other than the Anglo-American model (e.g., Latin America, Eastern Europe, francophone Africa, and Islamic countries). USAID must be extremely careful to ensure that advisors it provides are able and willing to work with the host country framework. USAID should also recognize that it is often more effective (and cost-effective) to rely on experts from within the region, furthering South-South exchange of knowledge.

5. Focal Points: Central Banks, Supervisory Authorities and Legal System

When country conditions are supportive, USAID can make an effective contribution through focused technical assistance in the following areas: improving central bank functions such as the conduct of monetary policy, developing banking legislation, legal reform, and training and operations of bank supervisory agencies. These are all areas of strong US expertise where technical support has proved effective and where, as discussed above, improvement can have an important impact on the development of sound banking institutions.

C. USAID's Role in Mainstream Markets: Commercial Banking and Capital Markets

1. Basics First

In selecting which areas of financial sector activity to pursue, USAID must be cognizant of the current state of national economic and financial sector development, and should seek 1) to tackle the fundamental, basic services and institutions first and 2) to focus on extending services to the majority. These two criteria are not always compatible, but USAID should avoid working in areas where neither is met and should seek to identify areas where both are met.

Some of the implications of this statement are:

- Work on capital market development is unlikely to return significant value in the poorest or smallest countries.
- Development of the ability of financial institutions to supply short term credit and to support transactions (make payments) should come before development of longer term instruments.
- Development of government securities markets forms a foundation to the subsequent development of money and bond markets.
- Savings mobilization should always be considered a priority.

2. USAID Role in Bank Restructuring

USAID is not often in a position to take the lead in a major, multi-institution bank restructuring program. However, USAID has been effective in supporting the transformation of individual banks. USAID can structure support to reforming banking institutions through equity investment (granting funds to prospective owners), triggered by achievement of specific reforms. This capital infusion can be supported by long term technical assistance. Such transformations work only where the resulting institution has effective ownership, incentive and governance structures. No amount of technical assistance will transform a financial institution lacking responsible ownership and management.

3. USAID Comparative Advantage: Information Standards

USAID may be able to make significant contributions to basic banking by supporting the development of financial information: audit and accounting standards, financial disclosure

standards, etc. Again, the US has strong expertise in these areas, the cost of providing technical assistance is low, and the payoff to improving information standards is potentially great.

4. Training

Training of bank staff can be an important way to support financial sector development. The main cautions in training involve ensuring that the training is linked to reforms within banking institutions and ensuring that trainers fully understand and can speak to local conditions. Most banker training is done by banks for their own staffs, and USAID can often design training for internal use by individual banks. However, it must be clear that the recipient bank is committed to introducing the new way of working or new product, and is actively introducing systems to operate the new product. This will require top management commitment and ongoing involvement. Contributions to bank training institutes can be a good idea, especially in systems where there are many smaller banks or new entrants into the banking sector. The pitfall of U.S. experts offering training inappropriate for the local setting is especially common in banker training.

5. Venture Capital

Most donor-supported venture capital projects have failed to reach their potential. While venture capital is a better approach conceptually than directed credit, it will not succeed where country conditions are lacking. The requirements for successful venture capital are extremely rigorous: a good supply of potential projects, good financial disclosure and appraisal rules, strong contracts law, and sufficiently developed capital market to ensure exit options. Only the upper tier of USAID-assisted countries begin to meet these requirements. In addition, operating margins (overhead staffing costs) are often prohibitive, resulting in the need for ongoing subsidy. With grant funds, USAID is not in a strong position to structure incentives without over-subsidizing. The result is likely to be a relatively expensive project whose main output is a small number of business investments.

6. Capital Markets

In the upper tier of USAID countries, USAID has made significant contributions to the development of money markets and stock exchanges. Work at level of securities market legislation, exchange operations, development of auction systems for government securities, and introduction of new types of securities (e.g. corporate or municipal bonds) has all succeeded -- in propitious settings. In transition countries, capital markets development can be an important companion (or prerequisite) of privatization, including financial sector privatization. However, capital markets are generally very thin in low

income countries, because of lack of suitable companies, and therefore, the benefits are narrow. In those instances, capital market development programs fail the test of doing basics first and extending service to the majority.

D. USAID's Role in Expanding the Frontier

It should be clear from the discussion to this point that progress in expanding the outreach of the financial system depends on healthy financial institutions that can turn their attention to product innovation rather than attempting to sort out past crises. Accordingly, one must regard development of the legal and regulatory framework for the financial system and the creation of strong basic banking institutions as important contributors to expanding the frontier.

In the absence of a healthy financial system, work at the frontier tends to require specialized institutions, such as NGOs, credit unions, or specialized banks, that may operate in parallel with the mainstream system. Such organizations are often the only ones interested in serving markets the mainstream institutions have ignored. While work through such organizations can often result in the availability of services to new groups of people, such work should always be driven by a vision of a long run outcome in which the service becomes a sustainable part of the financial system, either because the specialized institutions become integrated with the mainstream or because the mainstream institutions begin emulating them.

1. The Old and New Views

The old approach to outreach assumed that the frontier was static. This often unrecognized self-limitation led to directed credit interventions, which offered bribes (through heavy subsidies) to financial institutions to serve clients they otherwise wouldn't. The focus of such projects was to funnel money to desired groups. This approach is now discredited for a variety of reasons, including its high cost, low outreach, and lack of sustainability.

Moreover, we now know that specialized markets can be served on a financially viable basis, given careful innovation in financial service design and delivery. The frontier moves. Governments and donors should confine their actions to supporting the up-front costs of innovation and demonstration, rather than setting up permanent substitutes for the financial sector. The centerpiece of any effort in this respect should be expectation that the effort will create (within a reasonable time frame) the capacity to provide a specific service on a fully private, self-financed basis. In this effort, it is crucial that as the frontier advances, donors must retreat, so as not to undercut the ability of

commercial institutions to offer a service profitably.

The current approach also emphasizes building the health of specialized financial institutions, so that they can join the mainstream.

2. Best Practice in Microfinance

The top-performing microfinance institutions have demonstrated that it is possible to serve large numbers of very poor clients (mainly microenterprises) on a profitable basis. The challenge in any microfinance program is to reach scale and self-sufficiency.

USAID can work with a variety of institutions (private or government banks, credit unions, NGOs, finance companies), provided they have 1) sound, businesslike operating principles; and 2) commitment to reaching micro-level clients.

Before establishing any microfinance program, it is important to ensure that USAID planners are familiar with current worldwide best practice in providing credit to low income people, standards for institutional performance, and methods for making the transition from donor support to raising funds commercially or through savings.

Consult the "Guiding Principles for Selecting and Supporting Intermediaries" (in reading packet) and the new USAID Microenterprise Policy Paper (now in near-final form, available from PPC) before designing assistance packages.

The core requirement in supporting microfinance institutions is to ensure that the organization has a credible business plan to achieve financial viability and independence of donor funding. Credibility is evidenced by past history, reference to other organizations of similar type, and regular performance benchmarks. Assisted institutions must have loan delinquency below 10 percent and must charge interest rates sufficient to cover their costs (after a start-up period).

3. Working with Credit Unions

Credit unions can be effective vehicles for reaching low and middle income people. Credit union systems had serious problems becoming viable financial intermediaries in the past. Typical problems included dependence on subsidized external loans, weak credit administration, high delinquency, governmental/political interference, low earnings and a poor public image.

Many credit union movements continue to face these problems. However, in an increasing number of countries, USAID has contributed to significant turnarounds in the

systems. A new, more businesslike model of credit union policy/operations has been developed and promoted, based on eliminating reliance on external capital, pricing savings and loans competitively, mobilizing deposits aggressively, controlling costs, and retaining earnings to build capital accounts. The jury is still out on this new model, but experience in several Latin American and African countries suggest that it is on the right track.

Given the importance of deposit-taking successful credit unions an essential prerequisite or integral part of a credit union assistance program should be development of a qualified, independent supervisory body. Local savings must be protected with transparent accounting and prudent financial management discipline, best assured by external supervision. Supervision by entities owned by credit unions or by entities mainly charged with oversight of cooperatives is at best a temporary alternative and in many cases has been ineffective. Bank supervisory authorities are preferable.

USAID should avoid placing credit lines in credit unions or any other organization capable of raising funds through deposits. External funding tends to undermine incentives for savings mobilization. The main form of assistance to credit unions should be technical assistance in financial management, deposit mobilization and marketing of services, governance and internal administration.

E. Structuring Assistance to Financial Institutions

1. Technical Assistance

Technical assistance is the most widely applicable means of supporting financial institutions, and in most instances should be the main focus of USAID programs in the financial sector. However, at the level of individual institutions (as well as at the policy level discussed above), technical assistance can only succeed if the leadership of recipient institutions are fully committed to making the changes technical advisors propose.

2. Lines of Credit

Lines of credit are generally counterproductive in financial sector development and should be avoided, particularly if funds are provided below market rates. Lines of credit simply increase funds available for lending by recipient institutions. Where banks are highly liquid, additional funds are not needed; where highly leveraged, additional funds may overstretch their capital base. By supplying funds, lines of credit undermine incentives for banks to mobilize deposits. Moreover, they are not generally effective at inducing banks to enter new markets and remain there. Typically, support to the target

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sector ends when the funds are no longer available. Lines of credit may make a short term contribution in funding a specific number of businesses. However, they often leave behind a financial sector less rather than more capable of serving the target market.

For NGOs without access to the formal financial system for raising funds, lines of credit may be useful, but should be seen as an interim step in a process leading to funding from within the financial system, through either borrowing or eventual deposit-taking.

3. Loan Guarantees

Loan guarantees are highly specialized: they change only one aspect of a transaction, its credit risk. Loan guarantees cannot be used to overcome other banking problems: liquidity risk, interest rate risk, or transaction costs. Thus, in considering use of a loan guarantee, the key question is whether the problem preventing a transaction from taking place is perceived risk. If credit risk is the central problem, the next question is whether experience with that type of transaction in a sheltered setting will reduce the perceived credit risk. In other words, loan guarantees can be a useful adjunct to innovation when the expectation is high that learning will occur.

Guarantees should virtually never involve coverage of the full value of a loan or other transaction. Risk should be shared between guarantor and funder. Even in situations where lenders are willing to take only a tiny proportion of the total risk, the expectation should be clearly stated that the proportion will increase steadily over time.

USAID officers considering loan guarantees should investigate the Economic Growth Center's Micro and Small Enterprise Development program, and either use that program or emulate its key features, such as partial guarantees, guarantees of portfolios rather than individual loans, streamlined payment mechanisms, guarantee fees, bank risk and business analysis, and banker training offered as a complement to the guarantee itself.

4. Equity

One way to strengthen financial institutions is to increase their equity base. Because banks are highly leveraged (ten to one or sometimes even more), small equity contributions can have a major effect on the financial services banks are able to provide. However, the US government cannot take equity positions in any enterprise. Thus, USAID can provide equity only by granting funds to some entity that will use them to become an equity investor. While feasible, this strategy is applies only when the prospective owners to whom funds are granted are capable and likely to act responsibly to maximize the value of the institution's equity. It is unwise to provide equity in the absence of assurance that the financial institution is governed and managed well.

Economic Growth Training Workshop

September 17 - 21, 1995

Volume II

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BIOGRAPHICAL DATA
PRIVATIZATION

JOHN ALLGOOD currently serves as Director of the Finance, Administration and Support Services Unit of the International Fertilizer Development Center (IFDC). With IFDC for twenty years, Mr. Allgood has extensive experience in evaluation and development of fertilizer marketing systems in developing countries and background in identifying and solving fertilizer marketing problems. This experience includes serving as deputy chief of party (and subsequently chief of party) and credit/dealer development and training consultant of USAID/Bangladesh's Fertilizer Distribution Improvement Project. Mr. Allgood received an MBA in Accounting from the University of North Alabama and a B.S. in Marketing from Florida State University.

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LAURA DAVIS is an attorney and real estate specialist with more than nine years of experience. Ms. Davis currently manages PADCO's USAID-funded technical assistance programs for land privatization in the former Soviet Union. In this capacity, Ms. Davis directs the Enterprise Land Sales Pilot and the Land Auction Demonstration Project in the Russian Federation. Ms. Davis has drafted legal documents for and managed resident advisors during Ukraine's first series of land auctions, has assisted in editing and publishing a "how to" auction manual based on these experiences, and manages land titling and registration, zoning, and national level legislative reform efforts in Ukraine. Ms. Davis graduated *summa cum laude* in Russian Language and Literature from Dartmouth College in 1982 and obtained her J.D. from Harvard Law School in 1986.

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PETER HAUSLOHNER is a senior political economist with over a decade of professional experience analyzing the politics, economics, finances, and foreign commercial relations of the former Soviet Union. He currently directs a program aimed at privatizing the pharmaceutical sector in Kazakstan. Recent assignments include: an examination of U.S. government financing of American equipment and service exports in Russia's oil and gas industries, and a study of U.S. government support of American investment in the pharmaceutical and medical device industries of Russia and the Ukraine. Prior to joining Abt Associates, Dr. Hauslohner served for four years as Senior Soviet Affairs Expert in the State Department's Policy Planning Staff and as special assistant to the first U.S. Ambassador to Russia, Robert S. Strauss. Dr. Hauslohner received his Ph.D. in Political Science from the University of Michigan.

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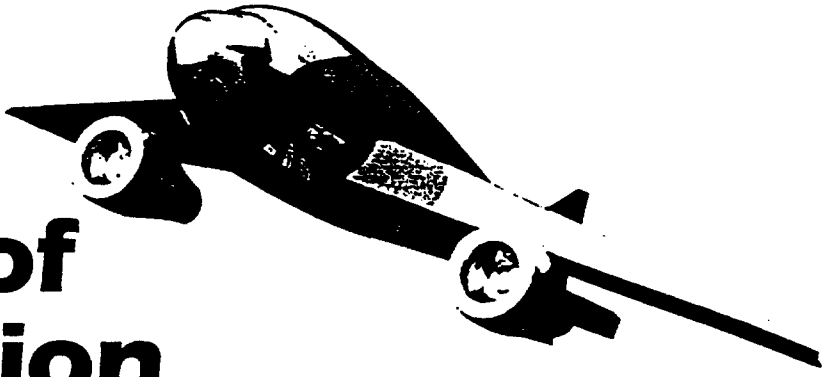
DAVID SEADER of Price Waterhouse L.L.P. is an urban planner and utilities privatization specialist with over 25 years of experience in privatization, public/private programs and partnerships, project finance, capital project planning, and development and financing experience in energy and infrastructure projects. Most recently, Mr. Seader served as Project Manager advising the Government of Grenada on the successful divestiture and privatization of its electrical utility, Grenada Electric Services, Ltd. For a variety of other clients he has undertaken economic analysis, financial structuring, project packaging, contract negotiations, feasibility analysis, investment presentations and project management. Mr. Seader holds an advanced degree in Urban and Regional Planning from Columbia University.

JAMES WADDELL currently serves as Partner-in-Charge of Price Waterhouse's Finance and Economic Consulting Group, which includes the Infrastructure Finance Group and the International Privatization Group. Mr. Waddell has 15 years of experience in infrastructure finance and privatization, including projects in the electric utilities, telecommunications, transportation, and water and waste sectors. Mr. Waddell has extensive international project experience including; advisory assignments involving power projects in Pakistan (Hab River) and Indonesia (Paiton), telecommunications companies in Nicaragua and Indonesia, toll roads in the

U.K. and Colombia toll roads, and airports in the U.S. and Canada. Mr. Waddell holds a Ph.D. (A.B.D.) and a Masters in Economics from Georgetown University as well as an advanced degree in Industrial and Labor Relations from Cornell University.

FRANK YOUNG serves as Director of Operations and Resource Allocation for the Asia and Near East Bureau. Mr. Young has been with USAID since 1976 and has served in the Philippines, India and Bangladesh. Prior to joining USAID, Mr. Young was on the staff of the House Majority Whip. Mr. Young holds a B.A. from the University of the Pacific and an M.A. and Ph.D. from the Fletcher School of Law and Diplomacy at Tufts University.

The Uneven Triumph of Privatization

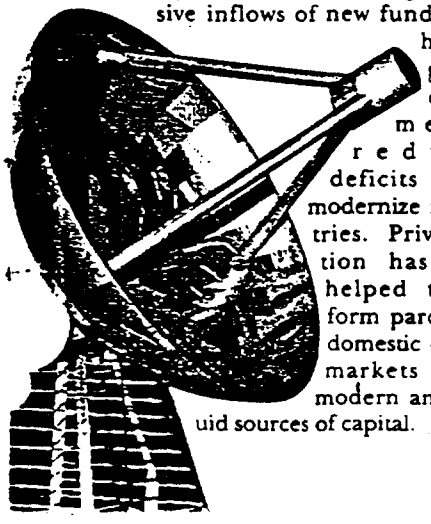


Privatization is here to stay. But its track record is better in some industries than in others.

By Sara Khalili

Driven by out-of-control government budget deficits, embarrassingly inefficient services and occasionally a deep-rooted commitment to reducing government's role in the economy, regimes around the world are pursuing an unprecedented wave of privatizations. "It is the extraordinary story of a phenomenon that started out in the 1980s. The great debate was how long it would last and whether it was durable. That debate is over," says Roger Leeds, a partner at KPMG Peat Marwick.

Since 1980, 80 countries have undertaken privatization programs and roughly 8,500 state-owned enterprises have been sold, generating $328 billion. In industrialized countries, privatization has helped create nations of shareholders while transforming bloated bureaucracies into lean and globally competitive private enterprises. In less developed countries, privatization has brought massive inflows of new funds and helped governments reduce deficits and modernize industries. Privatization has also helped transform parochial domestic equity markets into modern and liquid sources of capital.



In the following pages, *Infrastructure Finance* reviews three major privatization arenas. As a cornerstone of economic development, telecommunications companies have topped most governments' sell-off lists and promise to attract the most attention in capital markets for years to come. Airlines, on the other hand, plagued by heavy financial losses and years of poor performance, are budgetary burdens that remain difficult to sell. Meanwhile, efforts to sell ports — unprofitable yet strategic assets — promise to be politically charged.

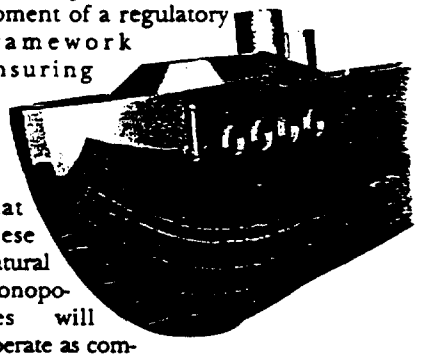
Telecom: The Message Is Loud and Clear

Telecommunications companies remain the hottest items in the global privatization market. Governments generated $102.8 billion from 20 privatizations between 1984 and 1992, and they expect to raise another $40 billion from future sales. Offerings will include Singapore Telecom, widely touted as the premier sale this year, as well as Deutsche Bundespost Telecom and Royal PTT Nederland.

Developing countries seek strategic investors with the deep pockets, advanced technology and managerial know-how to resurrect outdated systems. Industrialized nations continue to float shares on domestic and international capital markets.

Yet, telecom privatizations remain politically charged events. The government of Greece, for example, recently stepped up efforts to privatize OTE, the state telecom enterprise. With elections due next May, says one banker, the government is eager to offset revenue shortfalls by selling a 35 percent stake and management control in OTE by early September. Another 14 percent can then be floated on the Athens stock market by the end of 1993. The strategic stake could fetch Dr230 billion, while the flotation should bring in Dr90 billion.

The success of telecom privatizations hinges on the development of a regulatory framework ensuring that these natural monopolies will operate as commercial enterprises. "The investor community looks first at the regulations and at the risk of regulations changing or the regulator changing the economics of a company," says David Freud, director of Warburg Securities, global coordinator for the sale of the final tranche of British Telecommunications, plc (BT).



The successful privatizations of BT, Chile's Compania de Téléfonos de Chile (CTC) and Mexico's Téléfonos de México (Telmex) are attributable largely to the governments' painstaking efforts to create a regulatory framework that encourages competition, yet protects the companies long enough to adapt to a commercial set-

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ting. Regulators provided pricing mechanisms that protect consumers while giving BT, CTC and Telmex the financial resources to enhance their networks and generate profits.

In the U.K., BT operates under a price cap mechanism reset every four or five years for a basket of services. BT's regulatory environment is considered tough by international standards, but investors say it is clear.

"In the U.K., price regulations have been absolutely critical to new market entrants," says Elizabeth Hiester, telecommunications expert at the law firm of Clifford Chance in London. "Control on BT's tariff rebalancing has helped new entrants assess what pricing competition they can provide and the effect of these on revenues."

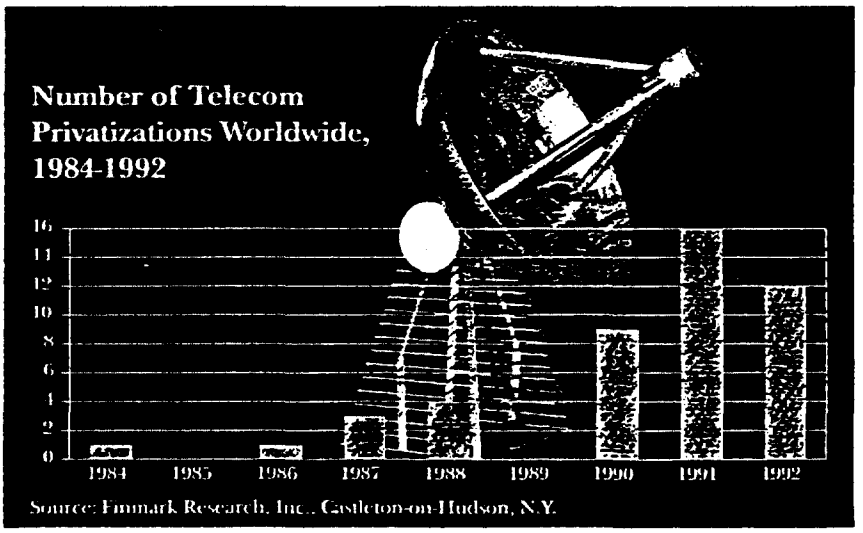
CTC's privatization also accompanied a five-year rate plan. After setting access-line growth targets to ensure future investments, rates were set to allow a 12 percent return with adjustments for inflation. Given its well-defined regulatory framework, CTC achieved a return on equity of 15.6 percent in 1991.

The lessons have been invaluable for the government of Hungary, which is preparing to privatize its telecom enterprise, MATAV. Michael Phair, a director of N.M. Rothschild who is leading the team advising the government, says Rothschild is recommending an indexing formula that would allow tariffs to be adjusted automatically over a number of years rather than be subject to annual negotiated settlements. "If there is a clear and transparent regulatory framework that provides a long-term assessment of tariffs and rates," he says, "one can assume there will be reasonable interest in the company." So far, the response to the initial sale memorandum for 30 percent of MATAV has been strong, he adds.

A regulatory structure, however, without a commitment to corporate reform and liberalization is not enough to guarantee success. The disappointing 1987 privatization of Japan's Nippon Telephone & Telegraph (NTT) best illustrates this. NTT shares that sold to the public in February 1987 peaked three months later, at ¥3.18 million. But they have since plummeted 82 percent.

"This is the classic case of shooting oneself in the foot," says Phair. "NTT was privatized into an uncertain regulatory regime both from a pricing and a competition perspective." According to Phair, the government erred by allowing an immediate increase in competition in the domestic long-distance area, NTT's most profitable business, rather than providing exclusivity while NTT rebalanced local and long-distance tariffs and adapted to a market setting.

Japan's Finance Ministry, which continues to hold a 65.7 percent stake in NTT, has battled the Ministry of Post & Telegraph, NTT's regulator, over rate increases for years. Post & Telegraph bureaucrats are determined to keep prices low. As a result, NTT is losing money in its local telephone business. To recoup losses, it charges long-distance rates about ten times those in the U.S. The government has put off selling additional shares in the company, and while new regulations allow NTT to list shares in overseas markets, the shares are unlikely to encounter great interest.



Meanwhile, the campaign to sell the British government's final 21.9 percent stake in BT, valued at $7.7 billion, is under way. To drum up demand and increase share prices, the government decided against the usual practice of giving brokers exclusive rights in different parts of the globe. For the first time in any privatization, 11 global managers will compete to sell shares throughout the world.

Telecom privatizations, especially in Europe, are rapidly creating a buyers' market. While some predict an oversupply of telecom equity, others, such as Warburg's Freud and Clifford Chance's Hiester, believe there will continue to be an insatiable appetite as long as revenue projections are credible and sustainable and the regulatory environment is stable.

Airlines: Keep Your Seatbelts Fastened

If telecommunications has been privatization's star performer, airlines have been one of the toughest assets to sell. Most are struggling to surmount volatile fuel prices, poor ticket sales, fierce price competition and continuing concern about terrorism.

"It's a horrible market for airlines. You can't make up a worse economic situation for a government to try to sell one," says James Silkenat, a partner at the New York law firm of Winthrop, Stimson, Putnam & Roberts.

Nonetheless, governments have so far sold 30 airlines and are hoping to privatize 55 more. The completed privatizations have been a mixed bag. It has worked well for British Airways (BA). Once a bloated and inefficient airline with a reputation for poor customer service, BA is now regarded as one of the most customer-friendly and efficient airlines. It is also one of the few making money, says Silkenat.

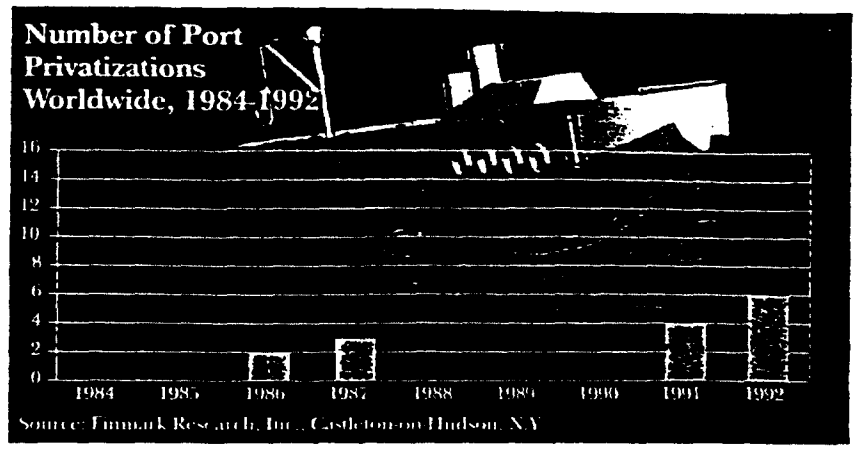
The success of BA following the sale of its shares in 1987 is attributed mostly to the strong new management that drastically reduced the labor force, slashed costs and put a strong emphasis on service, says Robert Poole, president of the Reason Foundation, a privatization think tank in California. On the other hand, Poole

says, the travails of Aerolineas Argentinas emphasize the importance of solid financing and the right alliance with a foreign joint venture partner in an airline privatization.

The botched 1990 sale of 85 percent interest in Aerolineas to Spain's Iberia and a few undercapitalized local investors has landed the airline in a morass of more than $1 billion of debt and $188 million in losses. Argentina's Transportation Secretariat estimates the company is losing about $30 million per month, up from $10 million in average monthly losses in 1992.

"The sale was a total disaster from the start," says professor E.S. Savas, director of the Privatization Research Organization at Baruch College. "The government made a few cardinal mistakes. The first was to sell the airline for payments to be made *mañana* rather than for more cash or substantial payments up front." The Iberia consortium, the only bidders, paid for the acquisition with $260 million in cash and $2.01 billion in debt. Soon all but two of the local investors abandoned the consortium, and disputes with Iberia over payment obligations forced the government to renationalize 28 percent of the airline. The second mistake, says Savas, was the government's willingness to create a domestic air travel monopoly. One of the buyers was a major shareholder in Austral, Argentina's only other main airline. He used Austral shares to pay for Aerolineas shares. Aerolineas ended up owning Austral.

John Baker, a director of privatization at Coopers & Lybrand, questions the sale of the airline to Iberia, itself a state-owned airline. "Entrusting a monopoly carrier to a company itself fully owned by a foreign state is against every basic goal of privatization," he says. Following several technical failures and accidents on Aerolineas planes, Iberia, with losses of $322 million last year, has been accused of neglect by government officials and labor unions.



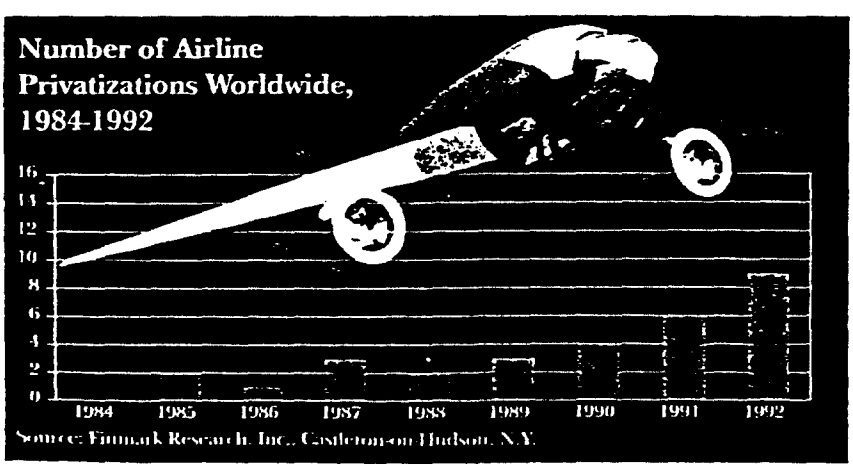
Aerolineas is likely to survive: but given the trends in privatization, many smaller carriers, often acquired for their routes and not their aging fleets, may soon disappear. That may be the lesson provided by the privatization of Air Panama. As of June of this year, its new owners, saddled with inherited debt and route problems, had yet to fly the aging fleet they paid $10 million to acquire in 1990.

"The notion of a 'qualified bidder' has escaped many developing countries' governments eager to divest of their troubled airlines," says Savas. Adds Mary Shirley of the World Bank: "For developing country governments, flag carriers are a luxury. In evaluating their privatization, one has to look at what that [sale] meant for the government budget and how it will use the proceeds of the sale, not necessarily whether the airline will survive a competitive market."

Flag carriers, however, are also a national status symbol. "The perception is that [airlines] are the crown jewels of a country," says Silkenat. "There are all sorts of emotions and ideas that go into these deals other than 'Who will pay me 50 cents more than the other guy?' " Even the privatization of Australia's Qantas, a competitive airline with the world's youngest fleet, seems to have been influenced by politics and national sympathies. "The government took three and a half years to decide on the privatization and has changed its policy on airlines and what can be an effective privatization vehicle half a dozen times," says Silkenat, who represented the government in the sale of 25 percent of Qantas to BA for $462 million.

Singapore Airlines' offer to acquire 20 percent of Qantas with the remaining 80 percent to be floated was not well received, some say, because the airline was a strong competitor in the Asia-Pacific region. Thus, the acquisition of Qantas may have been perceived as a sellout to a rival team. The decision to limit foreign ownership to 35 percent of Qantas was also determined by politics. "There is usually a lot of give and take as circumstances change," says Silkenat. "It's what you can get the majority of the people to agree to at a given point in time."

There are still many airlines left to sell. Storm clouds, however, line the routes for most. Until a cure for the ills of the industry is found, governments will continue to find it difficult to dispose of airlines at attractive prices, says Silkenat. "We are in chaos, and I see chaos in the future, whether



there is privatization or not."

Ports: The Newest Frontier

With the exception of the U.K., which privatized 19 ports in 1983, few ports have been privatized. But faced with the burden of subsidies and inefficiencies, 36 governments, including Mexico, Argentina, Brazil, Hongkong, Singapore and Venezuela, are looking to privatize the operation and management of their ports.

Many ports, however, have even worse balance sheets than airlines, and many political groups are even less eager to part with these assets, which they consider strategic to their national security as well as to their economic well being. KPMG's Leeds says of most ports, "They are a prime example of highly protected enterprises that are unprofitable and therefore will be a challenge to privatize."

As a result, port privatizations will be an incremental process, says David Haarmeyer of the Reason Foundation. Unlike telecommunications, where the rising costs of new technologies have been a major force in state sell-offs, he explains, port technology has changed less rapidly. Most privatizations have focused on container operations within ports, while ownership of ports remains in government hands.

"Governments don't like to transfer ownership of seafront for reasons of national security," explains Coopers & Lybrand's Baker, who is assisting the government of Mexico in its port privatization efforts. Baker explains that ports are likely to be privatized either as landlord ports, in which the private sector takes over operations under a long-term concession, or operated as tool ports, in which the private sector owns and operates heavy machinery and port equipment. Ports also are privatized as service ports, where ownership of the property is sold. These are likely to have little strategic value.

"One of the most important issues in port privatizations," says Silkenat, "is what the new purchaser will do and what sort of guarantees you can get that they will, in fact, make improvements at the port." It's also important to win the support of labor. Haarmeyer says, "Labor issues at ports are much more difficult and important than in other sectors since port operations are highly labor intensive."

TIM STRAWN

N.M. Rothschild's Phair: NTT's mistake was privatizing into an uncertain regulatory regime

In both respects, the privatization of Malaysia's Port Klang Container Terminal (KCT) was a success. In preparation for privatization, in 1985 the Klang Port Authority (KPA) incorporated the port as its wholly owned subsidiary and awarded it a 21-year license to operate the container terminal. A year later, KPA sold 51 percent of KCT shares to Konnas Terminal Klang — a joint venture of Kontenas Nasional, a Malaysian transport company, and P&O Australia Ltd., a container management company — for about $140 million. Legal problems with title to the land limited the sale to the port's equipment.

Since its privatization in 1985, there has been a 75 percent growth in container traffic at the port, which accounts for two thirds of Malaysia's containerized trade, and productivity has increased dramatically. "The privatization was a boon for labor as well," says Haarmeyer. All 800 employees were absorbed by KCT, which guaranteed employment for at least five years and promised to maintain the pension benefits accrued under KPA. Workers [illegible] targets were given merit pay. By 1990, compensation rates were 83 percent higher than in the public sector.

Nonetheless, few labor unions are likely to offer support for the privatization of ports. Some of the strongest opposition to the Mexican government's recent plans to privatize some 40 ports has come from stevedores and their unions.

Given the politically charged nature of the privatizations, the government of President Carlos Salinas de Gortari, whose term ends next year, hopes to advance the process to a point where future administrations will not be able to reverse it, says one financial adviser. It took only six months to ready the ports of Veracruz and Manzanillo for corporatizations and eventual privatization. The government is selling concessions for up to 50 years. While concessions will be valued based on future cash-flow streams, there is debate over how to regulate tariff structures. In all likelihood, says Baker, there will be a floor and a ceiling within which the port management can set its prices.

Although privatization is likely to increase efficiencies at Mexican ports, few are likely to find interested buyers. The greater the number of competing ports, explains Haarmeyer, the more difficult it is to find buyers. Of those that fail to attract investors, the smaller ports are likely to be turned over to local authorities, their current management or, in the case of fishing ports, to the fishermen.

Other ports around the world are likely to meet the same fate. "Many countries," says Haarmeyer, "suffer from an overcapacity of ports that oftentimes are subsidized and encouraged by governments to stay in business longer than they should or than is called for by market forces."

Shutting down unproductive and unprofitable ports, however, does not seem to be in the cards for many governments. "Much like the closing down of military bases in the U.S.," says Haarmeyer, "it will be an incredibly slow and political process as people are shown that there are better uses for some of these ports." ■

THE POLITICAL ECONOMY OF PRIVATIZATION: ASSESSING THE IMPACT OF THE FINANCIAL SECTOR ON THE ISSUES OF EQUITY AND EFFICIENCY

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SUMMARY

The political economy of privatization in developing countries is inevitably a complex and highly contextual one. Abasic element in assessing the process is to understand the role and structure of the financial sector. Governments generally state at least two objectives for their privatization efforts: economic efficiency of production through change of ownership and an equitable distribution of state-owned assets. The nature of the financial sector can determine in a significant way the conditions under which the goals of equity and efficiency are achieved. The author argues that the more market-oriented a country's financial structure, the less problematic the privatization effort is likely to be and the more transparent its political economy.

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INTRODUCTION

The political economy of privatization in developing countries represents a complex and dynamic pattern of shifting coalitions and changing interests. Some have argued convincingly[1] that privatization itself represents only a small part of larger and far more contentious structural adjustment packages. The degree of difficulty it entails, however, makes the process of privatization more sensitive, in many respects, to other adjustment measures which are largely "stroke of the pen" policy decisions.[2] Arguably, the privatization process involves a significantly less transparent set of elements which make its political economy both highly suspect and deeply controversial for many developing country populations. As with most economic policy adjustments, the processes of adopting and implementing privatization reforms remain highly contextual. In other words, the degree to which reforms are introduced successfully depends largely on the form and legitimacy of the government undertaking them, the nature of the reforms themselves, the strength of competing coalitions for or against them, and government's actual objectives versus its stated ones or those perceived by the public. A comprehensive study of the political economy of privatization would be lacking if it did not include those elements.[3] Likewise, the *type* of assets to be privatized itself is an important element in assessing the political economy of the action.[4]

Perhaps the most important components to understanding the political economy of privatization are the *nature, structure, and power* (both political and financial) of the numerous coalitions affected by any particular privatization action. To be sure, each of these components, in varying degrees, frames the context for privatization and each helps to shape the political economy of the process. Yet the key to understanding the political economy of privatization and its dynamics lies in understanding the composition, motivation, and influence of the groups which are most affected by the privatization decision. The political economy of privatization is, therefore, a complicated process, defined by a complex interlacing of technical, financial and political factors. In combination, the dynamics of the interactions between and among them determine policy successes or failures. Each of these multifaceted components is equally significant for understanding the complexity of the political economy which they form.[5]

This essay briefly reviews only one such component. It addresses, broadly, the potential contribution of the financial sector in shaping the political economy of privatization. Some have argued that the financial sector as a contributing factor to privatization's political economy and the usual "thinness" of capital markets is relatively insignificant.[6] While it is true that LDC stock markets are typically "thin" and not currently viable mechanisms for efficiently distributing equity, it is equally true that the broader financial system[7] is an essential element for successful privatization and meeting the government's goals.

The logic of the argument which charges the financial sector with a significant role in shaping the political economy rests upon one basic assumption. That assumption, supported by a significant body of empirical evidence, is that the "equity" of privatization is a central concern of government in structuring its privatization objectives. The "equity issue" is perceived by governments as critical either because of an ideological belief that the process *should* be equitable, or it emanates from an understanding that the political implications of divesting or

otherwise transferring assets (or control of state assets) to the private sector is divisive, polarizing, and creates rent-seeking opportunities which should be countered.

The thesis of this essay suggests that in most privatization activities in developing countries, equity[8] as well as economic efficiency issues drive the privatization process. Those issues tend to be an important, perhaps even central, preoccupation of government. The nature and scope of financial services for assuring equitable distribution and for establishing economic efficiency, therefore, can significantly influence government decision-making and alter the nature and direction of the political economy of privatization.

FRAMING THE EQUITY AND EFFICIENCY ISSUES

Governments endowed with the legitimacy bestowed by the governed, or governments that wish to develop it, are faced with a plethora of issues ranging from access to voting rights (as in South Africa) to constructing appropriate forms of representation (as we see in the Newly Independent States of the Former Soviet Union) to calculating the appropriate distribution of society's wealth. It is this latter category into which government's concerns about equity fall.

Developing country governments are presumed to be concerned about legitimacy partly because legitimacy imparts and is correlated with a degree of *regime sustainability*. Truly participatory democracies, for example, are inherently more politically stable than other forms of governance precisely because the principal-agent relationship is clearly structured where the governed (principal) have a direct effect on the actions of the governors (agents). The higher the level of legitimacy through public participation in choosing government, the greater the likelihood of regime stability. Therefore, governments are usually concerned to some degree about the impact of their decisions on the populations they govern. [9] [10]

In privatizing state assets, distributional equity is usually, if not universally, a central concern of government. For example, Costa Rica's privatization process of the CODESA state-owned enterprises, which began in the early 1980s, has centered on the distributional question for nearly a decade. The Costa Rican government has been concerned about diffusing the concentration of wealth in its society, eliminating monopoly power, and establishing an opportunity for the equitable access of its citizens to state assets. In 1972, Costa Rica's government adopted Law 5122 establishing CODESA as the holding company for parastatal industries, stating as its objective the strengthening of Costa Rica's private sector. Under the administration of Daniel Oduber (1974-1978), CODESA grew rapidly because it had unchecked loan access to government-subsidized credits. CODESA quickly became an instrument for poorly conceived and badly managed government investment projects. By 1984, CODESA's borrowing from the Central Bank accounted for over one-third of the Costa Rican government's entire public sector credit while contributing only 1 percent of the nation's GDP and less than one half of 1 percent of the country's employment. Its accumulated losses exceeded US $105 million. By 1985, CODESA's holdings consisted of 30 subsidiaries (owned 51 percent or more by CODESA) and 12 affiliates (owned 50 or less by CODESA).

In June 1984, due to mounting budgetary constraints, fiscal losses and pressure from international donors, Costa Rica's government

agreed to develop a divestiture strategy for CODESA. To begin the process a new law was required which eventually culminated in the enactment of legislation entitled The Law of Financial Equilibrium for the Public Sector [Law 6955] of 1984. In 1985, donor resources began to support CODESA's divestiture effectively starting Costa Rica's first major privatization of state enterprises. By April 1993, only four CODESA holdings remained out of an original 42 companies. The divestiture or liquidation of the 38 companies was planned and executed by FINTRA, a U.S. Agency for International Development-financed trust (not unlike the U.S. Resolution Trust Corporation but on a much smaller scale). In 1991, to complete the privatization process, FINTRA, acting as an advisor to the government, had drafted a new bill removing the remaining legal obstacles to completing CODESA's divestiture. The bill was adopted by Costa Rica's legislature in February 1993 and signed into law by President Rafael Calderón in March, adding the final page to a costly CODESA saga after substantial and contentious debate over methods to assure distribution to producer cooperatives, small shareholders and other Costa Rican interest groups.

While reducing fiscal deficits and curtailing future losses was the primary *technical rationale* which motivated Costa Rica's privatization, the government's overriding *political* concern was the *equitable transfer* of state assets into private hands. It was this issue around which Costa Rica's political economy of privatization was formed. The country's privatization decisions were shaped by a *political* preoccupation over the nature and extent of distribution. As a "legitimate", representative government, it was (and is) difficult for Costa Rica's political leaders to enter the privatization debate without the *equity* issue becoming a central theme in their proposals.[11]

The degree of government legitimacy and the effectiveness of the country's representational system, in large measure, will establish the level with which the equity objective enters into the political economy mixture. The higher the degree of government legitimacy, the greater its concern for equitable distribution and general welfare of its citizens. The greater the government's emphasis on citizen participation in privatization, the more important the role of the financial system becomes in framing its political economy, as will be discussed later in this paper.

Another facet of the equity objective is the degree to which equity played a role in the formation of the state's enterprises in the first place. For example, governments with socialist sentiments in the process of converting to market-based economies have been accustomed to framing every argument in "equity" terms.[12] Leaders in transitional economies point to the failure of past ideologies where, in order to "assure equity," the state owned and managed all production for the benefit of only a few but to the ultimate disadvantage of all. As socialist ideology is rejected and the transition to newly emerging market systems begins, "the economic efficiency objective" is now cited as the predominant justification for privatization actions.

Yet in the transition process the opportunity for equitable participation of the public in state-owned enterprises continues to be problematic and is a concern of government. The newly emerging market economies, for example, go to great lengths to preserve equity participation. Privatization schemes are carefully designed to assure some level of popular distribution of equity.[13] On the other hand, governments which have been largely market-based in historical terms (e.g., U.K., U.S., and Canada, etc.), while strongly citing "efficiency grounds" and "limiting the role of the state" as privatization rationales, are

equally likely to focus on equity issues. In a market-driven system, however, an infrastructure has been developed and has evolved to a level of sophistication where a "market economy" and the price system it employs act as the clearinghouse to ownership distribution. Citizens have equal opportunity to access information and capital resources. Appropriate government intervention prevents market failures, discourages monopolistic control through suitable levels of regulation, and reduces information asymmetry between the market "insiders" and the general public. Essentially, the equity objective is intrinsically problematic to the privatization process *regardless* of the past ideology of the state.

Less contentious is the economic efficiency objective. It can be perceived and debated as a "neutral" [14] policy goal and is therefore used as the vanguard or overarching and more transparent privatization objective. However, as some analysts have suggested, ideological beginnings of state enterprises can be important determinants of the environment and contexts in which privatization is attempted and for understanding the various limitations imposed by past predilection for achieving both the equity and efficiency objectives.[15] More important to the privatization process and certainly to the nature of its political economy is the general preoccupation of governments with *opportunity* for equitable access to assets which are perceived as "belonging" to the public. Overlooked as an important factor in determining privatization's success, a functioning financial sector can contribute significantly to a solution for governments seeking to broaden public access to meet equity objectives and in providing transparent and appropriately valued transactions to meet economic efficiency goals.

THE ROLE OF THE FINANCIAL SECTOR

How does the financial sector contribute to meeting a government's concern regarding economic efficiency and providing opportunities for equitable participation? If "equity" and "efficiency" are fundamental privatization objectives of government as the premise of this essay suggests, then the next step is to explain the financial sector's role in influencing the political economy of the privatization process, and consequently, in creating the *opportunity* for equitable and efficient participation which governments seek. An often overlooked or misunderstood aspect of the political economy of privatization is that the structure and effectiveness of the financial sector can be essential to the sustainabililty and effectiveness of *both* objectives of equity and efficiency,[16] whether governments want to assure fair opportunity to own assets or simply to provide equal ownership to all. It should be remembered that a relatively simple change in ownership of a productive enterprise itself is not sufficient to assure that *equitable participation* has occurred or that economic efficiency will result. For example, widely disbursed ownership can dilute management control which affects the nature of the principal-agent relationship between the firm and its owners. Conversely, excessive concentration of ownership can lead to monopoly abuses which deny both efficiency of production and equity of participation. To achieve the equity objective, then, a functioning financial sector can play a valuable role in *defining* the privatization process: for it is the financial sector that ultimately establishes the mechanisms and wherewithal that provide the opportunity for citizens to participate fairly in a privatization action.

It is also financial services which can assure

economic efficiency through market-determined valuation for share prices in the broader, macro level and for production inputs on the factory, micro level. Financial sector services provide *access* to capital resources for the general public, create alternative investment options, and help the investing public weigh the risks and the opportunity costs of financial decisions. Conversely, the absence of a functioning financial sector erodes the government's ability to provide its citizens with the opportunity to participate in purchasing shares because, by its absence, it limits access to resources to only those with accumulated wealth.[17]

Even if shares are distributed freely to each citizen or vouchers are provided to each individual in the hope that the piece of paper (which represents ownership) fulfills the government's equitable distribution concern, the absence of a freely functioning financial system which intermediates transactions between shareholders and would-be shareholders (sellers and buyers) will severely limit participation. The lack of capital markets impedes efficient transactions.[18] Capital market intermediation reduces the costs of transactions by efficiently identifying buyers and sellers, expediting transfers and providing information about the underlying value of the assets. The broader market-based financial sector, of which capital markets are an important part, provides the opportunity for equitable access to the general public for participation in a privatization action because it creates a *basis for competition* for assets (bidding), establishes the *appropriate prices for capital,*[19] and provides *liquidity to individuals* to meet their investment (borrowing) goals.[20] Privatization is the process through which ownership is changed to achieve greater goals of efficiency and equity. Yet, it is the *introduction of competition* into the equation which forces efficiency, *not* the change in asset ownership. A functioning market-driven financial sector establishes the mechanisms for capital competition and, hence, forces efficiency, both in allocating ownership of the means of production and in the production process itself.

As Goldstein and Gultekin point out, privatization is the re-establishment of the links of factors of production to capital markets and a change in ownership from public to private hands. Changing only one of these factors, however, will not necessarily achieve either the equity objective for fair participation in owning assets or appropriate linkage to the financial sector to assure efficient valuation. Transferring ownership through the purchase of state-owned assets by the private sector will not help to meet the efficiency objective if, for example, the price system is determined by government edict, *uncompetitively,* rather than by market forces. Under such a circumstance, the information about the real value of capital assets, as well as the underlying value of any security, would not be truly reflected in their prices. Therefore, an efficient basis for the general public's determination of appropriate value of opportunity costs and returns, or allocative decisions, is distorted by uncompetitive, government-imposed signals.[21]

Success in achieving the government's objectives will be difficult to obtain in the absence of market-based pricing mechanisms. Without the opportunity for the market to assess the true value of the underlying security of a state-owned enterprise, without the institutional mechanisms to shift ownership shares competitively with minimal cost, and without adequately regulated, accurate, and timely disbursed information, both the opportunity for participation and a shareholder's capacity to fairly determine underlying values will be seriously constrained. Hence, if equitable participation and efficiency are truly the main objectives of the privatization process, then the opportunity to achieve them is

greatly enhanced within a market-based financial system.

IMPACT ON THE POLITICAL ECONOMY

> *A prime U.S. objective is liberalization of services, which would allow supranational banks to displace domestic competitors and thus eliminate any threat of national economic planning and independent development. The agreements impose a mixture of liberalization and protection, designed to keep wealth and power firmly in the hands of the masters of the 'new imperial age'.* [Chomsky, 1993, p. 414]

Privatization is a tool of government, *a means to an end,* ideally characterized by increased production efficiencies and equitable participation in ownership. Yet in writing about the North American Free Trade Agreement, Noam Chomsky at once demonstrates the fear surrounding decentralization of financial services and the rhetorical ideology of the political economy surrounding privatization of the financial sector. If anything, the liberalization of services seeks to *disburse* wealth and power in order to introduce competition as the basis for efficiency.[22] True competition requires financial markets to function as a price and information transmitter.[23] In order for a market-based price system to work, however, markets must be free to determine prices while capital must be accessible and available to support the investment decisions of individuals. Without a functioning, market-based financial structure, the valuation system breaks down. It breaks down because the signals for prices are determined by non-market, government interventions which are motivated by short-term priorities in which decisions are characterized by political rather than technical criteria. The liberalization of the financial sector to which Chomsky refers shifts the Mexican political economy by introducing competition into its nationalized financial system. The privatization of Mexico's banking system has, in its own right, altered the political economic landscape by ceding a degree of government control to private hands, increasing competition, and thereby forcing efficiency. It has also shifted control of the financial sector and its resources to the private sector.

The nature and extent of control of the privatized enterprises is itself an issue in the political economy (which groups or individuals get what benefits).[24] The existence and appropriate functioning of a financial sector, including the development of a capital market, can make the privatization process efficient and meet the objectives of both equity and efficiency. However, government's reluctance to relinquish or otherwise dilute its authority over financial services in favor of a freer market inhibits and may even prevent efficient privatization *even though* by decentralizing its control, introducing competition, and freeing market forces, government's stated privatization objectives of equity and efficiency would be better served. Maintaining control of financial sector functions, however, is often perceived by government to be so much more important to other areas of governing that it is unlikely to restructure the financial sector primarily for the purpose of facilitating privatization objectives.[25] This paradox underlies privatization's political economy.

The levels at which financial markets operate, therefore, affect the political economy of privatization in both obvious and diffuse ways. First, the *opportunity* for the general population to access capital and thereby participate fairly in

ownership opportunities is affected by the nature of financial markets. The state of financial services is a defining element of privatization's political economy because accessibility and availability of those services either favors or discriminates against different groups. The greater the monopoly position of the sector (by government or the private sector), the higher the rent-seeking opportunities and the more restricted the access to resources. Therefore, understanding the nuances of how the sector functions should be an important policy issue for governments when designing a privatization program. Second, the level of sophistication and operation of financial markets largely determines the *efficiency and equity of transition* from inefficient state-oriented models of equity distribution to a model where individuals determine their own consumption and investment patterns. Third, financial market operations can either restrain or encourage the disposition of shares in productive assets. Distributional impacts are important to efficiency and require a balance to avoid the extremes of monopoly, on the one hand, or lack of management control because of too many owners, on the other.[26] Finally, the basic lesson is that when the financial sector becomes, to a greater extent, an agent of the government rather than a duly-regulated agent of the marketplace, the political economy of the process changes in ways which can inhibit efficient and equitable privatization.

CONCLUSIONS

This essay has argued that the political economy of privatization in developing countries is inevitably a complex and highly contextual one even within the relatively broad framework defined for this discussion. One basic element in assessing the process is to understand the role and structure of the financial sector. In framing the argument, the essay's thesis has assumed that governments generally state at least two objectives for their privatization efforts: economic efficiency of production through change of ownership and an equitable distribution of state-owned assets. One important but frequently overlooked component to the relative success or failure in meeting the government's privatization objectives is the nature of the financial sector which can determine, in a significant way, the conditions under which equity and efficiency are achieved.

Economic *efficiency* in production is an important objective of privatization as governments struggle to reduce expanding fiscal deficits. The efficiency objective, however, is achieved by the *introduction of competition* and relies upon, as its motivating force, the incentives conveyed by changing vested interests (ownership) from the public sector to the private sector. Selling government assets to the private sector can be relatively easy, but the transference of ownership alone is not likely to achieve the efficiency objective. If the financial sector is responding to predominantly government-dictated priorities rather than market-based ones, inefficiencies will still persist and the new private owners of the enterprise will face many of the same constraints to efficiency as the past government owners encountered. When interest rates are not reflective of real capital costs, when politically motivated lending and borrowing is the norm and absence of capital markets cause high transaction costs, then a change in governance of the firm from pubic to private hands will not resolve the economic efficiency of production. Perhaps government's deficit will be reduced as subsidies to the previously state-owned firms disappear, but the basic, overall inefficiencies in production will likely remain high.[27]

The *equity* objective of the privatization process is an equally powerful element in understanding

the political economy of privatization. The perspective that all its citizens should have an opportunity to share in the ownership of state-owned assets is an often stated goal especially in the newly emerging market economies, which complicates the process of divestiture. Legitimate governments view the opportunity for equitable ownership as a primary responsibility and rightfully so. However, the equity objective can also be helped or hindered by the financial sector's operation. An inefficient financial system, which is usually characterized by high government intervention, restricts individual investment decisions. It does so because the pricing signals for determining the real value of assets and opportunity costs of alternative investment are distorted. A highly interventionist state system also discourages market signals regarding the allocative efficiency for capital resources. Lack of capital markets inhibits transactions between borrowers and sellers and drives up the costs of information. Absence of timely and accurate information regarding the underlying assets of the firms to be privatized is yet another result of the failure of a state-dominated financial system. Each of these factors is important for assessing the political economy of privatization and in structuring a privatization strategy.

The political economy of privatization, therefore, is intricately linked to the behavior of the financial sector in which the privatization is undertaken. The precise manifestations of the political economy, however, depend upon the complex mixture of the *nature and legitimacy* of government, its stated versus its implicit objectives, and the degree to which equity concerns are balanced with efficiency goals.

In essence, the lack of a market-oriented financial system can frustrate government privatization objectives by increasing the opportunity for economic rents. In its absence, relevant and timely information is unavailable, transaction costs are excessive and state monopolistic practices in the financial sector promote economic distortions. The more market-oriented a country's financial structure, the less problematic the privatization effort is likely to be and the more transparent its political economy. Conversely, the greater the degree of monopolistic or oligopolistic control and manipulation (by the state or private sector) of the financial sector and the further its distance from competitive market forces, the more contentious, diffuse and obscure the political economy of privatization is likely to be.

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ENDNOTES

1. See Bienan and Waterbury, "The Political Economy of Privatization in Developing Countries," *World Development.* 17:5 (1989): 617-632.

2. The adoption of a crawling peg devaluation policy, for example, a typical stabilization measure, simply requires an administrative edict to be effectively adopted and implemented. Additionally, many "stroke of the pen" policy adoptions can claim to be "neutral" because the total economy is affected in the same way; i.e., local currency loses its purchasing power relative to foreign exchange. Different interest groups will obviously benefit more or less from a devaluation, (i.e., exporters gain, importers suffer) but the transparency and apparent "technical neutrality" of the decision can help to earn support and sustain the reform. The privatization process cannot make such a claim.

3. For example, the decision-making process for privatization undertaken in a totalitarian regime is usually different than one carried out within a democratic one. In the former, government edicts and favoritism usually dominate the process while in the later, public sentiment and interest group influence are publicly debated. The legitimacy of the reform-adopting government, therefore, can play an important role for both privatization as a policy option and in its sustainability through either public support or public opposition.

4. For example, privatization of the education system is distinctly different and far more complex and potentially divisive then say, the privatization of a cement factory.

5. In a sense, privatization is a political process *first* with economic and social consequences rather than the reverse. This is not to imply that economic and social rationale are not the motivating and driving objectives of privatization. Economic efficiency and equity are often government privatization objectives. Rather, the success of the privatization process depends first on the political will to undertake it and the nature of the coalitions which form in support or against it, which is often difficult to anticipate.

6. For example, Bienan and Waterbury (1989) comment that "...By and large,...the stock market is not likely to be a major vehicle for implementation of privatization in LDCs..." (620).

7. The" broader" financial system is taken to mean those services of intermediation which provide access and availability to capital, savings options and other services. It also is taken to mean prudential regulation and supervision which protect investors, mandate transparency in transactions, and which reduce asymmetry in information dissemination.

8. In some notable cases, such as Korea, Brazil and Chile, inter alia, "equity" was not the main issue but the main excuse for privatization.

9. Granted, this description may not account for the behavior of *all* regimes in *all* developing countries but its premise is sufficiently applicable to establish an argument for demonstrating the significance of the financial sector in determining the political economy of privatization.

10. For example, in Pinochet's Chile, it is unlikely that "equity" concerns played a major part in determining that country's privatization decisions. In fact, if distribution of assets was discussed at all in terms of equity, it was most likely centered around which of the select private sector groups would be eligible to access state assets rather than a concern about the welfare effects of distribution on the general population.

11. For an elaborate and interesting analysis of Costa Rica's privatization process from 1972-1993, see *CODESA: Origen y consecuencias* (1993, San José: FINTRA).

12. After all, Marxist socialism was based upon an ideology which believed that, "To each according to his need. From each according to his ability." In other words, everyone is entitled to what they require as determined by the "state" (equitable distribution) and, in return, to contribute to society what they could. The neo-liberal ideology, with apologies to Marx, might be summarized by the following: " To each according to his productivity."

13. Voucher systems, mutual funds, or simply giving every citizen a equal share are three commonly employed methods in the newly emerging market economies of Poland and Russia.

14. In this context, "neutral" is taken to mean that the effect of economic efficiency is broad-based in its impact rather than implying that there is no effect at all.

15. See Bienen and Waterbury (1989): 623-624.

16. It should be noted that the "*opportunity* to share" in privatization is not the same thing as "*assuring* equal and full" participation of the public. The two concepts are distinctly different. In the first, opportunities for broad-based participation can be created, but require functioning intermediation systems and developed infrastructure such as stock markets, financial instruments, regulatory agencies, and open information flows. Under this scenario, the likelihood for *equal opportunity* to participate in a privatization action is heightened if not assured. Rather than altering existing structures or creating new systems to provide *access opportunity* for all citizens, the second concept relies instead on designing methods *which assure* equal ownership for all citizens through mechanisms such as direct distribution of shares or a voucher system. In fact, methods which seek to "assure" equitable ownership may not be either equitable or efficient.

17. Wealth in developing countries is often concentrated among elite groups that can rely on their own resources. Capital can also enter from abroad by foreign investors which generates a different set of issues.

18. See Goldstein and Gultekin, (1992): 1-6. Without "thick" capital markets, transactions costs for individuals are excessively high. High transactions costs are the result of the lack of information about who wishes to sell and who wishes to buy. More importantly, transactions costs increase without a functioning capital market because the costs of obtaining information about the underlying securities themselves are extremely inefficient.

19. For example, interest cost of borrowing money versus the future expected value of investment returns of equity shares, (both in capital gains and in dividend) can be evaluated by potential investors.

20. Of course, a state-dominated financial system could provide the same services to the general public. However, state owned systems are notoriously inefficient because of asset allocations largely made on politically motivated criteria rather than based on market criteria confusing principal-agent relationship (see Aharoni, 1982). The market's pricing mechanism quickly becomes distorted because of government-mandated credit limits, directed lending schemes, negative real rates of interest and fixed exchange rates, etc. Ultimately, the general population is disadvantaged rather than helped through higher rates and poorer service and unsustainable government deficits. See also Von Pischke, *Finance at the Frontier (*World Bank, 1991).

21. Functioning, market-based financial structures, on the other hand, signal *allocative* and *production* efficiencies to the market. The *production* efficiencies of firms can frequently adjust to distorted markets by changing to a new point of tangency on the production curve. Allocative efficiencies which indicate macro-level scarcity, however, become distorted with government intervention, regulation and political manipulation.

22. Economic liberalization policies, by definition, reduce rent-seeking opportunity by forcing competition. Liberalization policies are designed to break up inefficient monopolies, lower tariff barriers, and introduce a rational exchange regime into previously "protected" economies. In so doing, power among coalitions is

redistributed as vested interests shift while opportunities for generating wealth by a larger and different segment of the population are created by introducing a more "level playing field".

23. For example, it is implicit in market-based economics that opportunities are produced by demand and supply with the price mechanism acting as the filtering system and the signal for changes in levels.

24. The "control" of the financial sector is, therefore, a key element to understanding why governments often resist financial sector restructuring. The reasons lie in the principal-agent relationship between government and the financial sector. Which groups benefit or lose when interest rates are raised to reflect real costs of capital? Who gains when prudential supervision regulates equity trading, or when allocation of banking resources is left to the discretion of the private banks rather than Central Bank edicts? What groups profit from opening the country's capital account and competition is introduced for both capital and information services?

25. Financial sector control by many LDC governments is viewed as critical to managing the economy. Governments dislike relinquishing their authority over capital flows, over direct lending to politically privileged or economically disadvantaged groups and over interest rate manipulation.

26. The issue of the principal-agent relationship and transaction costs can easily overwhelm any potential efficiency gains which the transfer of ownership from the state to the private sector may have conveyed according to the Capital Asset Pricing Model. Ideally, there is an *optimal* number to distribution of shares of company. 100% ownership by a single individual should be avoided but so should over dispersion of shares which limits effective management control because of lack of sufficient vested interests. See Goldstein and Gultekin (1992): 6-21.

27. While production efficiencies will improve somewhat with the transfer of ownership as the new private owners change the production function to meet domestic economic realities, the basic imbalance in *allocative* efficiency in the overall economy created by distorted government policies which affect interest rates, credit allocations, lending mandates, and monetary policies, etc. will limit the efficiency improvements that individual managers can make in their production.

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Mitigating the Social Impact of Privatization

Prepared for the U.S. Agency for International Development
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Office of Economic and Institutional Reform

under the Privatization and Development (PAD) Project

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MITIGATING THE SOCIAL IMPACT OF PRIVATIZATION

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PREFACE

The research paper "Mitigating the Social Impact of Privatization" was undertaken by SRI International under the Privatization and Development Project (PAD), funded by the Office of Emerging Markets under USAID's Bureau of Global Programs. SRI International is a subcontractor to Price Waterhouse under this project.

The goal of the paper is to provide to policymakers and the donor community an analytical framework for approaching social safety net issues within the context of privatization. It also presents possible short-term approaches to accommodating welfare considerations in privatization strategy and planning, and discusses several long-term social safety net considerations related to privatization.

This paper does not prescribe long-term social safety net systems for countries undergoing privatization, nor is it intended to ascribe specific roles for donor agencies in efforts to address the social impact of privatization. Rather, it is designed to set forth the social issues related to privatization, particularly those involving labor, and to present alternative approaches for addressing these important but often neglected issues.

This paper was prepared by John Mathieson, Ophelia Yeung and John Normand of SRI International. It also draws upon some of the factual and analytical materials presented in "Mitigating the Short Term Negative Impacts of Privatization: Compensatory Programs During Economic Transition" by Diana Deen and Tyler Holt of the Price Waterhouse Privatization Group in January 1994.

I. INTRODUCTION

Privatization is now one of the key forces driving economic reform throughout the world. The principal arenas of privatization initiatives are found in developing countries and especially in transitioning economies of Central and Eastern Europe, but privatization is truly a global phenomenon. Western European nations such as the United Kingdom, France and Italy have privatized major state-owned enterprises, as has Japan, and even the United States is facing this issue in the form of defense conversion and the commercialization of military facilities and national energy laboratories.

Defined broadly as the process of transferring ownership and management of government enterprises from public to private hands, privatization is an accepted and common component of economic reform. As proven by solid empirical evidence, state-owned and operated enterprises (SOEs) are with few exceptions managed less efficiently and profitably than their privately-owned counterparts. Therefore, most SOEs inevitably become a fiscal drain on governments. Perhaps more importantly, as a result of subsidies and preferential treatment provided to them, SOEs create significant misallocations of resources and retard the growth of viable private enterprises.

While simple in theory, privatization is a highly complex operation involving assessments of business viability, financial analysis and asset valuation, corporate restructuring, share distribution and other important procedures. While not a completely new phenomenon, privatization has recently risen sufficiently in scope and importance to generate a rapidly growing body of knowledge on these business processes, leading to improvements in the application of privatization techniques.

One major issue that has not been addressed adequately is the subject of economic and social dislocations caused by privatization, and the need to focus greater attention on means to ameliorate these negative impacts. That is the subject of this paper.

Few can dispute the fact that transferring control and ownership of productive capacity to private enterprise yields the benefits of increased efficiency, accelerated productive investment, and improved allocation of resources, and enhanced competitiveness. These gains in turn translate in more rapid and sustainable economic growth and improvements in per capita incomes and standards of living. This is the central logic and motivating force underlying privatization initiatives.

Notwithstanding the clear benefits of privatization -- which far outweigh the costs -- costs are nonetheless borne, mostly in the form of dislocation. Most state enterprises employ too many people, and so private managers of privatized firms must often reduce labor rolls in order to achieve and maintain commercially viable operations. Those who are laid off then pay the price of transition or "adjustment." This price is not limited to the elimination of wages and salaries, but also includes social benefits provided by their former government employers.

The issue of social safety nets associated with privatizations is important for at least three reasons:

1. The provision of assistance for laid off workers is intrinsically important under any circumstance as a matter of social and economic justice.

2. Unlike most Western industrialized nations, most developing and transitioning economies do not possess systems which offer social services and financial assistance to redundant workers, many of whom depend heavily on their government employers.

3. The absence of transitional assistance, either actual or perceived, will almost certainly lead to strong opposition by unions and work forces to privatizations, perhaps to the point of halting the transaction completely.

This report begins in Chapter II by examining the social impacts of privatization. Some of these effects are felt at the macro-economic level, but most are associated with labor force downsizing, which are felt at the level of the firm (the "micro-economic" level). While the focus will be placed on firm-level social impacts, certain macro-level social impacts will be addressed briefly. Chapter III focuses on the need to address negative social impacts. Drawing from actual experiences, Chapter IV explores alternative strategies and options for dealing as effectively as possible with social impact issues. The report concludes in Chapter V with a discussion on longer-term social safety net considerations related to privatization.

II. THE SOCIAL IMPACTS OF PRIVATIZATION

All economic activities and initiatives have social implications which are often ignored or downplayed. For purposes of this paper, "economic" is defined as relating to the allocation and management of productive resources. Privatization is hence an economic process, in that productive assets are transferred from public to private hands. "Social" in the context of this paper refers to effects on the welfare of individuals within an economy.

As with other economic restructuring strategies, the effects of privatization, both economic and social, are felt at several levels. At the macro-economic level, **fiscal impacts** and **consumer price effects** may be felt across the population, as can changes in **income distribution** and **national ownership/patrimony**. At the industry and regional level, privatization can affect **inter-industry relationships** and **the environment**. On the micro-economic level, the most direct social impact of privatization is usually related to **labor force downsizing**. Particularly in the cases of former communist countries, privatization also brings workers **uncertainty with regard to social services** formerly provided by state-owned enterprises.

A. Fiscal Impacts

The proceeds from privatization, viewed by most governments as additional revenue, often provide immediate and significant fiscal benefits. Even in instances where privatization proceeds to the government are deferred, they are usually guaranteed by financial institutions and represent additional fiscal resources for the government. In the case of unprofitable or loss-making enterprises, privatization also helps to rid the government of present and future liabilities incurred through the subsidization of the operations of these firms.

The immediate and often sizable fiscal gains from privatization can be redirected toward programs and policies to accelerate the economic and social development of the country, which may span from funding education and health programs to retiring national debt. To the extent that the additional fiscal resources resulting from privatization are wisely spent to benefit a wide segment of the population, the fiscal impact of privatization can be viewed as an important social gain.

B. Consumer Price Effects

An important theoretical basis for privatization is that given the appropriate competitive and regulatory environment, privatization places enterprises under increased market pressure and forces them to become more efficient. The efficiency gains from privatization eventually will be reflected in lower prices, higher quality products and services, and increased consumer choices. These benefits collectively create accelerated economic growth and significant, widespread welfare

gains in the long term. The privatization of the British Telecom in 1984, for example, has resulted in below-inflation price increases for telephone service and more choices in telecommunications equipment for British consumers.[1]

In the short term, however, privatization often leads to price increases due to the elimination of subsidies for SOEs. In many instances, state enterprises producing consumer goods sell their output at less than production cost or at some discounted rate as a matter of government policy. Privatized companies must price their goods at market rates, and higher prices reduce consumers' welfare.

Higher prices can also be experienced if insufficient competition is introduced in given markets, since new private firms can engage in monopolistic or oligopolistic pricing practices. In several cases of large privatizations in Mexico (e.g., Telmex, Mexicana and Aeromexico), the elimination of subsidies and industry deregulation have resulted in steep price increases in the short term.[2]

The negative welfare impact is most apparent in sub-Saharan Africa and Eastern Europe where privatization and deregulation have resulted in higher prices for basic foodstuffs and other necessities. When short-term price increases affect low income groups disproportionately, the temporary welfare effects of privatization often become a significant political issue which threatens to derail privatization and economic reform.

C. Effects on Income Distribution and Equity

Achieving improvements in equity is an important though sometimes neglected economic objective. Privatization can lead to greater concentrations of wealth and income if the already wealthy are permitted to purchase large blocks of attractively priced shares of government enterprises. However, appropriate privatization strategies can actually yield improvements in equity if procedures for widespread shareholding are followed. The sale of the National Bank of Jamaica placed an emphasis on small-scale share purchases. The "popular capitalism" process adopted in Chile led to diversified shareholding and a reduction in the concentration of wealth at the time of transactions.

Many "mass" privatization programs such as those being implemented in Central and Eastern Europe attempt to achieve equity by making shares available to small investors through vouchers and other devices. However, little can be done to preclude the sales of vouchers by individuals seeking immediate income, or the sale of shares once they are distributed. Another

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[1]See Privatization: An Economic Analysis, by Vickers and Yarrow, MIT Press, 1988, p. 223-229.

[2]See "Welfare Consequences of Selling Public Enterprises" by Galal, Jones, Tandon, and Vogelsang, the World Bank, 1992.

approach to promote equity is to offer Employee Stock Ownership Programs (ESOPs), providing equal and sometimes preferential access to shares of privatized firms to their employees. A series of other measures, such as media campaigns describing the merits (and risks) of shareholding to the general public, can be employed to promote broader distributions of shareholding.

A socio-economic equity issue of clear concern is the potential for industry concentration and biases against small businesses. SOEs tend to be large in scale, and often operate as conglomerates conducting business in several sectors. Many enjoy virtual monopoly positions in markets. If these companies are sold intact, they have the potential to wield strong market power and deter the entry of new firms. Fortunately, in practice many SOEs are being broken up before or at the time of privatization so that the risk of market dominance is reduced. In addition, most SOEs are very weak rather than strong financially, and so the real task is to establish viable enterprises.

As with other regulatory concerns, the most constructive approach for dealing with industry concentration is to design and implement effective anti-trust and fair competition laws. Given variations in economies of scale and other business factors among industries and countries, one cannot pre-ordain "optimal" sizes for firms. That determination must be left to market forces. Nevertheless, strong rules for fair competition can play a major constructive role by providing an "even playing field" for both small and large companies.

D. National Ownership and Patrimony

A considerable amount of attention has been given to the issue of the "sale" of national assets and patrimony, particularly in the transitioning economies of Central and Eastern Europe. A similar debate in both developing and industrial economies is often held over the issue of foreign investment. These debates, which often become heated and politically charged, revolve around the question of whether or not foreigners (or in some cases, domestic elites) should be permitted to purchase and control "critical" or "strategic" national assets, such as land, natural resources or important manufacturing facilities.

While the political arguments associated with national patrimony may never be fully resolved, the social dimension turns on the consideration of whether the new owners of the productive asset operate in a socially responsible and beneficial manner. Most studies on foreign investment conclude that overseas investors generally behave better than local owners in terms of environmental protection, compliance with intellectual property rights conventions, payment of market wages and adherence to international labor standards. However, some foreign corporations have been cited for labor exploitation, destructive use of natural resources, and other forms of socially irresponsible behavior. The only way to minimize or eliminate such conduct is the adoption and effective enforcement of laws and regulations which preclude unacceptable behavior.

E. Inter-Industry Linkages

Most attention on privatization initiatives is placed, appropriately, on the specific firm or industry involved in the transaction. One needs to keep inter-industry linkages in mind, however, since changes in one firm or industry can affect others through buyer/supplier relationships. Formerly centrally planned economies consisted of intricate networks of linked state enterprises. In other countries such as Zambia, networks of private supplier firms have emerged with near total dependency on sales to major parastatal companies. It is widely believed in Zambia that many of these private companies would be forced to restructure or go out of business if the major parastatals were privatized. Once these linkages are broken through privatization, economic and therefore social impacts ripple throughout the economy. Little can be done to mitigate negative effects at the level of the firm, but national policymakers should keep in mind potential spillover effects when they design and implement privatization programs.

F. Environmental Impacts

Some observers have noted that privately run firms are less likely to uphold environmental standards in their operations, since they have no incentive to do so -- there is no profit motive in environmental protection. This argument does not stand up in practice. First, the most stringent environmental standards are followed in OECD member countries, which are the most market oriented nations. Second, the environmental disasters (effluents, hazardous waste, bad husbandry of natural resources) discovered in Central and Eastern Europe prove that government ownership does little if anything to guarantee better environmental standards. Experience has shown that environmental protection is a function of widespread public understanding and support, sound laws and effective enforcement, rather than a function of the ownership structure of firms.

G. Labor Retrenchment

One of the anticipated long-term social gains of privatization is higher employment and wage levels in a more efficient, dynamic and expanding private sector. However, for many countries in both the industrialized and the developing worlds, the most immediate, visible and direct social impacts of privatization are related to labor force downsizing.

Typically, in cases where firms targeted for privatization are commercially viable with relatively efficient workforces, privatization is not likely to have a major impact on the structure of the existing work force. In cases of loss-making state-owned companies, many of which are chronically overstaffed, however, privatization and restructuring may result in the retrenchment of a substantial portion of the existing workforce. The privatization of Japanese National

Railways, for example, involved the general laying-off of 92,000 employees, which represented almost one-third of the company's work force.[3]

The negative social welfare impact of labor retrenchment is often aggravated by the limited capability of the private sector to generate alternative employment opportunities in the short term. The potential employment effect of privatization has been a major reason behind workers' opposition to specific privatizations as well as the more general resistance of labor unions to privatization as an economic restructuring tool. Moreover, in countries where governments have provided guaranteed employment to university graduates through public sector companies, such as Egypt and Kenya in the past, privatization-induced retrenchment may be viewed as a breach of the social contract.

On the human level, labor retrenchment which takes place in countries without sufficient social safety nets can cause considerable suffering and misery in the short term. Many developing countries and former socialist countries do not yet have in place income maintenance systems due to past practices of guaranteed public sector employment. The loss of income and benefits for individual workers and the uncertain prospects of finding alternative means of livelihood could amount to a substantial welfare loss which should be taken into account in the privatization process.

Overall, the short-term welfare loss associated with worker retrenchment will depend on the skill mobility of the labor force, alternative employment opportunities available in the private and public sectors, the efficiency of the labor market in facilitating reemployment of retrenched workers, and general economic conditions. On the level of the individual worker, the welfare loss will depend on his/her ability to find alternative sources of income, and the extent to which the short-term income loss can be compensated by the social safety net system.

H. Changes in Social Support Structures

In countries where employment with public enterprises provides access to a host of services such as health care, child care, education and housing, the welfare loss associated with unemployment also includes the loss of access to these free or subsidized services. The provision of these services, as part of the compensation package at large state-owned companies is especially pervasive in former socialist countries and some African countries (See box II.1 below).

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[3]See Techniques of Privatization of State-Owned Enterprises, Vol. 1, by Vuysteke, the World Bank, 1988, p. 129.

Box II.1

GORKI AUTOMOBILE ZAVOD IN RUSSIA

Gorki Automobile Zavod (GAZ) is a giant automobile manufacturing company being privatized under the Nizhny Novgorod privatization program in Russia. With a total workforce of 140,000, it is one of Russia's largest enterprises. GAZ functions much like a medium-sized city, supporting 80,000 acres of land on which food is produced at subsidized prices for GAZ workers. The company facilities also include a meat-processing plant, a fish farm, numerous day-care facilities and schools, a 1200-bed hospital, various health clinics, rest camps and resorts, a stadium and two hockey rinks. GAZ owns 95 percent of the housing stock in the district, owns and operates several construction companies, and operates heating plants serving the entire district of 270,000 people. Social services reportedly amount to approximately 35 percent of total payroll costs, which is similar to the cost of fringe benefits of medium to large companies in the United States but is much lower compared to those provided in some industrialized economies. In parastatals currently providing such extensive social services to its employees, social safety net planning and adjustments become a crucial issue in privatization preparation.

Source: "Defense Conversion in Russia: An American's View from Inside the Enterprise" by Wallis, in Genomics, Volume V, Number 5, September/October 1993.

When the loss of non-cash benefits is added to the loss of wage income, the welfare cost of retrenchment to individual workers could be substantial. Even in cases where there is no significant labor retrenchment, privatization and restructuring still bring uncertainty as to whether these benefits will be continued under new private ownership. In many developing countries and former socialist countries, these services often are not extensively available in the private market. Under those circumstances, the short-term provision of certain basic services may need to be considered and incorporated into the privatization process.

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III. THE IMPORTANCE OF ADDRESSING NEGATIVE SOCIAL IMPACTS

Addressing potential negative social impacts of privatization is critical for several reasons. At the most basic level, negative social impacts which result from privatization in the short-term provide opposition groups with sufficient ammunition to stall or derail privatization efforts which are beneficial to the country in the long term. In Tanzania, for example, the government has been unable to advance privatization beyond its initial strategy paper because of its inability to develop adequate social protection measures. Programs in Cameroon, Pakistan, Ukraine, the Dominican Republic, Paraguay and Uruguay have all faced similar pressures in recent years.

The primary reasons for addressing negative social impacts include: (i) minimizing labor opposition to privatization; (ii) defining liabilities for investors; (iii) distributing privatization gains equitably; and (iv) ensuring social and political stability. Following a discussion of each of these objectives, the chapter concludes with an assessment of how negative social impacts from privatization will vary among the different regions of the world depending on the particular economic and social context.

A. Minimizing Labor Opposition to Privatization

Substantial labor opposition to worker retrenchment has been a primary factor delaying privatization programs in numerous countries including Bangladesh, India, Sri Lanka and Thailand.[4] Part of this opposition grows from fears that privatization can lead to unemployment, wage reduction and the loss of seniority. Such fears are well grounded in view of the level of excess employment prevalent in most SOEs and the considerable savings which can accrue from eliminating redundant workers.

One of the best methods for reducing the opposition to privatization is to integrate labor's concerns from the start into the overall privatization program. The experience of countries worldwide has shown that direct income compensation programs such as severance pay are among the best suited methods for addressing retrenchment. This method and other techniques such as employee ownership plans, job training and public works programs are discussed in Chapter IV.

B. Defining Liabilities for Investors

Two critical issues often left unresolved prior to privatization concern investors' liabilities for environmental damage caused by SOEs and their potential liability for worker retrenchment.

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[4]See Privatization: The Lessons of Experience, Kikeri, Nellis and Shirley, the World Bank, 1992, p. 58.

Failure to address either of these liability issues can serve to deter both foreign and local investors from acquiring SOEs.

In Central and Eastern Europe, the potential liability for environmental damage caused by former SOEs has been one of the main obstacles to rapid privatization. Some countries (e.g., Poland, Hungary, Germany and the Czech Republic) have received requests to indemnify new foreign investors against possible environmental claims that might arise from existing contamination at sites they were considering purchasing. Buyers invariably want to know the extent of their liability for environmental damage caused by former SOEs. If they are liable, they often want to limit the extent of their liability through indemnification, or alternatively they might offer a lower purchase price for the enterprise.

Policymakers must also determine which party -- the government or the investor -- will bear the clean-up costs incurred in bringing a site up to acceptable environmental standards. These questions can be resolved by establishing clear guidelines in the country's environmental laws, its privatization code, or in individual divestiture contracts.

New buyers have similar concerns about their liability for worker retrenchment. In cases where worker retrenchment is imminent, investors are keenly interested in whether they or the government will be responsible for compensating displaced workers. Although some investors agree to maintain levels of employment until attrition eliminates overemployment, they often offer a lower selling price as a quid pro quo. Experience of countries worldwide has shown that since unresolved labor issues typically deter private investment, the most effective strategy is to implement an acceptable labor retrenchment program, if one is needed, prior to the sale of an enterprise.

C. Distributing Privatization Gains Equitably

Addressing the negative impacts of privatization is also of paramount importance for ensuring an equitable distribution of welfare gains from privatization. Although privatization's long-term goal is to increase efficiency, this is seldom achieved without short-term negative impacts which often fall disproportionately on the poor. The poor are typically the least skilled and therefore the least able to find immediate employment or other means of livelihood in the case of worker retrenchment. In addition, they often lack sufficient savings to support themselves during the transition period to another job, especially in a country with inadequate social safety nets.

A privatization program without a strategy for addressing social costs can also increase the wealth of a small group who have the financial or political clout to acquire and consolidate valuable productive assets, while depriving the poor of their means of livelihood and income support. The equity implications of such an approach could counter the social and political

rationale for undertaking privatization and economic restructuring in the first place. It is therefore critical to integrate equity concerns into any privatization program.

D. Ensuring Social and Political Stability

Privatization programs which do not adequately address the negative impacts are bound to engender significant social unrest leading to political opposition and instability. In Russia and Ukraine, for example, the inability of governments to address the social consequences of economic transformation has lent significant credence to those who would prefer to maintain a socialist economic system. Opponents of privatization can point to negative social impacts as sufficient reason to abandon policies of economic liberalization and revert to the former policies of inefficient socialist planning. If privatization -- and for that matter the larger transition to a democratic, market-driven society -- is to succeed, it must minimize social costs associated with structural adjustment.

E. Regional Dimensions

When assessing the negative impacts of privatization, policymakers must consider the unique political and economic context which will determine a country's need for compensatory social programs. Among the factors in each country one needs to consider are:

- Prevailing macroeconomic conditions
- The historical role of SOEs in the economy;
- The existence of institutions (either private or public) providing social services; and
- The strength of organized labor.

Blunt policy measures taken in disregard of contextual differences would not be as effective as those tailored to the unique circumstances of a particular country. While a country-specific discussion is beyond the scope of this paper, several generalizations can be made at the regional level.

Former Socialist Countries

Privatization exerts particularly strong impacts in the formerly socialist countries since their governments have historically provided most, if not all, social services through state-owned enterprises or government funds. Because of the potentially disruptive impact of privatization on both employment and social services in these countries, many privatization transactions have included guarantees to maintain employment and/or social services for a specified period after the privatization transaction has occurred. It is unlikely, however, that such services can be maintained indefinitely by enterprises due to the expense, administrative burden, and overall inefficiency of such programs.

Latin America and the Caribbean

Popular acceptance of government divestiture continues to strengthen the success of Latin America's privatization effort. The private sectors in most Latin American countries are active and growing, thereby providing alternative employment opportunities. This trend has aided the region in remaining well ahead of Central and Eastern Europe in the restructure and sale of its state entities, and attitudes toward privatization remain favorable in the region despite political instability in Peru, Venezuela and Brazil. Labor is generally well organized, at least in the formal and parastatal sectors. Governments have permitted increased employee participation when conducting the sale of state-owned companies and have allowed employees to be the first bidders on companies.

Although social support services lag behind those in most OECD countries, Latin America has some of the most extensive social security programs in the developing world. Uruguay and Argentina provide the most comprehensive benefits in the region. Nevertheless, only seven countries in Latin America provide any kind of formal unemployment benefits and even here the programs cover only a narrow section of the population and have restricted benefits.[5]

Africa and the Middle East

Though most countries in these regions have indicated an interest in privatization and private sector reform, large-scale privatization has not yet occurred. Only a few countries (Zambia, Morocco and Egypt) have active privatization programs, and even in these countries only limited progress has been made on actual sales. Privatization in North Africa has typically been limited to participation by domestic investor groups.

As in the former socialist countries, SOEs in many African countries typically provide a range of social services such as housing and health care. Formal social security systems in Africa are limited or non-existent, thus compounding the potentially negative social impacts of privatization.

Asia and the Pacific

Privatization programs in Asia and the Pacific vary widely. South Korea, Taiwan and Malaysia have been promoting capital market development through privatization while other countries such as India, Pakistan, the Philippines and Indonesia are pursuing isolated sales through tender offers. Privatization initiatives in the region have tended to emphasize sales of SOEs in infrastructure sectors such as transportation, power and telecommunications -- all of which are in desperate need of new investment.

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[5] "Social Protection and Economic Adjustment in Developing Countries", World Development Report, International Labor Office, 1993.

Some countries have placed strict conditions on the terms of privatization. Malaysia, for example, has made employment protection an explicit goal of privatization. In normal arrangements, no employees may be laid off within the first five years following privatization, leaving attrition to solve the problem of labor redundancy.[6] Pakistan, which has been more reluctant to privatize, guarantees employment for one year and generous unemployment benefits thereafter.

[6]UNCTAD, Ad Hoc Working Group on Comparative Experiences with Privatization, p.40.

IV. MITIGATING SHORT-TERM SOCIAL IMPACTS

Privatization is based on the economic rationale that private ownership and management of enterprises will help improve general economic efficiency and increase the welfare of the citizenry in the long term. Several social impacts of privatization on the macro-economic, regional and industry, and micro-economic levels have been examined in the previous chapter. Of those impacts assessed, the welfare effect of **labor retrenchment** and the **loss of social services** are often the most immediate, direct and poignant for workers affected by the process.

In Section A of this chapter, alternative strategies and options for dealing with labor cutbacks will be examined. Since the responsibility of alleviating the social impact of retrenchment can fall on either the government (old owners) or the new private owners of enterprises, this discussion does not distinguish between the obligations of the state and the new private owners. However, worldwide privatization experience has indicated that labor retrenchment is often better tackled by governments, since the effect of mass layoffs is likely to ripple throughout the economy with accompanying social and political ramifications. Governmental strategies or guidelines to deal with labor retrenchment also help clarify and define buyers' liabilities in the process of downsizing overstaffed SOEs.

Section B outlines different options for policymakers to mitigate social impacts resulting from changes in the social service infrastructure related to privatization. Finally, Section C focuses on areas where new owners of former SOEs can assume responsibility in assisting retrenched workers in the difficult period of transition to a market-based economy.

A. Labor Retrenchment

Although privatization is intended in the long term to increase employment opportunities through a more dynamic and expanding private sector, the short term impact of privatization inevitably involves some amount of labor retrenchment, especially in enterprises which have been chronically overstaffed as part of a country's guaranteed employment policy. An effective retrenchment strategy therefore should satisfy three goals:

(i) Provision of a temporary means of income support to displaced workers to alleviate the level of human suffering resulting from economic restructuring;

(ii) Demonstration of the government's commitment to assisting workers in a time of rising unemployment and layoffs; and

(iii) Enhancement of labor mobility and productivity by providing services which improve worker skills and enable workers to find alternative employment in other enterprises, sectors or regions.

The experience of both developing and industrialized countries suggests that a variety of programs can minimize privatization's impact on the labor force. The most commonly used strategies are: (i) direct income compensation; (ii) employee ownership plans; (iii) employment and information services; (iv) job training; (v) special credit/entrepreneurial programs; and (vi) employment-generating programs / labor-intensive public works. These strategies refer to income and reemployment. The issue of provision of social services to laid off employees is discussed in section B below.

Direct Income Compensation and Employment Subsidies

Direct income compensation programs are cash payments made to retrenched workers directly following privatization. Such compensation can come in the form of the following:

- Severance pay and/or bonuses for early retirement to encourage a voluntary reduction in the labor force; and

- Unemployment benefits to support workers financially during job search.

In some cases, income subsidies are provided in the form of commitments from new owners to maintain employment for a fixed period with the expectation that over-employment may be eventually eliminated by attrition or by future layoffs.

Direct income compensation is often most useful to retrenched workers and is considered the most effective labor reduction strategy for a variety of reasons. Severance payments provide maximum flexibility for laid off workers who can use the payments for subsistence until they find another job, to pay for further job training or to relocate to other areas. Direct income compensation and unemployment benefits are simpler to administer than job training programs and do not require the creation of programs or institutions (or government bureaucracies in cases where governments take responsibility). Severance payments for redundant workers have been used successfully in the privatization programs of Argentina, Ghana, Germany, Greece, Sri Lanka, Tunisia, Turkey and Venezuela.

The above mentioned advantages notwithstanding, direct payment programs are often the most costly form of worker assistance due to the fact that strong labor unions in many countries require generous cash payments to retrenched workers, even if such schemes are prohibitively expensive for new investors or cash-strapped governments. In the cases of Bolivia and Ghana (see Box IV.1), devising a severance strategy that is both attractive for workers and financially feasible is a delicate balance to strike. Well designed severance schemes like Bolivia's have succeeded in encouraging enough workers to leave voluntarily while still providing adequate incentives to retain

the most productive workers. Conversely, inadequately financed severance schemes are difficult to implement and can even threaten the entire privatization process, as in Ghana.

Box IV.1

COMPARING SEVERANCE SCHEMES IN GHANA AND BOLIVIA

The experiences of Ghana and Bolivia present two paradigms for severance pay strategies. Ghana's efforts to revitalize many of its SOEs in the late 1980s were jeopardized by its inability to meet the generous severance payments to which the government had agreed during collective bargaining negotiations. Between 1985 and 1991, end-of-service benefits grew to between $1,423 and $2,846 per worker, representing four to seven times the country's per capita GNP. Unable to meet such obligations through the proceeds from privatization, the government was forced to divert funds from the its central budget. The delays caused by the inability of the government to fund severance schemes has since delayed the privatization of many SOEs and has diminished the interest of private investors. Labor groups have been reluctant to negotiate for fear of losing generous benefits while private investors are wary of inheriting an enterprise which binds them to honor the government's severance payment obligations.

In contrast, a severance scheme designed to address over-employment in the Bolivian Central Bank during the mid 1980s was both attractive to workers and financially viable for the government. When the Bank decided to downsize by laying off 600 of its 1000 employees, the government conducted a careful cost-benefit analysis to determine the most appropriate severance scheme. After reviewing the payroll, the Bank determined that the future wage savings from a smaller staff would enable the Bank to finance generous severance payments for displaced workers and offer merit-based pay increases to those remaining on the job. The net result was a more efficient work force and an overall reduction in personnel costs.

The examples of Ghana and Bolivia illustrate the importance of crafting a financially feasible severance scheme. Among the variables to consider are: (i) the expected proceeds from privatization; (ii) the current fiscal position of the government; (iii) the expected cost savings from downsizing; and (iv) the possibility of spreading payments over several years rather than disbursing them as a lump sum.

Sources: Lieberman, Ira, Industrial Restructuring Policy and Practice, The World Bank, 1990; and Kikeri, Nellis and Shirley, Privatization: The Lessons of Experience, The World Bank, 1992.

Employee Ownership Plans

Employee buy-outs (sometimes carried out through Employee Stock Ownership Programs or ESOPs) in some cases have allowed some privatized SOEs to manage retrenchment or wage reductions by permitting employees to acquire controlling interest in companies. In Poland, partial employee ownership is actually required by the country's privatization law which mandates that a proportion of the discounted shares be reserved for workers in each privatization. The advantage of an ESOP is that it allows labor to gain an equity share of their company in exchange for wage reductions which may be necessary under privatization. Short-term wage reductions

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among workers can thus be compensated by medium-term to long-term gains in the value of their equity holdings as the enterprise becomes more efficient and profitable.

The disadvantage of ESOPs is that they may increase the financial burden on workers who already have little financial security and may raise unnecessary expectations of profitmaking in the near term. It also does not mitigate the short-term income loss for workers in the case of wage reductions or layoffs. Box IV.2 below describes a successful employee buy-out in Chile.

Box IV.2

EMPLOYEE BUY-OUT OF ECOM IN CHILE

The privatization of Chile's largest computer firm, Empresa Nacional de Computación e Informática (ECOM), was completed as an employee buy-out. The company's weak financial position had discouraged many private investors, and the only group which demonstrated an interest in acquiring the firm was its employees. ECOM was sold to its employees under the following arrangement: Ten percent of the purchase price was paid through an advance of retirement funds, and the balance of 90 percent was financed through a 10-year loan from the state holding company CORFO at a five percent interest rate. After reorganizing the company, reducing salaries and selling off disposable assets, the new owners realized a profit of $250,000 in 1986.

While the case of ECOM illustrates the potential feasibility of employee buy-outs, it should be noted that this privatization transaction was greatly facilitated by the state holding company which accepted a reduced price for the firm and provided low cost financing. It is not clear if such an experience could be replicated elsewhere in the absence of such special financial terms.

Source: Nankani, Helen. Techniques of Privatization of State-Owned Enterprises, Vol II: Selected Country Case Studies, World Bank Technical Paper No. 88, 1988.

Employment and Information Services

Employment and information services attempt to reduce frictional unemployment by preparing dislocated workers for relocation to another company or sector. Such services can be provided by either private or public agencies, and can be facilitated through computerization. The main types of employment and information services are:

- Job search services such as counselling, referrals and information about job markets;

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- Advance notification of plant closures or layoffs that allows workers time to search for another position; and

- Relocation services, (cost of fare for job search, funding relocation expenses, etc.) which are particularly critical when closures are concentrated in a geographic region.

On balance, the experience of countries worldwide has been mixed with respect to employment and information services. Job search services are considered cost-effective in that they help reduce the period of unemployment by matching dislocated workers with potential employers. However, in some cases these services have offered limited benefits in countries, regions or localities where unemployment is already high.

Studies of advanced notice programs have found that longer notice is preferable to shorter notice, and that notice of two to three weeks has only a negligible impact on displaced workers.[7] In Hungary, for example, the 1991 Employment Law requires that all employers with at least 30 workers who intend to reduce staff by 25 to 50 percent within a six month period must give government and worker representatives at least a three month notice. Another study by the U.S. Department of Labor found that advance notice is most effective when combined with a comprehensive job search program.[8]

Relocation schemes have not proven cost-effective, due to both the cost involved and the reluctance of workers to move to other regions. As a result, most governments prefer to promote re-employment locally.

Job Training

Job training programs target structural employment and focus on investing in human capital as a means of providing new employment opportunities for displaced workers. Most of these schemes aim to increase labor productivity by teaching occupational skills or providing basic education. Vocational training programs have been implemented to complement privatization in Benin, Colombia, Ghana, Japan, Portugal, Turkey and Venezuela, among others.

The experience of these countries has been inconclusive as to the cost effectiveness of job training programs. While investment in human capital is widely recognized as essential to boosting worker productivity, governments are often unable to design and implement training programs which meet the rapidly changing needs of private sector companies. Private companies

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[7] Positive Adjustment in Manpower and Social Policies, Organization for Economic Cooperation and Development, Paris, 1984.

[8] U.S. Department of Labor, Economic Adjustment and Worker Dislocation in a Competitive Society, 1986.

are likewise reluctant to undertake extensive training programs where there is the risk that their recently trained workers will may leave for other firms.

To overcome these problems, some governments have implemented contract training programs which prepare workers for specialized positions within a specific company that has agreed to participate in the program. The most effective programs provide tax or other financial incentives to the firm -- available only on the condition that the trained workers later be retained at the firm in the position for which they have been trained.

Special Credit/Entrepreneurial Programs

Employed workers who are interested in starting their own business enterprises are often constrained by the lack of investment funds, even though their credit needs are generally very modest. Thus, improving access to credit for business start-up could be considered part of an assistance package to workers facing lay-offs.

Small business programs vary from country to country. In Poland and Hungary, employment programs provide limited capital for enterprise development, while those in Tunisia offer technical assistance through local labor offices. While self-employment does hold some potential for dislocated workers, international experience has shown that only a small portion of the unemployed (two to three percent in the OECD and eight percent in the United States) are successfully reemployed through such programs.[9] In addition, such programs have proven most effective for higher skilled laborers rather than unskilled workers, as was the case in Ghana's Small Scale Enterprises program.

Other micro-enterprise credit programs in countries such as Colombia, Jamaica, Senegal, Tunisia, and Turkey have been more effective when built into existing systems or mechanisms in allocating loan capital to enterprises. To improve credit access to dislocated workers, the government can provide small subsidies or limited loan guarantees to small borrowers via credit institutions and/or programs.

As a general rule such programs should be demand driven rather than credit driven. Credit should only be allocated to feasible projects and not made available as if it were an entitlement. Borrowers should be discouraged from treating loans as grants that do not have to be repaid. In the cases where only large subsidies can induce additional lending by existing institutions to micro-enterprises, lump-sum grants are generally a better alternative to loans.

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[9]Fretwell, David and Goldberg, Susan, Developing Effective Employment Services, World Bank, 1993.

Employment-Generating Programs/Labor-Intensive Public Works

Public works programs represent perhaps the most visible and potentially costly option for countries facing significant retrenchment following privatization. Countries such as Bolivia, Chile, and Tunisia, all of which experienced high unemployment rates during periods of structural adjustment in the 1980s, introduced government-sponsored work programs to alleviate the social costs of retrenchment. Ghana, Guinea, Guinea-Bissau, Senegal and Mexico have recently secured funding for similar public works programs.

Such programs have several political and economic advantages. Since labor-intensive projects offer direct employment for displaced workers, they provide income for those who are most affected by privatization. The program also demonstrates government concern about the social costs of privatization, which in turn helps to diffuse political opposition. Finally, large public works programs build infrastructure such as schools, hospitals, roads, and bridges which contribute to long-term economic development. The problem with such projects is that large scale public work programs are expensive (e.g., $30 million in Tunisia and $181 million in Bolivia) and they tend to perpetuate dependence on the public sector as the only reliable source of employment. Box IV.3 details the experience of two such programs in Chile and Bolivia.

Box IV.3

PUBLIC WORK PROGRAMS IN CHILE AND BOLIVIA

During the mid 1970s and early 1980s when Chile was undergoing a painful economic restructuring, the Pinochet government implemented a large-scale public works program known as the Programas de Empleo. Even though Chile has one of the developing world's most extensive social security systems, the program played a critical role during the country's economic adjustment period. When the program was inaugurated in 1974, it soon employed 6 percent of the labor force, and by the height of unemployment in 1982, the program employed some 500,000 people, or 13 percent of the labor force. As unemployment fell, the program was phased down and eliminated completely in 1988.

Faced with comparable unemployment problems, including the closure of the state-owned mining company which employed 23,000 people, Bolivia implemented its own massive public works program in 1986. The Emergency Social Fund, backed by the World Bank and several international donors, funded a $180 million package which sponsored over 7,000 projects affecting some 20,000 workers. Among the projects approved for ESF funding were: (i) economic infrastructure; (ii) social infrastructure including schools and health clinics; and (iii) credit to micro-enterprises and cooperatives. Although the program's implementation has been criticized, it is nonetheless considered successful in having provided productive employment for thousands who might otherwise have fallen into poverty.

Although these programs did succeed in generating thousands of jobs for those who would otherwise have faced unemployment, they were both implemented under conditions which may not be replicable in other countries. Chile's Programas de Empleo was implemented under the authoritarian regime of General Pinochet, which allowed the government to direct substantial resources to poverty alleviation, but at the same time generated substantial controversy over the means used to do so. In the case of Bolivia, the ESF was funded with significant support from the international donor community.

Considering the massive scale of privatization taking place around the world in dozens of countries simultaneously, it is unlikely that the donor community could again fund a program on the scale of the ESF. A more cost-effective option in the future might be to implement smaller-scale public works programs which respond directly to local needs, or to combine such programs with other retrenchment strategies such as job training.

Source: International Labor Organization, World Labor Report 1992, Chapter 4; Jorgensen, Grosh, and Schacter, Bolivia's Answer to Poverty, Economic Crises, and Adjustment: The Emergency Social Fund, The World Bank, 1992.

Table IV.1 below summarizes the advantages and disadvantages of the different types of labor retrenchment and compensation strategies discussed in this section.

Table IV.1

COMPARISON OF LABOR RETRENCHMENT/COMPENSATION STRATEGIES

STRATEGY	ADVANTAGES	DISADVANTAGES
Direct Income Compensation	Provides immediate cash support to the unemployed. Relatively simple to administer.	Can be prohibitively expensive if generous severance payments are mandated by law.
Employee Ownership Plans	Builds public support by promoting widespread ownership of enterprises.	Can place financial burden on workers who may already lack financial security.
Employment and Information Services	Reduces period of unemployment by matching dislocated workers with potential employers.	Of limited use in a country with high unemployment and limited job opportunities.
Job Training	Provides investment in human capital to prepare workers for posts in other enterprises or sectors.	Of limited use in countries with high unemployment and limited job opportunities. Difficult to match training programs with private sector needs. Expensive to administer.
Special Credit Programs	Provides start-up funds for entrepreneurs who would otherwise have difficulty obtaining financing in countries with underdeveloped financial markets.	Self-employment is an option for only a few displaced workers. Usually benefits skilled rather than unskilled workers.
Employment Generating Programs	Provides immediate employment for displaced workers. Supports infrastructure development.	Promotes dependence on state for employment. Expensive to administer.

B. Short-Term Provision of Social Services

As described above, a system for providing income support is the most important and immediate need posed by labor reductions. However, policymakers also need strategies to address an additional challenge posed by privatization: How to restructure and ensure provision of social services which had previously been provided by state-owned enterprises.

In industrialized countries such as the United Kingdom, Italy and France, which have undertaken bold privatization initiatives, the short-term impacts of unemployment are usually limited to job losses which necessitate only severance plans or other forms of direct compensation. Essential social services such as health care and education are provided by the state, and employees retain access to these services even when they lose their jobs. In many developing countries, where state-owned enterprises are more pervasive, the enterprise often provides much more than employment. It may also furnish any or all of the following social services:

- Housing
- Food supplements
- Health care
- Child care
- Education
- Clothing allowances
- Pensions/retirement funds
- Recreation and resort privileges

For countries where former SOEs are the primary providers of a variety of social services, the challenge is twofold: (i) short-term, transitional measures which provide temporary support to workers during the period of ownership transfer (the subject of this section); and (ii) the long-term overhaul of the social services infrastructure to determine which, how and by whom such services will be provided (the subject of Chapter V).

It is likely that many social services eventually will be delivered by the private providers in countries currently undergoing privatization. For example, recreation and resort facilities, which are obviously not considered basic needs, are usually provided by the private sector in most countries, sometimes with subsidies from private employers. In non-socialist economies, necessities such as food, clothing, housing are usually provided by the private sector, with the state subsidizing the lower income segments of the population (such as the food stamp program in the United States and public housing construction and subsidy program in Hong Kong). Other essential services such as health care, child care, education, and pension and retirements funds may require a combination of public and private provision, with varying degrees of government supervision and control to ensure quality, accessibility and affordability.

The task of providing social services is a complex and evolving process which reflects the orientation and needs of a society in its particular socio-cultural, economic and political contexts Thus, it is beyond the scope of this paper to prescribe "the" appropriate policy mix to transfer responsibility of social services effectively from enterprises to other private or public agents. Nonetheless, in many countries undergoing privatization it is urgent and important to meet the needs of the citizens during the transitional period when social services delivery is transferred to other public sector agents or the private sector.

In the short term, when resources are scarce but needs are more urgent, policies should focus on providing a minimum level of income support to the neediest individuals and assure that they receive a minimum level of essential social services such as health care and housing. In cases where the cost of such services is minimal, they can be maintained by the new enterprise owner for a specified period of time (see Box IV.4 below). However, in cases where it is not feasible for privatized companies to continue to provide those services, it may be necessary for government institutions and private sector organizations to step in to provide transitional support in essential services until they can be effectively delivered by other means.

Box IV.4

PROVIDING SOCIAL SERVICES FOLLOWING THE PRIVATIZATION OF POLAND'S JAROSLAW GLASS COMPANY

Like many enterprises in formerly socialist countries, Jaroslaw glass company in Poland provided for its employees a comprehensive social benefits program which included full health care, subsidized housing for employees, a subsidized canteen and several recreational and vacation houses along the northern shore of the Baltic Sea. When the U.S. firm Owens-Illinois bid for the plant during privatization, it decided that maintaining the entire benefits package was financially feasible given the low costs of the benefits relative to total operating expenses, and the expected profitability of the company after its acquisition. While this solution may not be financially feasible in all cases, it does provide one possible option for maintaining adequate social services in the wake of privatization.

Source: Price Waterhouse

Chart IV.1 below summarizes some short term compensatory measures to alleviate the short term welfare impact resulting from privatization[10]. The next section focuses on alternative company strategies for former SOEs to assist retrenched workers. The longer term social safety nets considerations related to privatization will be the focus of Chapter V.

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[10] Theoretically, most of the social service needs can be met given sufficient income support, i.e., individuals can buy food, housing, health care and other services if they can afford them. However, most countries have administered social service programs in addition to direct income support to ensure that sufficient resources be allocated to different areas of need.

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Chart IV.1

SHORT TERM COMPENSATORY MEASURES IN THE CONTEXT OF PRIVATIZATION

SOCIAL NEED	*INTERIM POLICY PROVISIONS*
Income Support	Offer severance pay to retrenched workers. Consider public works program if true need for projects exists. Initiate special credit programs for those seeking self-employment. Initiate job search assistance/training programs.
Food	Encourage market prices for commodities. Maintain food subsidies only for the neediest.
Housing	Gradually move to market rents for housing. Continue subsidized housing for the neediest. Allow immediate private ownership for those who wish to purchase.
Health Care	Initiate government/private sector dialogue on appropriate provision of health care services. Introduce "means testing" to subsidize care only for the neediest.
Pension/Retirement	Rexamine eligibility criteria to provide pensions for the neediest. Raise retirement age. Explore options for establishing private pension funds.
Education	Continue public provision. Initiate government/private sector dialogue on most appropriate long-term provision of educational services.
Child Care	Continued enterprise provision if financially feasible, but set market price for services.
Vacation and Resort Benefits	Maintain standard vacation benefits. Eliminate subsidies for resorts.

➡ Indicates primary policy area to emphasize.
⇨ Indicates secondary policy areas.

C. Alternative Company Strategies

While many of the social impacts of privatization are related to fundamental economic changes and social service infrastructure which are beyond the influence of individual enterprises, companies undergoing privatization can play a role in mitigating the negative impact on their own workforces.

Adopting strategies to alleviate the potential negative welfare impact of privatization is beneficial to the enterprise for two principal reasons. First, it will help sustain labor's support or at least minimize labor's opposition to the process, especially in cases where privatization involves labor retrenchment and/or wage reductions. Secondly, investors acquiring ownership of former SOEs also have an ethical responsibility to help reduce workers' suffering from temporary income loss and facilitate the reemployment of retrenched workers when it is within their means.

This section will present several company level strategies to mitigate the welfare impact of individual privatizations. Some of those strategies which have already been examined on a policy level in previous sections will not be discussed in detail again here.

Maintaining the Current System

Some investors acquiring ownership of former SOEs choose to maintain the existing system of employment, wages and social service benefits even when it is not optimal from an efficiency standpoint. It is expected that natural attrition will reduce the size of the labor force over time. This option has the least negative welfare impact on workers and often helps to overcome labor opposition to privatization. However, it is only feasible when payroll and employee benefits are not a significant part of operating expenses and when the privatized company is expected to generate sufficient profits to cover the costs of maintaining the current employment structure (See Box IV.4)

Temporary Income Support

As discussed in Section IV.A, severance pay in the form of a lump sum payment is simple for the company to administer and helpful to retrenched workers in providing temporary income support. A lump sum payment could also be used by workers to cover relocation expenses, training costs or as capital for starting small businesses. The main disadvantage is the high cost often associated with payments acceptable to labor.

Training and Employment Services Assistance

New employers can provide training or offer to cover a portion of the training expenses of retrenched workers to facilitate their reemployment or self-employment. In addition, new management can assign specific personnel to administer an out-placement system providing job

market information, referral services, recommendation letters, and other office support (typing resumes, filling out forms, etc.). Since retrenched workers are more likely to find employment in the same or related sectors, industry-specific training assistance and employment services delivered by former employers could be more helpful than the general employment services provided by government agencies.

Management could also cultivate trust and good will by providing workers with longer notices of employment termination and present an early program of compensation and employment assistance. Such a policy will help reduce the shock to workers and give them sufficient lead time to undergo training and find other employment options.

Flexible Compensation Packages

Employers may offer a choice of compensation packages to retrenched workers, consisting of different combinations of lump sum payments, company stock ownership, training, employment services, small business loans or loan guarantees. For example, workers who are being laid off could be offered the options of substituting a portion of their severance pay with company stock shares at discount prices, or with loan guarantees for small business start-ups.

A flexible system will give retrenched workers more options, and force them to share responsibility in determining the types of resources which will best prepare them to meet the needs of the labor market. The drawbacks are the complexity in designing comparable packages from an equity standpoint and the difficulty involved in administering a flexible system.

V. LONG-TERM SOCIAL SAFETY NETS CONSIDERATIONS RELATED TO PRIVATIZATION

The appropriate roles for governments in the provision of social services has been the subject of significant debate in both industrialized and developing countries, with arguments focused particularly on efficiency and equity considerations. In this section, the term "social safety net" will be used in its broad definition to include two types of social service support:

(i) Direct income support to protect vulnerable groups in the form of unemployment assistance and pensions; and

(ii) Other assistance to meet the basic needs of low income groups, such as food aid, housing and health care.

Provision of long-term social safety nets is a particularly pressing issue in many economies where privatization and restructuring have fundamentally transformed the role of the state and state-owned companies as the primary provider of social services. While it is not possible nor within the scope of this paper to prescribe a particular social safety net system, it is nonetheless important to highlight several long-term social safety net considerations related to privatization.

In the short term, privatization often creates dislocation of individual workers. Several strategies for alleviating the suffering and income loss of retrenched workers have been discussed in Chapter IV.A. In the long term, one of the anticipated gains of privatization is higher employment and wage levels within a more efficient and dynamic economy. However, even economies with developed private sectors are susceptible to downward swings of economic cycles, and workers will still face the prospect of frictional unemployment even during periods of economic growth. Thus, macroeconomic fluctuations, labor market reality and the basic principles of social justice make it imperative for most governments to put into place a social safety net system which guarantees a minimum level of welfare for their citizenry.

Privatization heightens the urgency of addressing long-term social safety net issues for the following reasons:

- As a result of privatization, workers can no longer rely on state-owned enterprises for guaranteed employment, and are therefore more prone to income loss due to frictional and structural unemployment. Rising unemployment thus intensifies the need to overhaul the often inefficient, bankrupt, or in some cases non-existent social security systems in order to protect the welfare of its citizens.

- At the local or enterprise levels, workers in privatized firms may no longer be entitled to the social service packages such as education, health, and child care services where were formerly funded and provided by their state employers. Other public or private sector programs must then step in to provide those essential services.

- At the provincial and national levels, privatization reduces the state's ownership and management of productive assets, thereby diminishing its ability to subsidize social services with income from other state-owned enterprises. As a result, the state is often forced to reduce its role as the direct provider of social services and expand its role as a regulator of private providers.

The actual delivery of social services is a complicated task which must be considered within the particular context of individual countries. Social services in OECD countries, for example, have evolved over decades and in many cases are still in flux, as demonstrated by the current health care debate in the United States. The appropriate role for the governments in the provision of social services will depend on the cultural and social traditions, political history and environment, and economic condition of particular countries. Some options for dividing social service delivery between the public and private sector are presented in Figure V.1.

Figure V.1

OPTIONS FOR MEETING THE NEEDS OF SOCIAL SERVICES

	GOVERNMENT PROVIDER	PRIVATE PROVIDER
UNIVERSAL PROVISION	I Unemployment, Pension/ Retirement Health, Education	IV All services conditional on ability to pay
MEANS-TESTED ASSISTANCE FROM STATE	II Housing, Pension/ Retirement, Food (e.g., surplus food purchased by the government)	III Health, Education, Housing, Food (food stamps)

Quadrant I indicates social services for which the government may be viewed as the most appropriate provider. For example, the administration of unemployment benefits in most OECD countries and many Latin American countries is considered a state responsibility. In many OECD countries, the state also funds and administers a public education system or universal health system (Canada, United Kingdom).

Quadrant II represents the means-tested assistance which could be provided by the state directly to meet the basic needs of its most vulnerable citizens. For example, the government may finance and manage public housing projects, or purchase surplus food to distribute to the poos.

Quadrant III includes the social services which typically fall into the domain of the private sector, but for which the state can provide means-tested assistance to low income groups. An example is the Medicaid Program in the United States, under which low income groups can obtain medical services from private hospitals with government subsidies.

Quadrant IV indicates the services which could be provided by the private sector to all those who have the ability to pay for them. In those cases, the state can play an active role in ensuring appropriate quality standards, accessibility, and affordability of social services.

Governments are often viewed to have a fundamental responsibility to ensure a basic standard of living for their people. The challenging task, however, is to satisfy both principles of equity and efficiency, to balance minimal social protection with fostering self-reliance, and to meet social priorities which compete for scare resources. High unemployment benefits, for example, may act as a disincentive for the unemployed to find new jobs.

While the experience of developed countries with more advanced and extensive social safety nets may not be directly transferrable to developing countries, the recent shift of focus in social assistance in developed countries can be instructive. A visible trend has been the development of programs which encourage self-sufficiency and independence from passive income support. This approach often complements income support with job-search assistance and vocational training services, with reenforcement on self-sufficiency through premiums conditional on job-search, mobility, education and training. In countries undergoing privatization, efforts to develop skills and business capacity are perhaps even more important in assisting workers to take advantage of opportunities in the emerging private sector, as well as to adapt to a more competitive and dynamic labor market.

In countries where privatization has brought fundamental changes in the relationship between the state and its citizens, the overhaul of social safety net systems and the reconstruction of the social service infrastructures will require a lengthy and evolving process. Social and political particularities notwithstanding, there are several basic principles which should be considered when designing appropriate social safety nets. These are summarized in Box V.1 below.

Box V.1

CHECKLIST FOR REDESIGNING SOCIAL SAFETY NETS

- Provide a system that promotes macroeconomic efficiency;
- Design services which are affordable for individuals, enterprises and the government;
- Establish a minimum poverty threshold to target income support programs and poverty alleviation measures to the neediest;
- Provide a minimum level of the most essential social services which are used by the poor or more vulnerable groups, and protect these services from financial cutbacks;
- Design temporary assistance measures which assist displaced individuals from falling into extreme poverty but do not promote permanent dependence on the state;
- Provide an administrative system which is inexpensive yet effective; and
- Encourage the development and participation of community networks and non-governmental organizations.

Conclusion: Who is Responsible?

Looking beyond the issue of the most effective system to deliver social services, who bears responsibility for funding these activities, particularly as applicable to privatizations? Clearly it is the government owners of SOEs that through explicit policy or poor management practices create excessive labor rolls in government-run firms. At the same time, it is usually the new private owners that must administer layoffs and deal with the results of efficiency measures. On the other hand, local, regional and national governments are ultimately responsible for the welfare of their citizens.

Arguments over the assignment of responsibility could go on forever without any satisfactory solution. Therefore, the most effective approach would be to assign roles and responsibilities pragmatically. While social safety nets systems should be designed in the light of specific political, social and economic contexts, the responsibility is usually shared between the individual and his/her family, the employer, the family and the state in most societies.

The first tier consists of savings of the individual, support from his or her family, or assistance from charitable organizations. In some societies, this is the only real system to support the unemployed, elderly or disabled.

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A second tier of social safety nets may include public funds financed by individual or employer contributions to provide additional income support or cover long-term contingencies, such as retirement and disability.

A third tier usually consists of supplementary support with more private sector involvement, as in the areas of health care and private pensions in the United States.

The fourth and final tier, established in some but not all countries, is made up of government-sponsored programs aimed at meeting the basic needs of those who are fundamentally unable to help themselves. Such support is usually financed through general taxation.

Those charged with the task of defining and putting into place social safety nets should first determine the existence and relative strengths and weaknesses of each of these tiers of assistance. Then they should concentrate on filling significant gaps. Financing should come from some mix of individual contributions, payments by governments (perhaps all or in part from privatization proceeds), and payments by new owners.

Regardless of the eventual system and cost sharing used, strategies for dealing responsibly and humanely with employee layoffs and other social impacts of privatization should be developed and announced before the transaction takes place. Appropriate strategies for addressing social impacts will strongly enhance the ability of nations to make the difficult transition from statist to market-oriented economic structures.

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the 10 most Creative Deals of 1994

By Beth McGoldrick

What a difference twelve months can make. There may still be some bankers and dealmakers who grumble that there isn't enough action in the world of project finance—as many did in 1993—that case was a lot harder to make in 1994. Indeed, it was a banner year for deals of nearly every stripe.

Sources of capital expanded. And the need for deeper pockets to fund complex projects spurred consolidation among developers. Not all news was good, of course. Project finance in emerging markets faced a critical test when the Mexican peso collapsed in December.

There was no shortage of innovative structures, whether for a refinery in Texas or a toll road in Australia. Energy Investors Fund used the portfolio approach for refinancing its investments in 16 power plants. California Energy financed prospectively to fund future power plants in Asia and to bolster a war chest. New markets emerged: Kilroot tested the Euro-waters for nondollar projects, while Lumut plumbed the depths of Malaysia's capital market. In China, Huaneng Power's IPO is a milestone. Just as Rule 144A became firmly established as a preferred financing route—with Selkirk pushing the envelope—Indiantown set a new standard for large projects by registering its securities in the public capital markets.

Four major U.S. players chose to combine in two mergers. U.S. Generating's $250 million acquisition of J. Makowski Co., last summer, was the first move in a consolidation trend in project finance. By December, California Energy Co. succeeded in acquiring rival Magma Power Co. for $950 million.

The task of choosing ten significant deals to represent 1994 was a difficult one, coming in a time span that produced so many notable transactions. U.S. Generating's Northampton Energy project continued a trend of financing large power plants with a blend of commercial bank facilities and 144A bonds. AES China Generating Co. showed that the idea of pooled financings for project finance is still evolving. Gladstone power plant in Australia and the 1,180 megawatt Rayong generating station in Thailand numbered among key privatizations.

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Deals in Short

Lumut Combined-Cycle Power Project

Total financing: $1.5 billion. Equity: $400 million, provided by Sikap Energy Ventures. Debt: $1.1 billion of 15-year debt; $550 million of floating-rate debt, provided by lenders led by Bank Bumiputra Malaysia Berhad and Malayan Banking Berhad; $550 million of fixed-rate debt, provided by the Employees Provident Fund of Malaysia.

Adviser: Fieldstone Asia

Indiantown Cogeneration L.P.

Total financing: $630 million, consisting of $505 million of first mortgage bonds and $125 million of tax-exempt securities

Advisers: Morgan Stanley (lead), Goldman Sachs, Kidder Peabody, Lehman Brothers

Huaneng Power International, Inc.

Total financing: $625 million, $1.25 million American Depositary Shares at $20 per share

Advisers: Lehman Brothers (global coordinator), Goldman Sachs, Morgan Stanley

California Energy Co.

Total financing: $529.6 million, 10.25 percent senior discount notes due 2004 (net to company: $390 million)

Advisers: Lehman Brothers (lead); Salomon Brothers; Donaldson, Lufkin & Jenrette; Bear Stearns

Deer Park Refining L.P.

Total project cost: $1 billion plant upgrade and expansion

Total financing: $400 million, 14-year, 6.47 percent notes issued under Rule 144A

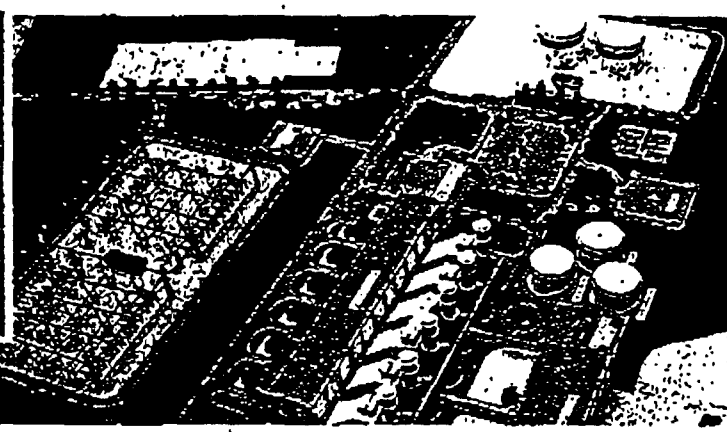
Agents: Goldman Sachs (lead agent), Lehman Brothers (co-agent)

Selkirk Cogen Funding Corp.

Total financing: $392 million, consisting of $165 million of 8.65 percent, 15-year first mortgage bonds and $227 million of 8.98 percent 18-year first mortgage bonds, issued under

LUMUT LOCAL MARKETS RUN DEEP

Ahmad Jamhari Yahya, *Lumut*



Charles Hill, *Fieldstone Private Capital Group*

The April closing of the $1.5 billion Lumut Combined-Cycle Power Project marked the first nonrecourse independent power project ever financed in Malaysia, as well as one of the biggest independent power projects in Asia.

But even more noteworthy is the fact that the deal was entirely funded by Malaysian financial institutions. "What this deal means for Malaysia, and possibly for the rest of Asia, is that local debt sources should be the first port of call for project sponsors, instead of the last," says Willy Lim, managing director of Fieldstone Asia, financial adviser for the transaction.

"Many have expressed reservations about the capacity of the local capital market to fund such a large project," says Abdul Aziz Oman, CEO of Bank Bumiputra, one of the lenders. "Most banks," adds Charles Hill, CEO of Fieldstone Private Capital Group in New York, "had very strong opinions on the subject that foreign banks would be needed in the deal," but were proven wrong.

Some $400 million in equity was provided by developer Sikap Energy Ventures (SEV), a joint venture between Malakoff Berhad (a publicly traded company, ultimately controlled by Malaysian Resources Corp. Berhad) and ABB (Malaysia) Holdings. At closing, ABB sold 5 percent of its stake to Malaysian Resources Corp. and the other 20 percent to Tenaga, the national utility.

The 15-year term financing was longer than a bank debt alternative. The $1.1 billion in debt was divided equally between fixed- and floating-rate sources.

The Employees Provident Fund of Malaysia, the pension fund for the country's salaried employees, purchased the fixed-rate securities. The power plant is a new type of investment for the fund, which in the past has bought only govern-

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Rule 144A. Simultaneously, $65 million of project equity was restructured.

Agents on the 144A issue: CS First Boston (lead), Chase Securities, Morgan Stanley

Sole placement agent for private equity: CS First Boston

Kilroot Electric Ltd.

Total financing: £198 million ($350 million), 9.5 percent sterling debentures due 2010

Advisers: Co-lead managers, Salomon Brothers International Ltd. and Barclays de Zoete Wedd Ltd.

MC-Cuernavaca Trust

Total financing: $265 million, 9.25 percent peso-exchange-rate-linked, targeted amortization notes due 2001. Issue price 97.965 percent.

Advisers: Lehman Brothers (lead), Bear Stearns Int'l Ltd., Goldman Sachs Int'l, Paribas Capital Markets, Chase Investment Bank Ltd., Nafinsa, S.G. Warburg Securities

Energy Investors Funding Corp.

Total financing: $125 million of 9.45 percent, 17-year secured bonds issued under Rule 144A

Agents: Lehman Brothers (lead), CS First Boston

M2 Motorway, or Northwest Transport Link

Total project cost: A$644 million

Total financing: Equity A$155 million ($119 million), provided by various investors; first tranche of CPI 15-year bond issue, A$100 million at an average yield of 7.35 percent, provided by institutional investors

Advisers: Macquarie Corporate Finance Ltd. (adviser to Hills Motorway Ltd.) Debt arranger: Westpac Banking Corp. Infrastructure Development Corp. (adviser to Roads & Traffic Authority)

ment debt or private deals with bank guarantees. Bank Bumiputra Malaysia Berhad and Malayan Banking Berhad led the lenders of the floating-rate debt. Ahmad Jauhari Yahya, who manages the project company for Lumut in Kuala Lumpur, declines to specify the interest rates on the privately placed fixed- and floating-rate debt, but officials at Sikap and the financiers say they were "above market rates."

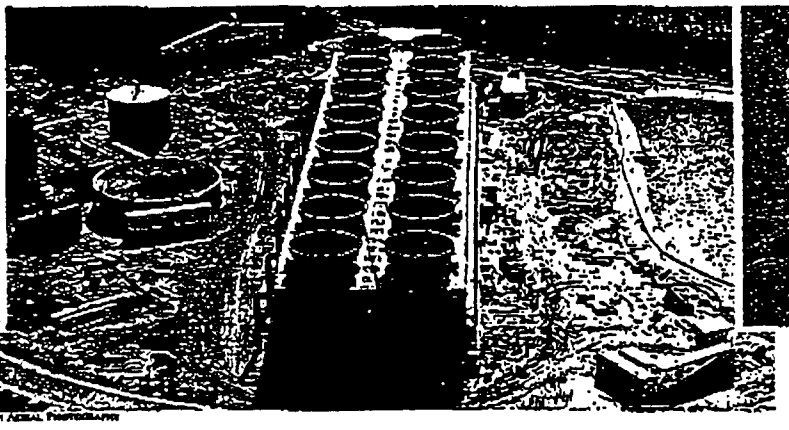
The plant—to be constructed in peninsular Malaysia near the shoreline at Lumut—is expected to provide 1,303 megawatts of power in two stages, approximately 11 percent of the country's total capacity.

There are no government guarantees on the power purchaser, nor on the fuel supplier, and the project's shareholders did not have to provide any cost overrun guarantees or cash deficiency support. "Lumut," says Lim, "represents a major breakthrough in changing the mentality of the local financing institutions," which may be the key to the success of future infrastructure projects in Asia.

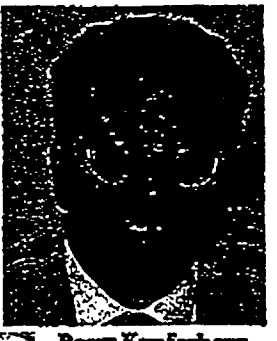
INDIANTOWN INVESTORS GET COMFORTABLE

Dave Hancock

John Cooper, *U.S. Generating*



North Aerial Photography



Barry Kupferberg, *Morgan Stanley*

By the time it closed on November 22, Indiantown Cogeneration L.P. had earned so many distinctions that it now ranks as one of the most important project financings completed to date. Issuing $630 million in bonds with terms from 1.6 to 31 years, the coal-fired cogeneration project in Indiantown, Florida, was the largest project financing in the U.S. market this year, and it featured the longest maturities, ever, for an independent power project.

Indiantown was rated Baa3/BBB-, but it was priced more in line with BBB-rated utilities. Its most significant feature, however, is that it marked the first pure project financing in the public capital markets. Indiantown suggests that investors are becoming more comfortable with longer maturi-

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nes, and that these deals may be sold into the public market without the comfort of Rule 144A, which limits certain private placements.

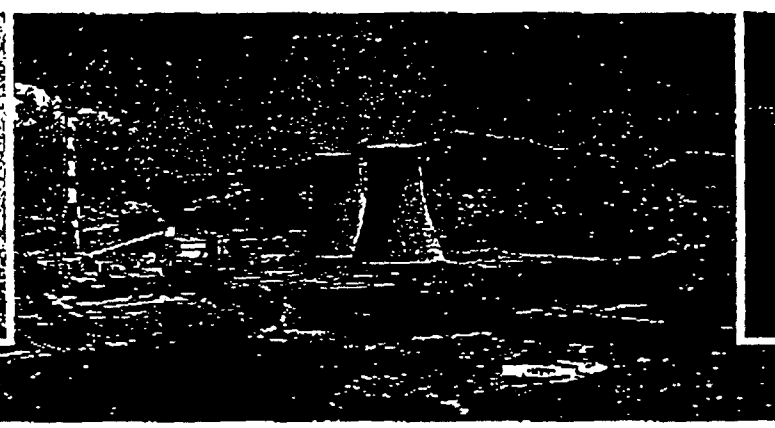
This year's Indiantown transaction is, of course, a refinancing. In 1992, the sponsors floated one of the first "mini-perm" structures in an IPP project. "The success of Indiantown affirms that the concept of a mini-perm works in project financing, instead of the more typical approach where a project might seek long-term financing at the outset," says Barry Kupferberg, vice president at Morgan Stanley.

U.S. Generating and lead manager Morgan Stanley had a lot on their plates two days before Thanksgiving, says John Cooper, senior vice president of finance at U.S. Generating, the project manager. By noon that day, $505 million in taxable bonds and $125 million in tax-exempts had been priced and sold to some 40 taxable and 20 tax-exempt investors, including insurance companies, investment advisers, banks, and pension and mutual funds. Later that afternoon, GE Capital—which owns Indiantown along with affiliates of Pacific Gas & Electric Enterprises and Bechtel Enterprises, and has commitment $140 million of equity—ran a two-hour auction to unwind the $525 million swap that had provided an interest rate hedge on debt service coverage ratios for Indiantown since 1992.

U.S. Generating didn't wait long for its next move. The sponsor closed in early December on the $551 million Hermiston Generating Plant in eastern Oregon. Entirely underwritten by Credit Suisse, "Hermiston is structured like Indiantown, in that we fully expect to refinance it," says U.S. Generating's Jeffrey McParland, vice president of project finance.

HUANENG CHINA ON WALL STREET

Sherman Lewis, *Lehman Brothers*



Wang Defang, *Huaneng Power International*

The five-and-a-half-week roadshow orchestrated by Lehman Brothers, global coordinator for the Huaneng Power International (HPI) IPO, began with high hopes over Labor Day. By the time it was over, confusion over mixed signals sent by the Chinese government had begun to deflate investor optimism. Goldman Sachs, in fact, postponed a planned offering for another power company.

Nonetheless, early last October, HPI offered 31.25 million American Depositary Shares at $20, thus becoming the largest independent power issue ever for China, as well as the second Chinese IPP to be listed on the New York Stock Exchange (NYSE). "It was important for the Chinese government, and for the company, that the deal be done—and done successfully," says Sherman Lewis, vice chairman of Lehman Brothers in New York.

HPI, which is based in Beijing, owns five power plants with a total capacity of 2,900 megawatts (MW) located in China's most prosperous and populous provinces. Under chairman Wang Defang, the company is developing eight more plants with a total capacity of 5,900 MW and has preliminary plans to add another 6,100 MW.

A squabble over equity returns that the government will allow foreign investors in power projects complicated HPI's issue and caused the booming calendar of new Chinese issues to come to an abrupt halt. Interest rates were on the rise and share prices for some prominent Chinese companies brought to market in 1993 slumped.

In addition, certain foreign investment firms, including Lehman Brothers, sued Chinese state-owned enterprises for allegedly walking away from their trading obligations.

HPI, and its predecessor, Shandong Huaneng Power Development Co. (listed on the NYSE last August), have, in their short lives, disappointed investors. Shandong listed on the NYSE at $14.25 for an aggregate amount of $332 million, but has now dropped to the $9 range.

HPI's shares now trade at around $13 5/8, down about one-third from issue price. But Lewis says, "This was the largest equity issue to come out of China, and it was done under difficult market conditions." Meanwhile, China-watchers are bracing for a shake-out among the foreign investment banks fighting for a toehold in China.

The cost of keeping employees in Hongkong has convinced at least one investment firm, Goldman Sachs, to downsize, while others wait to see just how serious the Chinese are about attracting foreign investment.

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Corporate governance in the new Russia

Roswell B Perkins, of Debevoise & Plimpton, New York, reflects on the importance of sound corporate governance to investor confidence in Russia's emerging market.

The transition of the Russian economy from a state-owned and state-directed economy to a free-market system calls out urgently for an influx of Western capital. Unhappily, the pace of new investment from outside Russia has been slow and faltering.

The message of this article is simply this: foreign investment will not flow significantly into publicly-held Russian companies unless foreign investors have confidence in the way such companies are governed and the way stockholders are treated.

Importance of effective corporate governance

The importance of effective corporate governance to Russian enterprises is, quite simply, the need to assure prospective investors that unfair treatment as stockholders is a concern that can be eliminated from the risk side of the risk/reward equation.

The rewards to be derived from investment in Russia are potentially great. Much has been written, for example, about the undervaluation of Russian companies as they have become privatized. Given potentially high rewards, the issue becomes one of risk.

The usual risks associated with foreign investment — the risks of political violence, expropriation and currency inconvertibility — play a lesser role in deterring investment in Russia than either the threat of excessive taxation or uncertainty as to how investors will be treated in the newly-privatized corporate structures. Obviously, corporate managers in Russia cannot control the actions of the Russian Parliament in relation to taxation. Protection of investors through the adoption of sound principles of corporate governance, on the other hand, is entirely within the control of Russian managers.

The stock register

Corporate governance begins with assuring investors that their share ownership will be clearly established on the books of the company and that they will be able to transfer their shares when the time comes to sell them. Unfortunately, as numerous articles in the press have reported, investors in the Russian market have been subject to so-called custody risk: the fear that the shareholder registers could become lost or destroyed or manipulated by unscrupulous registrars or management, resulting in the disappearance of any physical proof of ownership.

The importance of an effective registration system is recognized in Russian laws and regulations. Article 9 of Decree No. 601 of the Council of Ministers of Russia, dated December 25 1990 (Decree No. 601), establishes the basic legal requirement to maintain a registry of stockholders. Article 51 of Decree No. 601 specifically permits the delegation to banks or other specialized organizations of the function of maintaining the stock register. Presidential Edict No. 1769 of October 27 1993, and Order No. 840-r, dated April 18 1994, of the State Committee for Management of State Property, establish a legal framework for a system of registration and transfer of shares.

Presidential Edict No. 2063, of November 4 1994, created the Federal Securities and Stock Market Commission (the Securities Commission) and charged it with overseeing the developing Russian securities market. An April 18 1995 resolution of the Council of Ministers called upon the Securities Commission to create new procedures for a modern, efficient federal settlement and custodial system. Such a system is beginning to take form in a new joint venture share registrar, to be called the National Registry Company, under the sponsorship of the Securities Commission, the International Finance Corporation (the private development arm of the World Bank),

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EBRD, Bank of New York and two Russian companies. It may take several years to achieve a fully functioning, independent registrar system, but a promising start is being made.

Meanwhile, private efforts are also being made. One example is the programme of proposed custody arrangements developed on behalf of the proposed Templeton Russia Fund. Templeton proposes to use a Moscow-based subsidiary of Chase Manhattan Bank as the coordinator and monitor of all registry and custodian relationships in Russian companies, by means of a network of contracts with the registrars of the Russian companies in which the new Fund will invest.

The fact that the US Securities and Exchange Commission has recently granted and published an extensive ruling and an exemption order that permit the proposed Templeton Russia Fund to market mutual fund shares to US investors on the basis of this custody structure has given further prominence in the US to the issue of registration and custody mechanisms in Russia. This publicity will further raise the expectations of foreign investors as to safe registration and custody procedures.

It is imperative that Russian managers both understand the vital importance of these evolving measures and give them full support.

An indication that some Russian managers and owners appreciate the importance of the stock register lies in a recent press report concerning the Tomsk Petrochemical Plant. The Moscow investment corporation, Nipek, recently gained control of Tomsk, and, according to the press report, the new board of directors will "work to make (the Tomsk) shares more appealing .... Nipek management plans to transform the plant into a progressive joint-stock company. The company's share register will be maintained by a leading Moscow registration company .... Tomsk shares could eventually be offered on international stock markets."

Clearly the motivation to create highly marketable shares, in this instance, is bringing into sharp focus the share register and other considerations of importance to foreign investors.

Stockholders' meetings and voting procedures

As is recognized by Article 18 of Decree No. 601, the annual meeting of stockholders is the most important event in corporate governance. The President's Edict of January 4 1994 entitled On the State Programme for Privatization of State and Municipal Enterprises in the Russian Federation (the 1994 Privatization Programme) requires that the annual meeting be held no later than 120 calendar days after the end of the fiscal year, which is a positive step in the direction of shareholder protection.

The most important function to be carried out at the annual meeting is, of course, the election of the directors. The other important functions of the annual meeting, as provided for in Article 98 of Decree No. 601, are the approval of the financial statements, the designation of the auditor and the fixing of the auditor's compensation.

Russian law contains some basic protections for minority stockholders by requiring more than a simple majority of the votes to adopt major changes. Article 105 of Decree No. 601 calls for a majority of at least 75% of the votes of the stockholders present at the meeting in favour of changes to the charter and decisions to reorganize the joint stock company or convert its activities. The 1994 Privatization Programme goes further and calls for a vote of at least 75% in favour of changes in the size of the authorized capital, the sale of corporate assets if the value of the sold assets exceeds 25% of the authorized capital, and other important matters.

Thus, Russian law provides the due framework for stockholder voting. The problems are threefold:

- outright resistance on the part of many Russian managers to stockholder voting and stockholder initiatives;
- non-existence of independent proxy-counting mechanisms; and
- inexperience in the running of annual meetings.

As to the first of these problems, the *Wall Street Journal* of April 21 1995 carried a story of alleged extortion in the form of a demand by a Russian company handling the stock registry of Sakhalin Shipping Co. for payment of $75,000 in order for a Russian shareholder to vote its shares at the annual meeting. The same article reports, in the case of another Russian company annual meeting, physical blocking of entry to the annual meeting. These reports obviously reverberate around the world and cannot help but serve as a deterrent to foreign investment. The remedy lies within the easy control of Russian corporate managers.

As to the second problem, while Article 105 of Decree No. 601 permits voting by proxy, Russia has none of the sophisticated mechanisms for proxy voting and counting that have been developed in the US. We recommend that the Securities Commission undertake the preparation of guidelines for corporate secretaries as to proxy voting procedures and take steps to assure that independent proxy counting firms are available and are used to help ensure the integrity of the voting process.

Finally, as to the conduct of the annual meeting, US experience demonstrates that the proper conduct of the meeting of stockholders requires a presiding officer who has both knowledge of the ground rules of parliamentary procedure and a balance of firmness, diplomacy and good judgement. We recommend that the Securities Commission, or another appropriate body, develop a handbook for presiding officers at meetings of shareholders, and that steps be taken to encourage the wide use of the principles and procedures set forth in such a handbook.

The board of directors

Size of the board. The 1994 Privatization Programme requires a Board of Directors of at least seven members in the case of joint stock companies having not more than

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10,000 stockholders and of at least nine members in the case of joint stock companies with more than 10,000 stockholders. It also requires cumulative voting.

Composition of the board. The 1994 Privatization Programme recognized the distinction between inside and outside directors and took a bold step forward. It required that at least two-thirds of the members of the Board be non-employees of the company.

No doubt there will be difficulty in finding well-qualified individuals to fill the outside director slots. However, the pool of talent is growing daily, as more and more Russians gain experience of operating within a free market system. We understand that very recently the Red October Chocolate Factory and Irkutskenergo, both of which are trying to attract foreign investment, elected Americans to their boards.

Russian managers should also understand that if an outside director is to qualify as being independent, it is not enough that he or she not be an employee of the company. The outside director should not have such a close relationship to the chief executive officer (whether by family or economic or other ties) that he or she is subservient to the opinions or decisions of the chief executive officer.

Functions of the board. By far the most important function of the board of directors is the selection of the chief executive officer (CEO), the fixing of his or her compensation, the evaluation of his or her performance and the replacement of the CEO when appropriate. In recent years US boards of directors have been more insistent on high-level performance by the CEO and more willing to recognize their own errors of selection by moving decisively toward replacement of a poorly performing CEO.

In contrast to this locus in the board of directors of responsibility for selection of the CEO, Article 124 of Decree No. 601 provides that the *stockholders* choose the CEO ("a general or executive director or president") from among the board of directors. We recommend that in any corporation law enacted by the Russian Parliament, or in any revision of Decree No. 601, the selection of the CEO be made a function of the board of directors.

Boards of Russian companies must be encouraged to accept the other principal responsibilities of a board of directors. In US corporations the board normally:

- oversees the conduct of the corporation's business to evaluate whether it is being properly managed;
- reviews and approves major corporate plans and actions;
- approves the corporation's financial statements; and
- makes recommendations to shareholders as to matters on which they have power to vote.

We recommend that educational materials be prepared for boards of directors of Russian joint-stock companies, describing their functions and their duties. This project could appropriately be undertaken by the Securities Commission.

The audit committee

Article 130 of Decree No. 601 requires that the stockholders at the annual meeting elect from among the stockholders an audit commission. None of the members may be officers of the company ("executive directors", in the terminology of Decree No. 601). The difference between Decree No. 601 and US law or practice is that the audit committee in the US is chosen by the *board of directors* from among the outside or independent directors.

Decree No. 601 prescribes the duties of the audit commission in general terms, which are: "To oversee the financial and commercial activity of the company." (Article 170) Also, the audit commission in Russia "presents the results of its audit to the general stockholders' meeting." (Article 133).

Much has been written in the US as to the importance of the audit committee and the scope of its functions. Again, we recommend that educational materials, including guidelines, be prepared by the Securities Commission for the use of audit committee members.

Other committees of the board of directors

Article 123 of Decree No. 601 provides:

> "The Board of Directors may, when necessary, designate persons from among their number or other personnel of the joint-stock company to perform specific tasks."

This authorization could readily be used by a board of directors to designate two committees that are well established in US practice: the compensation committee of the board and the nominating committee of the board. Designation of such committees would demonstrate a commitment to effective corporate governance and a sophistication in corporate governance structures which would enhance investor confidence.

Although Decree No. 601 calls for CEO compensation to be established by the stockholders, presumably a recommendation must be taken to the stockholders by the board of directors. That recommendation would ideally, be worked out initially in a committee of outside or independent directors, that is, a compensation committee.

A nominating committee of the board of directors could take the lead in the search for outside directors who will bring experience and judgment to the board of directors of Russian joint stock companies. At least a majority of the committee (if not all) should be outside directors.

The mere designation of these two committees by a Russian joint-stock company would bring very favourable attention from foreign investors.

Duties of directors and officers

Although Russia is a civil law country, investor confidence would be greatly enhanced if the fiduciary principles applicable to directors and officers which have evolved in England and the US over two centuries were given effect in Russia.

In the US the duties of directors and officers are

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generally classified under two broad categories. These are:

Duty of care: Russian managers should be trained to accept the basic precept of the duty of care, namely: that a director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise under similar circumstances.

This duty includes the duty to investigate suspicious facts or circumstances and to find out the causes of unusual events.

Obviously Russian managers need the protection of the 'business judgement rule', which states that the conscious decisions of directors and officers, if made in good faith and with adequate information, are not subject to second guessing.

Duty of fair dealing, or duty of loyalty. Particularly where the ownership of the means of production is moving from governmental entities into privately-owned companies, there are many situations in which a conflict of interest can arise between a director or officer, on the one hand, and the company or its stockholders, on the other hand. Whenever a director or officer has a personal financial interest in a matter affecting the corporation, he has a duty to act fairly toward the corporation and its stockholders. The fundamental principles of disclosure to the board of directors (and in some cases to the stockholders) and of disqualification from voting on matters in which an officer or director has a personal interest must be learned and put into practice in Russia.

The principles of fair dealing, disclosure and informed choice by disinterested stockholders also apply where a majority stockholder seeks to acquire or restructure minority interests in subsidiaries. Several Russian companies, including Lukoil and Komitek, have recently engaged in transactions involving minority interests in subsidiaries, and undoubtedly other Russian companies will be taking similar action.

Remedies

The use of joint-stock companies as the principal vehicle for conducting the free enterprise system in Russia cannot succeed in the long run without some system of remedies whereby stockholders can enforce the duties of the company's officers and directors. The freedom to sell shares of a poorly-managed company or one that is being wrongfully exploited by its managers is not a sufficient answer for shareholders in the new joint-stock companies of Russia, where values are likely to increase if shares are retained.

Similarly, proxy contests are not a viable remedy in the present state of immaturity of the securities markets in Russia and of voting procedures of Russian companies.

Civil suits by stockholders. The ultimate means of enforcing the duties of directors and officers in the US is, of course, the commencement of a judicial proceeding. The suit can either be:

- to prevent the wrongful action from taking place or continuing (an injunction); or
- to require the wrongful directors and officers to pay money (damages) to compensate the stockholders or the corporation for the injury done by past actions.

While one might not want to see the litigious proclivities of US stockholders (or, more realistically, their attorneys) taking hold in Russia, legislation should be enacted permitting stockholders of Russian joint stock companies to protect their rights through the Arbitration Court. The legislation ideally would create a special branch of the Arbitration Court for dealing with intra-corporate disputes.

The Arbitration Court could adopt a set of special rules and procedures to help ensure that intra-corporate disputes are resolved expeditiously. A precedent exists in the state of Delaware in the US, where most large corporations have been organized and where most corporate governance litigation takes place. Delaware has recently adopted a special set of rules and procedures designed to have major commercial litigation resolved expeditiously and cost-effectively by an experienced judge.

Governmental enforcement. Both in Russia and in the US, when the directors and officers cause the corporation to violate applicable law, the government can bring enforcement proceedings. In the US these proceedings may be brought by the federal government, a state government, or a local government (county, city or town), depending on what kind of law has been violated. The proceedings may be civil or criminal in nature. A corporation can be fined, and in some cases the officers responsible for the illegal conduct have even been found criminally liable and either fined or imprisoned or both.

We recommend that a new position be created within the Securities Commission for an officer whose particular responsibilities will be to investigate and prosecute corporate wrongdoing, and that the procurator-general be empowered to prosecute corporate officials where criminal behaviour is involved.

Conclusion

The transition to a free market economy in Russia requires foreign investment. Foreign investment will flow significantly only if there is confidence in the way corporations are governed. This requires:

- basic stockholder protections in respect of ownership rights and voting;
- rules of conduct for officers and directors of Russian joint-stock companies that are as clear as possible;
- an educational process for such officers and directors; and
- the existence of a judicial forum wherein stockholder rights can be enforced.

While a good start has been made in establishing sound principles of corporate governance in Russia, the need for more rapid progress is clear and compelling. ❑

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Case Study: The Privatization of Fertilizer Distribution in Bangladesh

I. Introduction[1]

On January 16, 1995, Mr. Michael Armitage[2], a USAID/Bangladesh Mission officer, was reviewing a disturbing report on recent violence in the countryside. Apparently several farmers in Bangladesh had been killed in riots over fertilizer supplies the day before. The report also stated that seven fertilizer distributors in Bangladesh were arrested for selling fertilizers at above the maximum retail price set by the Government of Bangladesh (GoB). The events proved particularly disturbing for Mr. Armitage, in light of the recent completion of the fertilizer distribution improvement project in Bangladesh. The 16 year project, completed in August 1994, had led to the increased use and supply of fertilizers to improve agricultural production levels, eliminated price controls on fertilizers, and facilitated the privatization of fertilizer distribution.

The recent violence resulted from a series of unfortunate events that had occurred since the project had ended. The problems in the fertilizer sector could be traced to a world-wide increase in urea prices that began in the summer of 1994. In response to price increases, local factories, all of which were still owned by the government, began to export aggressively in search of more profitable earnings abroad. This limited the supply of fertilizer to private local dealers and reduced the supply sold to local farmers. The shortages and the increasing violence had given the GoB an excuse to introduce price controls and other measures which threatened the accomplishments of the fertilizer distribution improvement project. The nascent private fertilizer distribution industry was threatened. What options, if any, did the Mission have to address the crisis? How could the Mission prevent the government's gradual reclaiming of what had once been a vibrant private sector distribution network?

II. Bangladesh- Recent Economic Background

The rate of economic growth in GDP in Bangladesh had averaged 4.5% over the past three decades. By 1994, Bangladesh achieved a 50% increase in rice production and neared self-sufficiency in rice production due to increased fertilizer use and groundwater irrigation. Improvements in non-traditional exports (other than jute, leather, and leather products) and garments led to an increase in the export to GDP ratio from 7.4% in 1985 to 9.4% in

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[1]This case study was developed by *Price Waterhouse LLP* for the Economic Growth Training Workshop given for the United States Agency for International Development (USAID). The case is meant to serve as a basis for class discussion rather than to illustrate either effective or ineffective handling of a business scenario. The author of this case wishes to thank Mr. John Allgood of the International Fertilizer Development Center (IFDC) and Mr. Ralph Cummings of USAID. Further use of the case is prohibited without permission from Price Waterhouse LLP and USAID. August 1995.

[2]Names and positions have been fictionalized for the purpose of case writing.

1991.The ratio of imports to GDP was 16-18%, fluctuating with the annual food aid requirement and changes in the annual bill for oil imports.

Poverty alleviation remained a major issue for the GoB. The per capita income of US$180 made Bangladesh as one of the lowest income countries in the world. Income distribution in Bangladesh was highly skewed, with the upper 5% of the population contributing 21% to the national income and the lower 40% contributing 18%. Nearly half Bangladesh's 110 million people lived below the poverty line, while 27% were considered to be in extreme poverty. Bangladesh remained heavily dependent upon foreign aid, with total aid disbursements, though declining, accounting for nearly 7% of GDP in fiscal 1993.

To encourage private sector initiatives, the GoB passed the 1991 Industrial Policy, through which it planned to privatize all public enterprises, with the exception of airways, railways, electricity, telecommunications, and minting and security printing. The government planned, in particular, the restructuring of the Bangladesh Jute Manufacturing Corporation, the Bangladesh Jute Corporation, the Bangladesh Power Development Board, and the Bangladesh Agricultural Development Corporation. In 1993, the government permitted private sector investment in power and telecommunications, in addition to establishing a privatization board to speed the divestiture process. By 1995, the government had initiated a major restructuring program in the jute sector that called for the closing or privatization of all but two of its 29 mills.

III. The Agriculture Sector in Bangladesh

Predominantly an agrarian economy, Bangladesh's agriculture production contributed to 40% of GDP in 1994. In 1994, about 85% of the population resided in rural areas, with over 2/3 of this rural community working in the agriculture sector. Between 1980 and 1993, the number of persons per cultivated hectare had increased from 10 to 14 persons.

Bangladesh farmed 9 million hectares of cultivable land. About 30% of the cultivated land was irrigated, with 85% of the irrigated land using modern methods and tools such as tubewells and low lift pumps. Farm sizes averaged 0.9 hectares, with small farms dominating 70% of the farm community and 29% of total farm area.[3] Landholding patterns were also skewed. About 11% of rural households owned half of the total cultivable land, while 33% of the rural population were considered landless.

Wheat and rice paddy crops accounted for, on average, 80% of the value of annual

[3]Landholding of up to 2.5 acres were considered small farms. Medium farms were up to 7.5 acres, and anything above 7.5 acres were considered large farms. Large farms accounted for 4.9% of the total farm population and 26% of the total farm area. In 1994, the farm community consisted of about 10 million farmers.

agricultural production. [4] Three seasonal rice crops (Aus, Aman, and Boro)[5] represented about 74% of the total cropped area; other important crops included wheat (5%) and pulses (5%).

Urea, triple superphosphate (TSP), and muriate of potash (MP) were the principal chemical fertilizers used in Bangladesh. Domestic fertilizer production consisted primarily of urea and TSP, and some single superphosphate (SSP). The government imported all of its MP supply and 75% of TSP. Imports of MP, TSP, and other products accounted for about 25% of the total fertilizer supply in Bangladesh.[6] Approximately 80% of the total fertilizer use was applied to rice each year.[7]

Demand for fertilizers peaked at three periods during the year. For urea, the peaks were February-March (Boro), June (Aus), and September-October (Aman). For TSP, the peak use periods were January-February, July-August, and October-November. A pattern of peak use for MP was not apparent.

IV. Fertilizer Distribution and Marketing in Bangladesh Prior to 1978

Inefficient traditional subsistence agriculture and poor climate and drainage led to low productivity. The use of manure, compost and rice hulls to soil was practiced, but on a limited basis.

Bangladesh did not begin use of chemical fertilizers until the 1950s, primarily for tea gardens and agricultural research. At the time, the Directorate of Agriculture procured, stored, and distributed the fertilizer. The Bangladesh Chemical Industries Corporation (BCIC), a parastatal operating under the Ministry of Industries, controlled all domestic fertilizer production.

In the early 1960s, the East Pakistan Agricultural Development Corporation (EPADC), was established to import, procure and distribute to the farm level fertilizer, seeds, and irrigation equipment and services. After independence from Pakistan in 1971, EPADC was renamed the Bangladesh Agricultural Development Corporation (BADC), and placed under the Ministry of Agriculture and Forests. In addition to duties formerly carried out by EPADC, the BADC gained responsibility for monitoring and controlling prices of fertilizer distributed

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[4]Other important crops included jute, sugarcane, tea, tobacco, cotton, oilseeds, potato and pulses.

[5]The three rice crops corresponded to the early monsoon, late monsoon, and winter (dry) seasons.

[6]In 1977, urea represented approximately 66% of total fertilizer sales; TSP, 27%; MP, 6%, and other, 1%.

[7]Of the total used on rice, the Aus crop accounted for 32%, the Aman, 55%, and the Boro, 13%.

and sold to retailers and farmers.

Between 1967 and 1968, BADC began a campaign to inform farmers about the value of fertilizer to increase crop yields. This involved the development of a distribution system through private dealers and cooperatives. Between 1964 and 1977, fertilizer sales increased from 305,900 metric tons to 715,000 metric tons. By 1977, 65% of the farm community used chemical fertilizers, though most of the users were larger farmers. Fertilizer imports represented 57% of total sales in 1977, mostly funded by various sources under loans and grants. Supply shortages and timely delivery of fertilizers hindered sales.

The Old Marketing System

Under what was known as the Old Marketing System (OMS), the BADC used a national network of about 22,000 private sector retailers for fertilizer sales to farmers.[8] The BADC procured the fertilizers from the domestic state-owned factories or imported them, and then shipped the fertilizers to 67 intermediate warehouses. The BADC then shipped the fertilizers to a network of 423 thana[9] sales centers or Thana Central Cooperative Associations (TCCA). Finally, private retailers purchased the fertilizers from the thana sales centers or TCCAs and sold the products to farmers (see Exhibit 1). Thana sales centers distributed about 75% of the fertilizers directly to private retailers, while TCCAs sold the remaining 25% on a wholesale basis to private retailers and to member village cooperatives called Krishi Samabaya Samity.

Retailers could only purchase fertilizers from specific sales centers assigned to them. The OMS permitted retailers to sell fertilizers only to farmers in specified areas and at prices established and controlled by the GoB. The retailer would also receive a discount off the official retail price of the fertilizer product, set by the GoB, to cover transportation costs, losses, and profit margin.[10] BADC gave retailers an average discount of 8.6% off BADC's gross sales revenue. The discount and profit margin proved insignificant after accounting for transportation and handling costs. In addition, if the price of fertilizer increased, the discount only compensated the retailer for distance, and the retailer paid for the price difference out of his own pocket.

Under the OMS, all retailer accounts and sales were subject to inspection by the BADC. To

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[8]Dealers were appointed by the BADC on approval of a thana committee composed of BADC's thana inspector, the Ministry of Agriculture's thana extension officer, the local union council chairman, and an officer representing the deputy commissioner at the thana level.

[9]Thanas were the administrative unit of the local government below the district level.

[10]The formula for establishing a dealer's gross discount off the official retail price was based on the dealer's distance from the assigned thana sales center. This discount did not take into account the dealer's purchase cost. Thus, the gross discount varied from product to product and according to distance.

help achieve promotion of fertilizer use, retailers had to maintain a sign board indicating retail fertilizer prices in a prominent place at their sale site, distribute leaflets and pamphlets to farmers about fertilizer use, and display posters issued by the BADC. But retailers rarely bothered to display these posters or hand out leaflets.

The BADC had few incentives to cut costs under the OMS. Though sales volumes increased by 90% between 1973 and 1978, BADC's operating costs escalated by 240%.

Moreover, retailers and farmers experienced frequent temporary fertilizer shortages. This resulted, at times, in restricted product choices for farmers. These problems in fertilizer use and supply were mainly attributed by:

- Poorly timed arrival of imported products, limited access to foreign exchange, and low production levels from domestic factories.
- Inadequate transportation infrastructure to meet higher shipping demands and limited storage capacity.
- Lack of coordination and communication between donors on fertilizer aid and organizations responsible for various segments of the fertilizer sectors at the Ministry level (e.g. transport, finance, port operations, and rural development).
- Ineffective agricultural extension efforts to advise farmers on proper use practices.
- Shortage of skilled (technical and management) personnel.

Fertilizer subsidies

Beginning in the 1960s, budgetary subsidies were employed as part of the GoB's effort to popularize chemical fertilizer use and achieve accelerated growth in fertilizer consumption. The subsidy reflected the differences between the BADC expenditures on fertilizer procurement and distribution and sales revenues. As fertilizer use began to increase dramatically during the 1970s, subsidized prices created a serious budget problem for the GoB. By 1977, the fertilizer price subsidies (from factory to farm-levels) amounted to 59% of BADC total budget and 4% of total GoB budget expenditures. Subsidies as a percentage of total fertilizer costs averaged 50% (see Exhibit 2). The GoB wanted to phase out the use of subsidies and more efficiently use the savings for activities such as irrigation development.

In 1978, the GoB with the assistance of USAID, began an ambitious fertilizer distribution improvement project to remedy these and other problems faced by the fertilizer sector.

V. The Fertilizer Distribution Improvement Project, Phase I (FDI-I): 1978-1983

The FDI-I project integrated and expanded three separate USAID agricultural development efforts in fertilizer storage, bulk handling, and agricultural input supply initiated in the early 1970s. The project aimed to increase crop production through increased use of fertilizers, particularly among small farmers, and improve BADC's effectiveness in fertilizer distribution and marketing. The GoB hoped to achieve a 4% annual increase in foodgrain production on

all land, as well as a minimum 6% increase in foodgrain production on small landholding.

The GoB/Ministry of Agriculture and USAID/Bangladesh signed the FDI-I project agreement in July 1978.[11] USAID and the GoB contracted the services of the International Fertilizer Development Center (IFDC) to provide technical assistance for the FDI-I project. IFDC would provide assistance to the Ministry of Agriculture and the BADC in the areas of inventory control, least cost routing, and use of high-volume transactions as a means to cut costs and pass on savings to private retailers. In addition, IFDC would deliver training to private retailers on how to promote fertilizer use and increase demand through improved information dissemination on optimal fertilizer use.

Constraints to fertilizer supply due to the lack of foreign exchange for imports and storage capacity would be addressed through financing of fertilizer imports and the construction of additional fertilizer warehouses. Further, FDI-I aimed to develop and implement a new marketing system (NMS).[12]

The New Marketing System

The project encouraged policy and operational changes in the fertilizer marketing and distribution system through technical assistance, restructuring and privatization. The major changes brought about by the NMS included the following (see Exhibit 3):

- The intermediate warehouses, thana sales centers, and TCCAs were condensed into 97 Primary Distribution Points (PDP) under BADC control. BADC kept some of the thana sales centers and TCCAs located in remote areas where PDP dealers could not effectively supply fertilizer due to high transportation costs.

- The BADC would now only distribute fertilizers down to the PDP levels and in remote thanas not adequately served by PDP dealers.

- At these PDPs, BADC could sell fertilizers at reduced wholesale rates for large quantities over 3 tons directly to retailers.[13]

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[11]Total U.S. assistance as of May 1988 was approximately US$222 million ($190 million in grants, $32 million in loans).

[12]Funding for the three components were as follows: US$142 million to finance 527,000 tons of fertilizer imports, US$60 million to finance the construction of BADC fertilizer warehouses, and US $33 million for technical assistance and training in fertilizer marketing policy and marketing systems.

[13]Wholesale prices were determined by the GoB based on BCIC production cost or import costs, plus a markup for BADC overhead.

- Retailers could sell directly to farmers or to other private dealers. The ability to sell to subdealers allowed some retailers to become distributors of fertilizers.

- Restrictions on the resale price of fertilizers to farmers no longer existed.

- The gross discount rate offered by BADC to retailers and distributors was no longer based on distance from purchase site to sales site. Rather, the retailer or distributor would receive a fixed discount dependent on the type of fertilizer purchased at a PDP or a remote thana sales center. The discount received under the NMS averaged 11.8%, 3.2% higher than under the OMS.

- The BADC no longer appointed retailers. Any private individual, company, farmer association, or cooperative could buy or sell to and from anyplace or anyone they desired within Bangladesh.

Achievements under FDI-I

Over the 1978-1983 period, the FDI-I project achieved important results:

Foodgrain production: Between 1978 and 1983, foodgrain production increased by about 2.6% per year, from 13.3 million metric tons to 16.5 million metric tons. Though foodgrain production did not meet the 4% per annum goal, rice production increased at an annual rate of 2.15% (boro rice production increased by 8% per year alone) and wheat production increased by 12% per year over the life of the project.

Warehouse construction: Warehouse construction led to 34 new BADC warehouse sites with a rated capacity of 188,000 metric tons. This represented over 40% of total capacity (449,092 metric tons) by 1983.

Fertilizer imports, sales and use: Through the US$142 million fund support for imports, BADC imported a total 527,461 metric tons, averaging about 13% of the country's total fertilizer imports.

The gradual reduction of subsidies on urea, TSP, and MP did not result in reduced consumption of fertilizers, evidenced by increased sales to local farmers from about 730,000 metric tons to 1,129,000 metric tons between 1978 and 1983. This demonstrated an annual growth rate from about 8% to about 55%.

Over the life of FDI-I, the percentage of farmers using fertilizer on at least one rice crop grew from about 65% to 98%.

New Marketing System: The NMS limited BADC's responsibility for distribution of fertilizer down to the PDP level. In light of the fact that private retailers could now purchase directly

from PDPs and sell to anyone of their choice below the PDP level, some private retailers chose to become distributors and resell fertilizer to subdealers for slightly higher profits than before. By the end of the project, private distributors and retailers controlled nearly 99% of fertilizer trade below the PDP level. Though not openly stated as part of the project goal, the policy changes under FDI-I resulted in the gradual privatization of fertilizer marketing and distribution below the PDP level.

Remaining Issues under FDI-I

Though BADC's distribution costs did not increase, they remained very high, attributed mainly to BADC mismanagement. Fertilizer use by farmers and dealer receivables were still often constrained due to BADC's failure to make fertilizer available in an adequate, timely, and convenient manner. Access to and reasonable prices for fertilizer in remote areas remained an issue for the BADC, given higher prices for transportation and marketing, and a limited number of distributors in the remote areas. Further, as retailers and distributors began purchasing larger amounts of fertilizers, they complained of a lack of access to commercial credit to finance their purchases.

VI. The Fertilizer Distribution Improvement Project, Phase II (FDI-II) : 1987-August 1994

The experience under FDI-I revealed that improvements in fertilizer use depended on the liberalization of the distribution system. Thus, FDI-II was born. Though FDI-II maintained the same development objective as FDI-I, this follow-on project focused more on improving efficiency in fertilizer distribution by focusing on the establishment of a free, competitive, open fertilizer marketing system. IFDC continued to provide technical assistance to the project and the Ministry of Agriculture.

Project implementation began in February 1987 with the re-contracting of IFDC to provide technical assistance. FDI-II included four major components: policy reform, a commercial credit program, dealer development and technology transfer, and institutionalization of a market information system.[14]

Policy Reform

The objective of the policy reform component was to identify, formulate and recommend policies that would provide a strong basis for a viable and sustainable private sector fertilizer

[14]More specifically, the key components were: a US$44 million fertilizer Commodity Import Program (CIP) with the local currencies generated by the sale of the imports used to create a fertilizer credit fund; US$6 million for construction of storage, bagging, and handling facilities; and US$5 million of technical assistance and training under an IFDC contract. Including US$10 million for contingency and inflation, total USAID funding for FDI-II was US$65 million.

marketing system. This was accomplished through several programs which sought to reduce fertilizer distribution costs and encourage greater private sector participation in procurement and importation of fertilizers.

TDP Program: In July 1987, IFDC recommended the creation of transportation discount points (TDP) to allow private dealers to bypass PDPs and purchase larger quantities of fertilizers (84 metric ton minimum) at discounted prices from 4 major TDPs strategically located closer to factories and ports. Offering a discounted price to dealers to purchase fertilizer from the TDPs proved less expensive for the BADC than transporting and distributing fertilizer to dealers from the PDPs.

By December 1988, private wholesalers made nearly 22% of their sales through the TDPs. The BADC, seeing its role in distribution fading, made the concerted effort to obstruct use of TDPs by delaying the delivery of fertilizers to the TDPs. The TDP program suffered from inefficient operations and resulted in supply interruptions to private dealers and fertilizer shortages at the farm level.

Direct Procurement of Fertilizers: Beginning in July 1989, the Ministry of Agriculture decided to allow private distributors to purchase fertilizers directly from all factories. The policy initially applied only to the purchase of urea from domestic factories. The private sector responded with aggressive purchasing of urea from the factories and led to improved availability of urea throughout Bangladesh. This, in turn, led to significant decreases in farm-level prices (see exhibit 4). The policy encouraging dealers to buy urea directly from factories persuaded the Ministry of Agriculture to permit the direct purchase of TSP and other domestically produced fertilizers by the private sector. In 1992, the GoB began to allow the private sector to import fertilizers, such as MP and TSP, directly on a full cost basis.

Reorganization of BADC: BADC, which in 1988 employed 20,700 people, found itself with nearly 6,000 redundant employees as an increasing number of its activities were transferred to the private sector. An initial recommendation by IFDC involved reorganizing BADC regional offices into centers for promotion, development, market research monitoring, demonstration, and technology transfer activities related to fertilizer marketing. An alternative to this involved shifting all responsibilities for monitoring farm-level prices, quality control, stock availability, and import of agricultural inputs to a monitoring branch of the Ministry of Agriculture. BADC employees and unions, however, demonstrated great resistance to such changes. They did not favor the concept of phasing out redundant employees, even if counterbalanced by an attractive voluntary retirement package.

Commercial Credit Program

In June 1989, to complement the deregulation of the fertilizer imports and marketing system, the FDI-II project established a commercial credit program (CCP). USAID granted the CCP a head start with US$15.0 million in funds. The funds were placed with the Bangladesh Bank

to be used to provide loans to commercial banks. The commercial banks then provided loans to finance private distributors' fertilizer inventories. The CCP funds were periodically increased with (1) local currency payments made on fertilizers imported under USAID funding, and (2) interest paid on refinancing received by the participatory banks. The CCP funds totaled US$26 million at the end of FDI-II.

The CCP system also introduced a new banking instrument in Bangladesh, the Inland Letter of Credit (ILC). The ILC enabled fertilizer distributors to receive commercial bank financing (at rates ranging from 12.5%-15% per annum) for 90-day periods to purchase fertilizers from the factories. Under the ILC system, the banks provided credit to the distributors, guaranteeing payment by the bank to the BCIC within 5 days of delivery of the fertilizer. Advantages to this credit medium included lower bank charges, lower risks in arranging cash payments, no credit risk to the BCIC, and no blockage of funds to distributors with the BCIC for prolonged periods.[15] The delinquency rate for loans made to distributors was estimated at 24% in mid-1994, as opposed to an estimated 80% for foodgrain traders.

Dealer Development and Technology Transfer

This project component sought to improve the technical skills of fertilizer distributors and retailers to improve the efficiency of fertilizer suppliers, actively promote proper fertilizer use, and provide better advice to farmers. Part of IFDC's technical assistance role included training to various fertilizer industry players, funded out of the project's technical assistance component. IFDC provided training to government officials on fertilizer policy and market-based fertilizer distribution; to private distributors on fertilizer marketing; and to bankers and distributors on the use of bank financing for fertilizer marketing. During FDI-II, over 11,000 fertilizer industry players participated in domestic training programs and almost 200 participated in external study tours/programs.

Market Information System (MIS)

IFDC developed and operated an MIS to collect and disseminate information on fertilizer sales, imports, stock, prices, and availability. Other monitoring activities included the institutional and economic impacts of fertilizer distribution, the determinants of fertilizer uses, and the profitability of fertilizer use under different circumstances. The MIS sought to ensure transparency in fertilizer marketing and provide policy officials with improved and timely information as a basis for sound policy development.

Achievements under FDI-II

By the completion of the project in August 1994, the USAID/Bangladesh mission could only

[15]An estimated US$400 million credit had been provided to fertilizer dealers under the ILC system.

find satisfaction in the project's numerous accomplishments.

Subsidy withdrawal: The final stage of subsidy removal targeted TSP and MP fertilizers and was completed by December 1992. Total savings to the national budget due over the 1989-1994 period as a result amounted to approximately US$44 million (see Exhibit 5). Gross margins remained low between factory to farm-level prices, averaging between 16-19% in 1991-1994.

Improved efficiency by the private sector: Policy changes in fertilizer procurement and distribution led to the emergence of a growing group of private sector importers, distributors, and retailers (see Exhibit 6).[16] Costs in the distribution of urea from the factories to the farm level declined from 30% in 1988 to 14%, on average, in 1993.

The public sector share of the national fertilizer market decreased from 100% in 1987 to less than 1% by 1994. Imports by BADC declined from 100% in 1990 to 0% in August 1994. The private sector managed the importation of fertilizers at full cost.

The direct purchase of fertilizer from the BDIC factories by the private sector led to a steady decrease in farm level prices for urea and TSP to competitive market levels (see Exhibit 4).

Increased fertilizer use, availability and sales: Fertilizer use increased significantly. Aggregate fertilizer sales during 1987 to 1994 increased by 70% with an annual compound growth of 8% (see Exhibit 7). The number of farmers using fertilizer grew from about 8 million in 1985 to 11 million by 1992. In particular, fertilizer use spread more rapidly among small farmers (see Exhibit 8). This led to an average increase in paddy yields from 1.4 metric tons to 1.8 metric tons per hectare between 1987 and 1993, an increase of about 30%.

Fertilizer availability had also improved significantly throughout Bangladesh with the exception in the remote regions of Chittagong. In 1986, about 41% of the Bangladeshi farmers were able to purchase fertilizer at retail shops within 5 km of their farms. In 1994, this increased to 80%. The higher urea sales level from BCIC factories by 1990 to the private distributors complimented the increased domestic production.

Higher levels of agricultural production: Food grain production increased considerably. Total food grain production increased from 16.5 million metric tons in 1987 to 19.5 million metric tons by 1993. Total rice production increased by an annual compound rate of about 3%.

Market Information System: The output of the MIS provided by IFDC to sector policy makers served as a basis for a series of reports including: weekly reports on fertilizer

[16]Between 1987 and 1994, the number of importers increased from 0 to 215, distributors from 0 to 1,400, dealers from 6,000 to 13,000, and retailers from 36,000 to 108,000.

production and sales; fortnightly reports on farm-level prices; trade bulletins; monthly farm-level fertilizer price and availability surveys; monitoring reports on fertilizer distribution; CCP monitoring; quarterly progress reports; annual reports; and farm-level use studies.

Formation of the Bangladesh Fertilizer Association (BFA): The BFA was created out of the need for fertilizer dealers in Bangladesh to develop their own capabilities to deal with certain key issues, such as market monitoring and intelligence, liaison with the government on fertilizer and agriculture related issues, dealer training and technology transfer, and dealer or retailer and farmer education about fertilizer use. The BFA received technical and organizational assistance from FDI-II.

Close collaboration between project players: The cooperation among the Ministry of Agriculture, USAID and IFDC proved crucial to the success of FDI-I and II. Officers of each entity actively participated at every phase of the project and maintained consistent contact with their project counterparts. IFDC maintained daily communication with the Ministry of Agriculture on all issues pertaining to the project. The Ministry of Agriculture committed itself to opening the fertilizer market to the private sector and consistently implemented policy changes recommended by IFDC. The level of cooperation between USAID, IFDC, and the Ministry of Agriculture also extended to the Bangladesh Bank, Ministry of Finance, BCIC, commercial banks, and the donor community.

Remaining Issues under FDI-II

Transfer of BADC Warehouses: The gradual privatization of fertilizer distribution left the BADC with a handful of unused warehouses. The transfer of the warehouses was proposed and only partially carried out, leaving the GoB to incur costs for the idle storage sites. By 1994, the GoB divested a capacity of 95,700 metric tons, but there remained an additional 373,900 metric tons still under the BADC. BADC retained an unnecessary budgetary burden of nearly US$5 million/annum to cover overhead, salaries and allowances of redundant employees.

Non-institutionalization of the MIS: The MIS proved itself highly valuable and effective in information dissemination to sector policy makers. It was hoped that the MIS would be integrated with the Ministry of Agriculture or even the BFA through an upcoming Agro-based Industry and Technology Development project (ATDP). However, implementation of ATDP did not take place until March 1995, and the MIS stood idle during the interim.

VII. Unexpected Problems in the Fertilizer Sector

In July 1994, world prices for urea began to rapidly increase. The BCIC took advantage of the higher fertilizer prices and began to export to take advantage of lucrative international markets. The exports continued to grow during August- December 1994, apparently without the knowledge of government policy officials. Further, factories stopped extending credit to

private sector dealers under the ILC scheme, thus limiting amounts private sector dealers could afford to purchase. As a result, the domestic pipeline was not adequately supplied for the boro rice season. Fertilizer prices escalated.

The government attempted to respond by using civil administration and later the army to uproot the unofficial embargo of fertilizer products placed on domestic distributors and dealers. The government also implemented a maximum retail price for the urea in January 1995. Although not rigorously enforced, implementation of price controls added further to the uncertainty in the market place. The GoB also began to assign command areas to urea factories, and restrict dealers to buying fertilizers from particular factories. In addition, individual distributors/firms could only purchase a limited amount of fertilizer from these factories.

As a result of tight fertilizer supplies and 25-40% higher prices since December 1994, it was estimated that foodgrain production for the 1995 (April/May harvest) boro crop of rice would fall 500,000 tons short of what it would have been with fertilizer available.

VII. The Decision

Mr. Armitage knew that the situation would worsen if the GoB continued to recapture control over the fertilizer distribution system. Given that the reform process had begun to unravel, what issues did Mr. Armitage need to address in order to get the reform process back on track? What could have been better addressed under FDI-II that could have prevented any of these events from taking place?

Exhibit 1: Old Marketing System

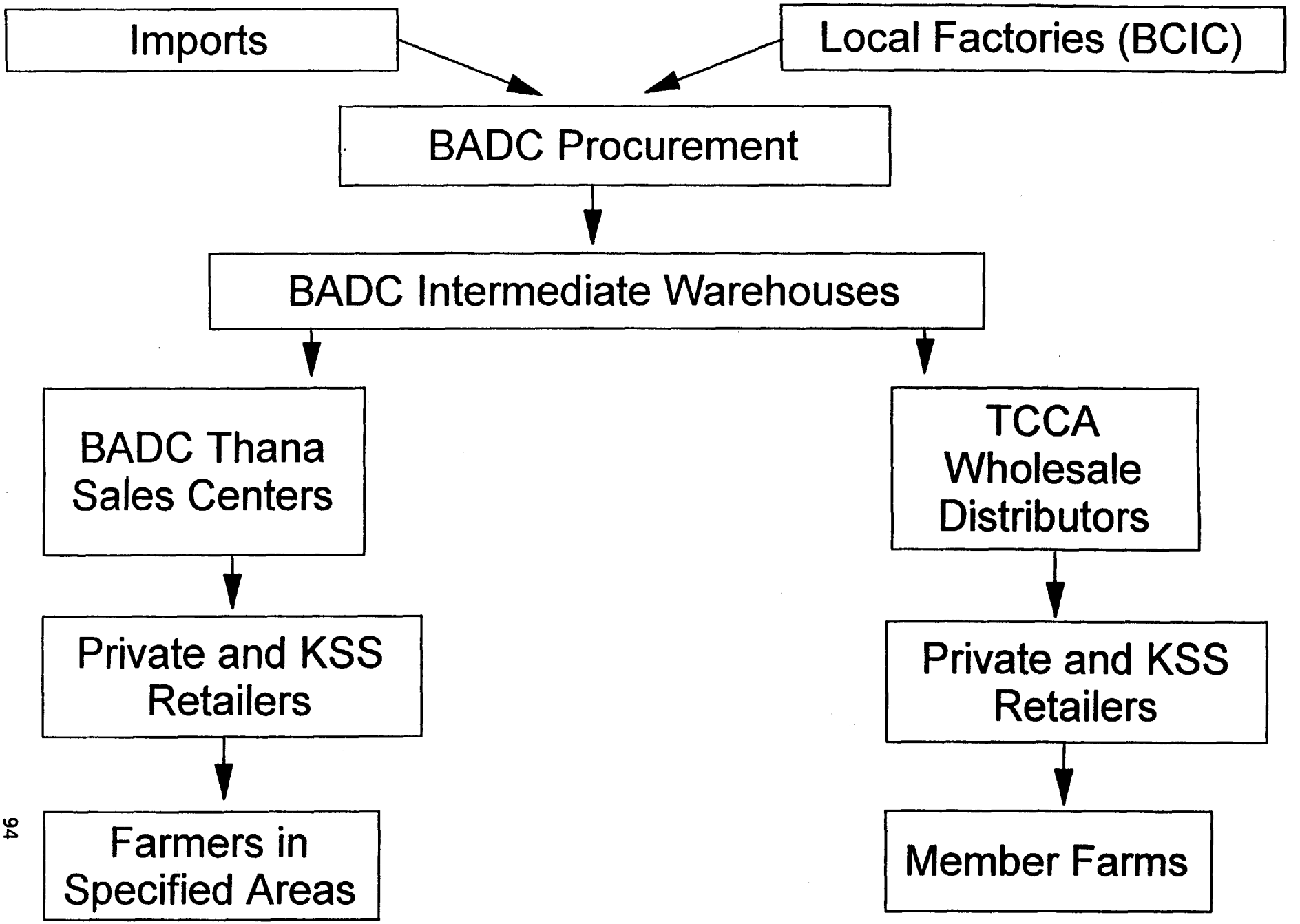

Exhibit 2: Estimated BADC Fertilizer Procurement Costs, Sale Prices, and Approximate Nominal Subsidy (1975-1983)

	Estimated BADC Supply Costs			Estimated BADC Sale Prices			Approximate Nominal Subsidy		
	Urea	TSP	MP	Urea	TSP	MP	Urea	TSP	MP
	(Tk/Metric Ton)						(%)		
FY									
75/76	2841	4149	2800	1361	1089	816	52	74	71
76/77	2982	3985	2990	1633	1307	1089	45	67	64
77/78	2564	3785	2221	1633	1307	1089	36	65	51
78/79	3222	4460	2670	1905	1497	1225	41	66	54
79/80	3426	4926	3330	2450	1905	1497	28	61	55
80/81	2741	5841	4092	2994	2450	1769	-9	58	57
81/82	3793	5474	3856	3390	2802	2189	11	51	43
82/83	4118	5945	4370	3966	3752	2948	4	37	33

*US$1=40 takas

Exhibit 3: New Marketing System (1978-1984)

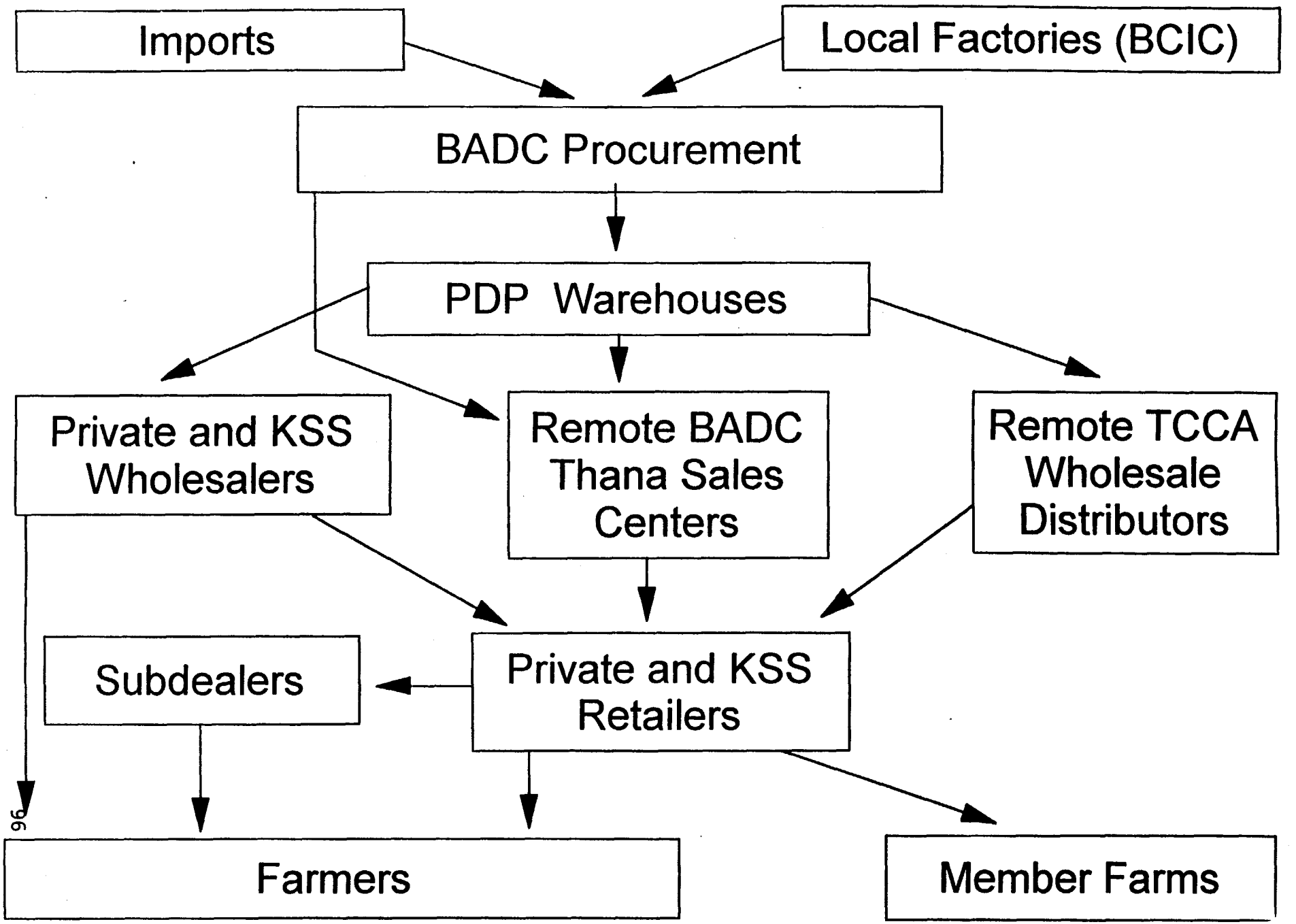

Exhibit 4: Average Issue and Retail Prices of Chemical Fertilizers July 1989 to January 1994 (takas per 50 kg. bag)

Month/Year	Issue Price	Retail Price	Margin	Margin as a % of Issue Price
UREA				
7/89	201	243	42	21%
1/90	201	227	26	13%
7/90	201	229	28	14%
1/91	203	233	30	15%
7/91	188	244	56	30%
1/92	216	244	28	13%
7/92	219	260	41	19%
1/93	233	268	35	15%
7/93	204	252	48	24%
1/94	202	235	33	16%
1/94 as % of 7/89	100%	97%		
TSP				
7/89	216	252	36	17%
1/90	216	249	33	15%
7/90	216	256	40	19%
1/91	216	262	46	21%
7/91	250	267	17	7%
1/92	275	320	45	16%
7/92	300	341	41	14%
1/93	343	402	59	17%
7/93	343	404	61	18%
1/94	366	403	37	10%
1/94 as % of 7/89	169%	160%		
MP				
7/89	166	226	60	36%
1/90	166	210	44	27%
7/90	166	214	48	29%
1/91	166	208	42	25%
7/91	183	215	32	17%
1/92	212	267	55	26%
7/92	237	285	48	20%
1/93	324	353	29	9%
7/93	283	355	72	25%
1/94	249	369	120	48%
1/94 as % of 7/89	150%	163%		

Note: For urea, the issue price is the factory price; for TSP and MP, the issue price is the BADC TDP price.

*US$1=40 takas

Exhibit 5: GoB Savings Attributable to Subsidy Withdrawal and Private Fertilizer Business Activity

Fiscal Year	Savings due to subsidy withdrawal	Savings due to reduced GoB activity in fertilizer sector	TOTAL
	----------	Millions of Taka	----------
1988-1989		23	23
1989-1990		286	286
1990-1991		454	454
1991-1992	405	516	921
1992-1993	530	1,186	1,716
1993-1994	824	534	1,358
TOTAL	1,759	2,999	4,758
	(US$44 million)	(US$75 million)	(US$119 million)

Exhibit 6: Estimated Number of Private Fertilizer Importers, Distributors, Subdealers and Retailers 1987-1994

	Fiscal Year						
Business Type	1987-1988	1988-1989	1989-1990	1990-1991	1991-1992	1992-1993	1993-1994
Importers				215	215	215	215
Distributors		143	276	590	1,271	1,335	1,398
Subdealers	6,000	6,500	7800,	8,500	9,500	12,000	13,000
Retailers	36,000	43,500	47,200	71,500	100,500	104,000	108,000

Exhibit 7: Chemical Fertilizer Sales, by Product (thousand metric tons)

Year	Urea	TSP	MP	Total	Growth Rate(%)
1972/73	281	90	19	390	
1973/74	272	95	19	386	-1
1974/75	177	76	18	271	-30
1975/76	317	112	22	451	66
1976/77	359	128	23	510	13
1977'78	488	195	42	725	42
1978/79	476	215	45	736	2
1979/80	542	251	47	840	14
1980/81	560	257	45	862	3
1981/82	519	256	45	820	-5
1982/83	629	279	50	958	17
1983/84	708	354	63	1125	17
1984/85	832	346	69	1247	11
1985/86	825	307	63	1195	-4
1986/87	947	376	78	1401	17
1987/88	1050	402	86	1538	10
1988/89	1322	449	94	1865	21
1989/90	1369	480	119	1968	6
1990/91	1321	513	146	1980	1
1991/92	1533	457	137	2127	7
1992/93	1547	407	126	2080	-2
Annual Growth (%)					
1972/73-1982/83	8%	12%	10%	9%	
1982/83-1992/93	9%	4%	10%	8%	

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Exhibit 8: Number of Farm Households Using Fertilizer by Farm Size

	1985-1986				1991-1992			
Farm Size	Total Number of Farms (million)	Percentage	Number of Farmers Using Fertilizer (million)	Percentage	Total Number of Farms (million)	Percentage	Number of Farmers Using Fertilizer (million)	Percentage
Small	7.5	70	5.6	74	10.0	81	8.7	86
Medium	2.7	25	1.9	73	2.0	16	1.7	87
Large	0.5	5	0.4	76	0.4	3	0.3	83
Total	10.7	100	7.9	74	12.4	100	10.7	86

Techniques of Mass Privatization: Implementing the Voucher Auction Program October 1992 to June 1994

Jeffrey L. Schwartz and Zoanne L. Nelson

This paper presents a summary of the operational phases of the voucher auction process which was adopted by the Russian government in 1992 as part of the mass privatization program. The overall results of the voucher auction program's transfer of more than 12,000 enterprises from government to private hands are well known. In part, the success of mass privatization in Russia is due to the program's design and mechanics, which allowed for rapid replication and implementation across the country. Between October 1992 and January 1993, the Russian government issued each Russian citizen a privatization voucher; almost 150 million vouchers were distributed. A mechanism of publicly-held voucher auctions was established by the government to provide the opportunity for citizens to invest directly in large-scale enterprises undergoing privatization or to participate in one of more than 600 voucher investment funds which were licensed to operate in Russia.

The mass privatization program was initiated by the State Committee of the Russian Federation for the Management of State Property (Goskomimushchestvo, GKI). According to the Russian Privatization Center, as of April 30, 1994, eighty-six of the eighty-nine regions in Russia had initiated voucher auction programs, and approximately 11,000 enterprises had been privatized. The program was scheduled to be completed with the expiration of privatization vouchers on June 30, 1994.

The overall design of the mass corporatization and privatization program included the use of simple and standard procedures at each level of the process. The deliberate lack of complexity in the process facilitated the timely implementation and contributed to the success of the program. This design also made it possible to effectively use targeted international technical assistance and financing to support the program's replication throughout the country. As the coordinating ministry, the GKI has been highly effective in using technical assistance to support the program's design and implementation. Technical assistance has been provided by professional staff and private consultants supported by USAID, the World Bank, and the EBRD.

The deliberate lack of complexity in the process facilitated the timely implementation and contributed to the success of the program.

In outlining the design and mechanics of the voucher auction privatization program, this paper examines the three operational components of the program. The first step in the mass privatization program was the mass corporatization of enterprises which were to be privatized. The key steps in the mass corporatization process are outlined in the first section. The public and operational focus of the mass privatization program were the public voucher auctions which were conducted in almost every region across the Russian Federation. The main elements of the regional voucher auction process are outlined in second section. The last section summarizes the operations for national auctions, such as for the mass privatization of enterprises which were simultaneously auctioned in multiple regions.

Key steps in the corporatization and preparation for privatization of an enterprise in the mass privatization program

The initial phase of the mass privatization program involved the preparation and mass

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corporatization of thousands of enterprises across the country. The mass corporatization process included standard procedures for the selection of privatization options, the drafting of a privatization plan including a standard valuation of an enterprise's assets, the transformation of enterprises into joint stock, companies and the compilation of documents to register the shares to be distributed and sold at internal and public auctions.

In practice, options 1 and 2 have been predominant choices for enterprises undergoing privatization.

Phase 1: Preparation for privatization

There were three key preparation steps required to transform an enterprise into a joint stock company. The Director General of each enterprise was responsible for establishing a working commission for privatization of the enterprise. The commission was charged with the following tasks (see figure 6.1).

Valuation of assets. Enterprises' valuations were mechanically derived summaries of an enterprise's assets. These valuations were primarily driven by book values and were prepared according to requirements specified in GKI Regulation No. 763p.

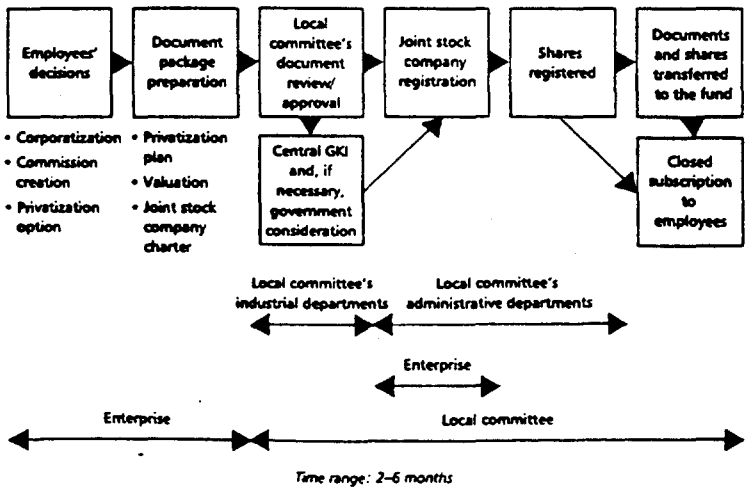
Privatization options. According to the 1993 State Program of Privatization in Russia, each commission was required to provide information to the employees of the enterprise in order to choose one of three options for privatizing the enterprise. The three privatization options involved a range of share allocations to enterprise insiders (enterprise managers and employees) and outside investors. Shares available to outside investors were distributed through voucher auctions or investment tenders. Each of the privatization options specified that 29 percent or more of available shares would be distributed through voucher auctions unless the enterprise belonged to a group of enterprises whereby less shares were required to be sold, such as energy, extraction, and refining enterprises. The share allocations for the privatization options are summarized in table 6.1. A dominant feature of the mass privatization program was the availability of large percentages of shares to employees and managers in enterprises to be privatized. Each of the three options involved between 50 and 60 percent of the initial shares of newly privatized companies to be distributed to enterprise managers, employees, or the Enterprise Employees' Shareholder Fund (EESF).

The selection of privatization option 2 or 3 required the approval of two-thirds of the employees either in a general meeting of the workers' collective or by obtaining signatures of the employees. If options 2 or 3 were not selected, option 1 was chosen by default. In practice, options 1 and 2 have been predominant choices for enterprises undergoing privatization. Approximately 70 percent of enterprises selected option 2 and approximately 30 percent of enterprises selected option 1. Less than one percent of enterprises selected option 3. Many of the largest enterprises chose option 1 by default due, in part, to difficulties in organizing a workers' meeting or difficulties for employees in purchasing the majority amount of shares for large enterprises with high levels of statutory capital.

The key elements of the privatization options are summarized below.

OPTION 1. Enterprise insiders can obtain control of up to 50 percent of the shares. Fifty percent of the shares are available to outside investors through voucher auctions or investment tenders. From the authorized capital,

Figure 6.1 Preparation of a Russian enterprise for voucher privatization



- Employees are given preferred nonvoting shares representing 25 percent of the charter capital. These shares are distributed free of charge to all members of the work collective provided the value does not exceed 20 times the legal minimum remuneration for the employee;
- Common shares constituting up to 10 percent of the charter capital, but not exceeding six times the legally established minimum remuneration of one employee, are sold by closed subscription to the work force at a 30 percent discount from the nominal price of a share. Payment can be made in installments over a three-month period with a 50 percent initial payment of the nominal price;
- Management can acquire common shares constituting five percent of the charter capital at a nominal price not to exceed 2,000 times the legal minimum remuneration; and
- The work force may establish an Enterprise Employees' Shareholding Fund (EESF) which is eligible to receive 10 percent of the charter capital with a two year option to purchase the shares at their nominal value. Transfer of the shares from the EESF to the employees is conditional upon the completed sale of 80 percent of shares including the sale for vouchers of the shares established by legislation.

OPTION 2. Enterprise insiders can acquire 56 percent of the shares and 44 percent are available to investors through voucher auctions and future cash sales or investment tenders:

- Employees have the right to buy common voting shares representing 51 percent of the authorized capital at a price equal to 1.7 times the nominal value of the shares and
- The EESF may retain up to 5 percent to be purchased within two years.

OPTION 3. Enterprise employees and managers can acquire 60 percent of the shares with 40 percent of the shares to be sold through voucher auctions and investment tenders or cash sales.

- If a group of workers or any physical or legal person takes the responsibility to fulfill the privatization plan and to ensure the solvency of the enterprise, and receives the consent of the general assembly of the work force under an agreement which should not exceed one year, the group has the right within a specified period to acquire 30 percent of the common shares at the nominal price.
- Enterprise workers (including members of the above group) can purchase common shares constituting 20 percent of the charter capital not exceeding 20 times the minimum remuneration at a 30 percent discount from the nominal price payable over a three month period with a 25 percent initial payment.
- If the managing group cannot fulfill the provisions of the agreement, the shares of the group will be sold to the public at a specialized voucher auction (or for cash after July 1, 1994).
- Shares transferred to the EESF should not exceed 10 percent of the charter capital.

Table 6.2 illustrates the allocation of shares among internal and external investors for selected enterprises.

Privatization plan. The privatization plan for an enterprise details basic information on a company and its privatization. This includes a sign valuation of the enter-

Table 6.1 Allocation of shares under privatization options 1, 2, and 3
(percent)

Description	*Option 1*	*Option 2*	*Option 3*
Free to employees	25		20
Sold to employees at 1.7 index of nominal value (cash or vouchers)	10	51	
Sold to management at nominal value (cash or vouchers)	5		
Sold to employee group committed to fulfilling the privatization plan and managing the enterprise at nominal value after one year (cash only)			30
Sold to Enterprise Employees' Shareholder Fund (EESF) with two-year right to purchase (cash only)	10	5	10
Subtotal retained by enterprise	50	56	60
Voucher auction (minimum percentage by law)	29	29	29
Investment, tender, retained by government, or other	21	15	11
Subtotal available to investors or government	50	44	40
Total	100	100	100

prise's assets and the proposed number and allocation of shares to be issued. A typical privatization plan depicts the following information:

- Summary characteristics and information including the name, address, ownership status, bank name and account numbers, names and addresses of wholly-owned and partially-owned subsidiaries, number of employees, founding capital, list of products made by the enterprise, and information regarding the location of company plants and operations. The plans also include lists of all social, as well as productive, assets.
- The selected privatization option and the names of the commission members.
- The distribution of shares according to the privatization option including the calculation of shares outstanding, and for whom specified amounts of shares are available.
- The proposed placement of the shares of the enterprise including the new name of the joint stock company, the total number and nominal value of shares, the percentage of preferred and common shares, and the form of shares (actual certificates or central registrar). The plan should include a table which summarizes the proposed placement of the shares to employees and management, along with external placements (such as voucher auction and investment tenders).

The privatization plans were signed by the chairman and members of the auction commission and chairman and members of the local property committee.

Articles of the joint stock company. A model corporate charter was provided in the attachment to Presidential Decree No. 721 entitled, "Regulations for the Commercialization and Transformation of State Enterprises into Open Joint Stock Companies." The decree provided a detailed example of a company charter including the company's purposes and the role of the board of directors and company's management.

Table 6.2 Distribution of shares for selected Russian enterprises

Company (principal industry)	*ZIL (automobiles)*	*Saransk Factory Orbita (semi-conductor devices)*	*Amurenergo (electric utilities and thermal power)*	*Lukoil Kogalimneftegas (oil drilling and gas extraction)*	*Krasnoyarsk Tire Factory (tires)*	*Krasnoyarsk TsBK (cellulose, paper, and cardboard)*	*Tekstilmash (textile looms)*	*Tomsk Neftekhimiches Factory (oil-based chemicals)*
Privatization option	1	1	1	1	2	2	2	2
Internal placement *(percent)*								
Preferred stock placement for employees (option 1 only)	25.0	25.0	18.5	18.6	0.0	0.0	0.0	0.0
Closed subscription of common stock for employees	10.0	10.0	5.6	10.0	51.0	51.0	51.0	51.0
Common stock placement for managers (option 1 only)	5.0	3.6	5.0	5.0	0.0	0.0	0.0	0.0
Enterprise Employees' Shareholding Fund (EESF)	10.0	10.0	10.0	0.0	5.0	0.5	0.0	5.0
Total internal placement	50.0	48.6	39.1	33.6	56.0	51.5	51.0	56.0
External placement *(percent)*								
Voucher auctions	35.0	29.0	11.9	17.3	29.0	29.0	29.0	44.0
Retained by government or holding company	13.0	20.0	49.0	38.0	15.0	19.5	20.0	0.0
Distribution to population in the far north and employees of the oil transportation companies and subcontractors	0.0	0.0	0.0	9.7	0.0	0.0	0.0	0.0
Investment tenders	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cash sale	2.0	2.4	0.0	1.4	0.0	0.0	0.0	0.0
Total external placement	50.0	51.4	60.9	66.4	44.0	48.5	49.0	44.0
Total shares *(percent)*	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: Figures are rounded to the first number after the decimal point.
Source: Privatization Plan of the Enterprises.

Phase 2: Transformation to a joint stock company

Enterprises changed their legal status to joint stock companies through the registration of their privatization plans and founding documents by the Local and Federal Property Committees. The process included:

Approval. Privatization plans were to be submitted by October 1, 1992 to the industrial departments of the local property management committees. The committees were required to approve these plans within seven days of their submission. If a plan was not approved, the committee had one week to amend and approve the plan. The approval of the central government and the GKI were required for certain size companies and industries.[1]

Registration. Within the property committees, the industrial department submitted an application, foundation documents for registration, and a prospectus for the registration of a securities issue for approval by the administrative department. The enterprise is considered transformed into a legal joint stock company upon its registration. The new shares of the enterprise are registered by the finance department of the regional authority.

Board of directors. As part of the legal registration and transformation process, the enterprise formed a Board of Directors which by law included the director general or a representative from that office, a representative of the property committee, a representative of the work force, and a representative of the local authorities. The board of directors' composition and duties were outlined in the model corporate charter included in the attachment to Presidential decree No. 721.

Phase 3: Distribution of shares to employees (closed subscription)

According to the privatization option chosen, enterprises were obliged to allocate shares within the company according to the approved privatization plan.

Distribution of shares. Upon registration, the company had fifteen days to conduct a closed subscription auction in order to either transfer the shares free of charge to the employees under option 1, or to make available for purchase the shares under options 1, 2, or 3. Employees, pensioned employees, and under certain regulations, the employees of suppliers or native inhabitants of the regions, submitted applications for the receipt or purchase of shares. Applications were processed to determine the allocation of shares.

Share registry. Following the distribution of shares to employees, the list of applicants formed the basis for drawing up a register of shareholders. These lists were later expanded to include new shareholders such as the winning participants in voucher auctions and investment tenders.

Phase 4: Voucher privatization

In accordance with government regulation and the approved privatization plans, a percentage of shares from each enterprise was allocated for distribution by the government to external investors through public voucher auctions. The percentages for distribution through closed and public auctions were specified in the privatization plans. Typically 29 percent of an enterprise's shares were allocated to be distributed through public voucher auctions.

Voucher auctions were conducted by sellers designated in the privatization legislation. The local property committee transferred the enterprise's registration documents to the seller who assumed responsibility for the shares created in the process of privatization. Sellers were generally the Federal Property Fund for companies which were federally owned, or the appropriate local property fund for companies that were under ownership of the territories, regions, the cities of St. Petersburg or Moscow, and municipalities.

The sellers managed the voucher privatization process. At the regional level, voucher auctions included a number of fundamental steps.

- Assigning an auction commission to provide oversight to the conduct of the auction and approval of the auction results

Typically 29 percent of an enterprise's shares were allocated to be distributed through public voucher auctions.

The location and reach of voucher auctions was a function of the size of the enterprises...

- Arranging for publication of required announcements for the upcoming auction
- Conducting the voucher auction
- Compiling and calculating the results of an auction, legitimizing the auction by the signing of a protocol of auction results, and ensuring that the shareholders are entered into the share registry of the enterprise
- Announcing the results of the auction to the public
- Ensuring the cancellation or return of vouchers
- Conducting a cash sale auction for a small percentage of shares to cover the expenditures of conducting the auction.

The regional voucher auction process

The initial voucher auction phase of the mass privatization program emphasized the development of regional voucher auction capabilities to conduct auctions for medium-sized, local enterprises in the regions where companies conducted their primary activities. Eighty-six of the eighty-nine regions in the Russian Federation had initiated and conducted regional voucher auctions prior to the program's close at the end of June 1994.

The Russian Federation Committee for the Management of Property (GKI) was responsible for overseeing and supporting the development of regional auction capabilities and ensuring that local regional programs conformed to the laws, decrees, and regulations governing the mass privatization program. Following the program's basic design, regions participating in the program established comparable systems providing the opportunity for citizens to invest in privatization vouchers through auction centers or bid reception centers located in cities and towns throughout the regions. The use of basic auction procedures and decentralized bid reception centers facilitated a widespread implementation of the program. The use of common bid reception and auction procedures also made it possible to integrate regional voucher auction capabilities into a national system to conduct auctions simultaneously in multiple regions for the largest Russian enterprises participating in the voucher privatization program. To establish voucher auction programs, regions developed similar systems of processing voucher auctions which included the basic steps outlined below.

Pipeline management

Working with the local property committee, the property fund identified enterprises which were eligible for selling shares through voucher auctions. They then performed a minimum level of due diligence on the enterprises, and generally organized an auction "wave" for the auctioning of several enterprises simultaneously. A typical wave would include anywhere from five to fifty companies being auctioned simultaneously in a two week period.

The location and reach of voucher auctions was a function of the size of the enterprises: companies with a fixed asset value of less than 250 million rubles could be auctioned only in the seller's region, enterprises with a fixed asset value of between 250 and 500 million rubles were required to be offered in at least five regions, and enterprises with a value of greater than 500 million rubles were to be auctioned nationally.

Bid collection

The local property fund established a regional auction center and several bid reception locations throughout the region depending upon the size of the region and distribution of the population. Over 750 bid collection sites were operating nationwide (approximately 10 sites per region) during the last six months of the voucher auction program.[2] Each region operated a central regional auction center which was run by the property fund or their designated agents. The property fund or agent generally subcontracted with commercial or government entities to open a network of bid reception sites which received applications for voucher auctions. Consultants at the bid collection sites provided basic information (drawn from the privatization plans) to potential applicants about the voucher auction process and companies being auctioned. Additional staff accepted and processed ap-

plications, and submitted the collected applications to the regional auction center for processing and calculating auction results.

Type 1 versus type 2 bids

Two types of bids were allowed under the voucher auction program. Each applicant, whether an individual or legal entity, was entitled to select the type of bid to be made in an auction. If an applicant submitted a type 1 bid, he would automatically become a winner in the auction and receive some number of shares in the auction. Type 1 bidders were indifferent to the strike price (the number of shares per winning voucher). Under a type 2 bid, the applicant specified the minimum strike price at which he was willing to accept shares in the company. If the calculated strike price was equal to or lower than the indicated bid, the applicant became a winner (for example, an applicant who specified a strike price of five shares per voucher would be a winner in an auction where the strike price was five shares per vouchers or lower). An estimated 95 percent of all bids in the voucher auction program were type 1 bids.

Auction results processing

Once the auction was closed, all bids were entered into a computerized database program. The auction results were calculated according to an algorithm which determined the strike price of shares per voucher. If there were no splits in the number of shares being offered at the auction at least 80 percent of the shares were to be sold. If there was a split in shares being offered (for example, 300,000 shares of 1,000 rubles nominal value were split to 600,000 shares of 500 rubles nominal value), one of two things occurred. If there was a split in shares being offered and less than 29 percent of the shares were offered for the auction, then 95 percent of the shares were to be sold. However, if a split occurred and 29 percent of the shares or more were offered, then 90 percent of the shares were to be sold.

To ensure the accuracy of voucher auction calculations, GKI developed and distributed standard auction software to the regions. Regions were permitted to develop and use their own software provided that it was tested and certified by GKI. Most regions used versions of the standard auction software issued by GKI.

Results of the auctions were presented in a protocol which was approved by the Auction Commission. Attached to the protocol summarizing the auction results was a list of winning applicants which was transferred to the share register of the company. After auction results were announced, the vouchers of winning applicants were canceled and the vouchers of the losing type 2 bids were returned to the applicants for resubmission in subsequent auctions.

Cash sale

To defray the operating costs for local voucher auctions and to provide incentives for agents operating local bid reception centers, post voucher auction cash sales were organized in regions which conducted voucher auctions. These were typically simple open outcry auctions where lots with varying numbers of shares were sold for cash. Regional property funds could sell up to 5 percent of the amount of shares sold through the voucher auction for enterprises which sold less than 29 percent of their shares, or they could sell up to 10 percent of the shares allotted to voucher auctions if 29 percent or more of an enterprise's shares were sold through voucher auctions. Proceeds from cash auctions were collected by the property fund and redistributed to participating agents which operated bid reception centers. Agents were generally reimbursed on the basis of the number of vouchers which were collected and canceled (the presentation of a cancellation protocol to the seller was necessary in order to receive compensation). Lists of winners of shares in cash sale auctions were also forwarded to the company or its registrar to be included in the share registry.

Examples of regional voucher auction systems

To illustrate the operations and results of regional voucher auction programs, the activities of five regions are summarized below.

Sverdlovsk Regional Auction Center. The property fund designated the Ural Stock Center (USC), a commercial entity, to act as the agent for the region. The fund played a key role in creating this entity in cooperation with a private consulting firm with funding provided by USAID. Initial funding of the bid process was provided by USAID until the introduction of post-voucher auction cash sales enabled the system to become self-financing.

- *Bid reception network.* The USC opened approximately 30 bid reception sites to provide coverage in the 20 districts of the region. Locations were primarily in the local house of culture or the district property funds or committee offices.
- *Auction software.* The property fund developed their own software which was certified by GKI for use in local auctions, but uses the GKI standard auction software for national auctions.
- *Auctions results.* By the end of June 1994, the property fund conducted an estimated sixteen auction waves for a total of 350 enterprises.

Omsk Regional Auction Center. The regional auction center was managed directly by the property fund and was created with start-up technical assistance and funding provided by USAID. After the introduction of post-voucher auction cash sales, the operation became self-financing.

- *Bid reception network.* The property fund subcontracted with the local Sberbank (government-owned savings bank) branches, which opened two bid collection sites in the city of Omsk and two in other population centers in the region.
- *Auction software.* The property fund used the GKI standard software for calculating the local and national auctions.
- *Auctions results.* Omsk property fund conducted an estimated twenty waves of auctions for a total of 194 enterprises. Auctions were typically held for a period of two weeks.

Saratov Regional Auction Center. The property fund originally delegated the auctions to the local stock exchange. Towards the end of the program, the property fund ended this arrangement and developed its own center. This was a trend in several regions as the privatization program was drawing to a close and property funds were seeking to identify future roles for their organization in the post-voucher privatization system.

- *Bid reception network.* There were six bid reception centers that were operated directly by the property fund and its agent. In addition, twenty-three bid reception sites were operating in the region at the local postal offices and district property fund or committee offices.
- *Auction software.* The property fund used the GKI standard auction software for calculating local and national auctions.
- *Auctions results.* Saratov property fund has auctioned approximately 250 enterprises in twenty-five auction waves, each wave consisting of approximately ten companies. Enterprises were auctioned for a two week period.

Orenburg Regional Auction Center. The property fund signed an agreement with a local currency exchange to act as their representative in the region. The exchange received start-up funding from the local property fund and committee. At the request of GKI, periodic technical assistance was provided with funding from USAID.

- *Bid reception network.* Up to twenty bid reception points were operating in Orenburg through an agreement with the local Sberbank.
- *Auction software.* The property fund used the GKI standard auction software.
- *Auctions results.* Approximately 100 enterprises have been auctioned, each company being auctioned for four weeks. The property fund auctioned companies individually as opposed to grouping them into waves.

Tula Regional Auction Center. The property fund managed the regional auction center directly. The voucher auction program had been financed by the property fund without outside assistance. Periodic technical assistance was provided at the request of GKI with funding from USAID.

- *Bid reception network.* Over forty bid reception sites were opened by the property fund by subcontracting with a privately-held bank to open sites in twenty-five branch offices and with the district property funds and committees in another fifteen locations.
- *Auction software.* The property fund used the GKI standard auction software.
- *Auctions results.* 166 enterprises were auctioned by the property fund in thirty-eight auction waves. Each enterprise was auctioned over a two week period.

The National Auction System

In February 1993, the National Auction System (NAS) was created as a mechanism for conducting voucher auctions for large Russian enterprises in multiple regions simultaneously. It was designed as an "overlay" of the regional auction system utilizing the processes and procedures that had already been implemented at the regional level. The National Auction System enabled voucherholders throughout Russia to participate in voucher auctions for the largest enterprises without travelling to the region where the companies were located.

Russian legislation stipulated that enterprises with a fixed asset value greater than 500 million were to be offered for sale nationally.[3] The first company to be auctioned through the NAS was the giant automaker ZIL which was offered in twelve regions throughout Russia. These twelve regions included the locations of ZIL plants, major suppliers, major investors and voucher investment funds. From March 1993 until the conclusion of the voucher auction program on June 30, 1994, 313 companies were auctioned through the NAS in eighty regions. Regional participation in the NAS is presented in table 6.3 and a summary of the performance results of the NAS is presented in table 6.4.

To coordinate the national auction system, the National Network Center (NNC) was initiated under the auspices of GKI. The NNC facilitates the cooperation among participants to conduct national auctions. The procedures for national auctions remained essentially the same as regional auctions except that bids were received in local bid reception centers across the country. The bid reception process for national

Table 6.3 Participating regions in the National Auction System

The following regions in the Russian Federation participated as selling agents for the national auction system. Regions with an asterisk offered companies to be privatized through the national system.

1. Abakan	*	41. Nefteyugansk	
2. Anadyr		42. Nizhni Novgorod	*
3. Arkhangelsk	*	43. Novgorod	*
4. Astrahan	*	44. Novosibirsk	*
5. Barnaul	*	45. Omsk Oblast	*
6. Belgorod	*	46. Orel	
7. Blagoveshensk	*	47. Orenburg	*
8. Bryansk	*	48. Penza	*
9. Cheboksary	*	49. Perm	*
10. Chelyabinsk	*	50. Petropavlovsk Kamchatski	*
11. Cherckessk		51. Petrozavodsk	*
12. Chita	*	52. Pskov	
13. Dudinka	*	53. Rostov-on-Don	*
14. Ekaterinburg	*	54. Ryazan	*
15. Elista		55. Salekhard	*
16. Irkutsk	*	56. Samara	*
17. Ivanovo	*	57. Saransk	*
18. Izhevsk	*	58. Saratov	*
19. Kaliningrad	*	59. Smolensk	
20. Kaluga		60. St.Petersburg	*
21. Kemerovo	*	61. Stavropol	*
22. Khabarovsk	*	62. Sycktyvkar	*
23. Khanty-Mansijsk	*	63. Tambov	*
24. Kirov	*	64. Tomsk	*
25. Kostroma		65. Tula	*
26. Krasnodar	*	66. Tumen	*
27. Krasnoyarsk	*	67. Tver	
28. Kurgan		68. Ufa	
29. Kursk	*	69. Ulan-Ude	*
30. Kyzyl		70. Ulyanovsk	*
31. Leningradskaya Oblast	*	71. Vladikavkaz	
32. Lipetsk	*	72. Vladimir	*
33. Magadan	*	73. Vladivostok	*
34. Mahachkala		74. Volgograd	*
35. Maikop		75. Vologda	*
36. Moscow	*	76. Voronezh	*
37. Moscow Oblast	*	77. Yakutsk	
38. Murmansk	*	78. Yaroslavl	*
39. Nahodka	*	79. Yoshkar-Ola	
40. Nalchick		80. Yuzhno-Sahalinsk	*

Table 6.4 Performance results of the National Auction System

	May 1, 1993	*May 1, 1994*	*June 30, 1994*
Number of companies			
sold (closed)	3	113	313
sold or in process	3	157	313
Total charter capital (thousand rubles)			
sold	6,082,034	239,060,698	439,425,289
sold or in process	6,082,034	316,532,042	439,425,289
Vouchers collected	1,149,038	23,763,134	34,060,139
Bids received	80,526	269,697	325,270
Number of regions	26	79	80
Number of shares			
offered	1,910,764	83,086,466	118,917,045
sold[a]	4,701,750	160,188,649	239,102,861
Number of regions transmitting bid data electronically	0	36	40

a. Number of shares sold will exceed number offered in the case of share splitting during the calculation of the auction.

auctions was typically four weeks as opposed to two weeks for local auctions. The NNC was responsible for essentially the same basic functions as the regional auction centers. These main functions are summarized below and summarized in figure 6.2 which outlines the auction process at the regional and national levels.

Managing the auction pipeline

The NNC worked closely with the GKI, regional and federal property funds, local property committees, and the enterprises to coordinate the pipeline and to schedule those companies to be auctioned nationally.

Contracting with the seller

The NNC drafted and arranged for the signing of contracts between the regional property fund responsible for selling an enterprise, and participating property funds in other regions which accepted bids for shares through local bid reception centers. The NNC was required to invite all regions to participate in the auctioning of enterprises available for national auctions.

Developing regional participation

By the end of the program, seventy-nine regions had participated as agents in the NAS: shares of companies slated for national auctions were offered through their local bid reception networks. All regions participating in the NAS received initial training and inspections by NAS staff prior to participation in the system to ensure compliance with national auction standards and procedures.

Announcing the auction

The NNC worked with the sellers to ensure that the legal requirements for announcing auctions in the national press were met before any deadline.

Commencing the auction

Privatization plans and other essential documentation necessary for the bid reception sites to conduct an auction were delivered to all participating regions. Each region confirmed that the bid collection had commenced in their region.

Closing the auction

At the end of an auction, regions collected the applications and entered them into the standard computerized database program. The actual bids and vouchers were maintained at the local bid reception centers where application bids were offered. The summary auction data from participating regions was then carried by hand or transmitted electronically to the NNC. Upon receipt, the data was tested for accuracy and completeness prior to being incorporated into the national database for the calculation of the auction results.

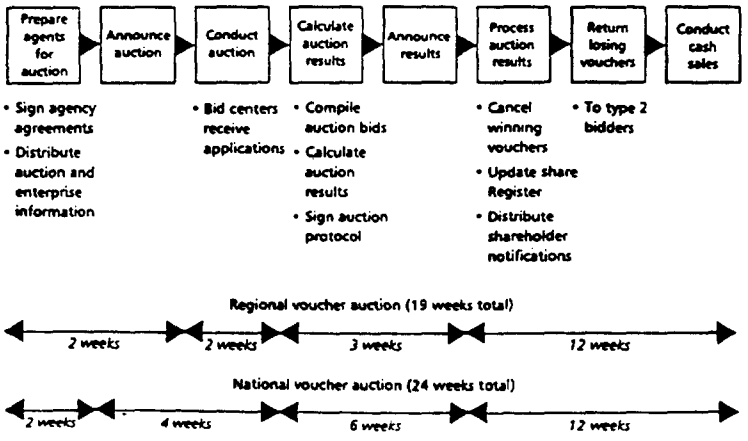
Compiling and calculating the auction

In the presence of a member from the auction commission, the NNC compiled the data from participating regions and calculated the auction results. A draft protocol with the auction results was prepared and presented to the auction commission for approval.

Processing the auction results

Following approval of the auction by the commission, the NNC prepared summa-

Figure 6.2 Sequence of regional and national voucher auctions



ry reports for the selling property fund, enterprise, participating property funds, and winning applicants. Each new shareholder was issued a notification of ownership confirming the information that was to be entered into the share registry of the enterprise. Results of the auction were announced in the Federal press. At the local level, winning vouchers were canceled and destroyed and losing voucher bids were returned.

National cash sales

In addition to managing national voucher auctions, the NNC coordinates a post-voucher auction cash sale to sell a percentage of the company's shares for cash. The proceeds from these cash sales are used to defray the costs of conducting national auctions. The percentage of shares offered for sale is the result of the difference between the amount of shares available for the voucher auction and the amount of shares actually distributed during the voucher auction. The maximum level of shares available for cash sales is the same as for regional cash sales: either 5 percent of the shares sold in the voucher auction if less than 29 percent of the enterprise's shares were put up for auction or 10 percent if 29 percent or more of the shares were available for auction.

Upon conclusion of the cash sale, proceeds are distributed to participants in the voucher auction to finance the operational costs of conducting the auction. The NNC monitors the cash auction process until all funds have been distributed. Since the inception of the National Auction System, several mechanisms have been created to implement the post-voucher auction cash sale. These include the following.

Interregional open cash auctions

The NNC has overseen the management of cash sales in up to four regions simultaneously. Cash sales typically are managed by a third party general agent including brokerage companies or stock exchanges which are responsible for organizing and conducting the cash auction. The responsibilities of these general agents include the following steps:

- Polling potential investors,
- Collecting applications and deposits prior to the auction,
- Agreeing with local agents in other regions to participate in the auction,
- Connecting the agents to a telecommunication network to conduct a simultaneous auction in multiple regions,
- Conducting the auction in an open outcry format (lots of shares are sold to the highest bidder),
- Processing the auction results, and
- Coordinating distribution of proceeds to the participating voucher auction agents.

Regional auction

In certain cases, given the relatively low percentage of total shares available for the cash sale and the limited number of potential investors interested in purchasing shares, cash sales for national auctions are conducted in the region where the selling property fund and enterprise are located. The NNC works with the local property fund or their designated agent to conduct the cash sale using one of a variety of formats:

- *Open out-cry.* The shares are divided into varying sized lots which are auctioned to the highest bidder.
- *Brokering.* Shares are placed on the exchange at a fixed price which can be modified by the broker according to the buyers' demand. This approach was used in a number of regions, with active local stock exchanges such as Vladivostok.
- *Closed tender.* During specified time periods, closed bids are accepted in sealed envelopes that are opened on the announced date by the auction commission. Shares are sold to the highest bidder in the amount indicated by the bidder until all shares are sold.

Cash sales for national auctions have generated significant funds to defray the system's operating costs. By the end of April 1994, cash sales had been conducted for seventy companies which had been auctioned by thirty-nine property funds in national auctions. These cash sales generated approxi-

Cash sales for national auctions have generated significant funds to defray the system's operating costs.

mately 7.4 billion rubles or an estimated $4.1 million. While the results for the largest companies generated the largest proceeds, the average result for national cash sales was 105,000,000 rubles or $58,500.

Conclusion

Between early 1993 and mid-1994, voucher auctions were conducted nationally and locally in eighty-six regions across the Russian Federation for shares in more than 12,000 medium-size and large companies. The successful completion of the mass corporatization and privatization of an unprecedented number of companies was the result of a number of political and economic factors. This paper has focused on the standard operating procedures utilized in the corporatization and voucher privatization programs. The use of standard program procedures facilitated the rapid and geographically far reaching implementation of voucher privatization. One of the main challenges in designing and supporting post-voucher privatization programs, including efforts aimed at providing restructuring and financial assistance to newly privatized enterprises, will be the development of standard approaches, tools, and systems which also can be widely replicated and implemented with targeted international technical assistance and financing.

Notes

The authors of this paper are management consultants with Price Waterhouse's International Privatization Group. They directed and participated in a program of technical assistance, supported by USAID, to work with the GKI in the development and implementation of the national auction system.

1. In practice it was not always possible to meet these deadlines as there were logistical and political delays in both the preparation and approval of the plans.

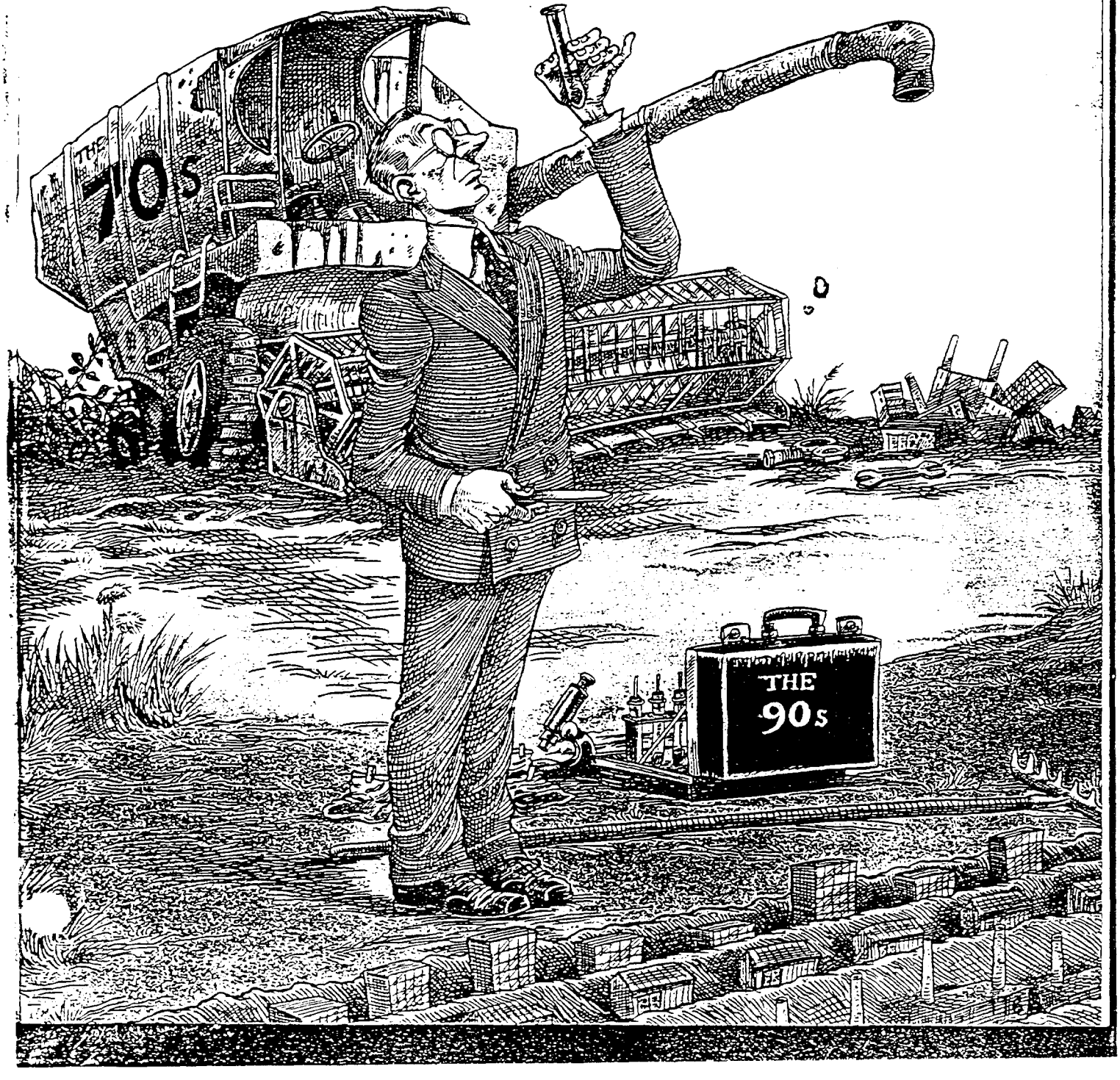
2. The last six months of the voucher auction program was the first half of 1994.

3. Some large enterprises below these levels were offered the option to use the National Auction System.

The Economist

A SURVEY OF THIRD WORLD FINANCE

New ways to grow



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THIRD-WORLD FINANCE

New ways to grow

The flow of private capital to the developing countries, having all but ceased in the 1980s, is reviving. Does this herald faster growth in investment and living standards—or, in due course, another third-world debt crisis? Our deputy editor, Clive Crook, reports

THE outlook for the developing countries seems brighter than for many years. After the battering of the 1980s, a mere pause in the third world's troubles might easily be mistaken for a miracle—but for some countries, at least, the improvement that now looks achievable could be lasting. When the world's finance ministers and central-bank governors, corralled in Washington, DC, for the annual meetings of the International Monetary Fund and the World Bank on September 28th, come to write their communiqués, the obligatory guarded optimism about the developing countries' prospects will be better grounded than usual—the optimism, that is, rather than the guardedness.

In the past few years, growth in the world economy has been sluggish. It is therefore not only welcome but surprising that this change is coming just now. Economic growth in the third world depends partly on demand in the industrial countries, which account for three-quarters of the world's output. America's recovery remains hesitant, and Japan and Germany are in recession. For the moment, therefore, the poor countries' economic opportunities are expanding without much help from the traditional motor of third-world growth: rich-country demand for imports.

Instead, two other changes are under way. One is the effort that the governments of many poor countries are making to reform their economies. When these efforts began, spurred in many cases by the financial distress of the past ten years, the scale of the reformers' task could hardly be exaggerated—and, except in the boldest cases, a great deal remains to be done. But over the past few years, countries in almost every part of the third world (as well as in Eastern Europe and the former Soviet Union) have been engaged in what amounts to a revolution in economic policy. The other change, connected to the first, is the revival (in new forms) of flows of private capital to the developing world. Together, economic reform and adequate supplies of capital appear to offer exactly what the developing countries need: a big increase in profitable investment. That, in one sentence, is the new case for optimism on development.

At this point, however, anybody with even the slightest sense of history will pause. During the 1970s many people were equally optimistic about the prospects for growth in parts of the third world, especially in Latin America. That mood encouraged, and was in turn encouraged by, an enormous flow of capital to the region. For more than ten years Mexico, Brazil, Argentina and others took on debts that could be comfortably financed only if rosy (though not, in fact, outlandish) assumptions about economic growth and interest rates came true. They did not. In the early 1980s, when dollar interest rates rose sharply, borrowers were pushed to the brink of default. And lenders, desperate to curb their losses, acted in individually sensible ways that threatened for a while collectively to bring down the world's financial system.

This was not the first time that economic euphoria soon turned to bitter disappointment, and it is safe to predict that it will not be the last. What a pity it would be, though, if the cycle of excessive optimism, heavy borrowing and economic collapse of the 1970s and 1980s was about to repeat itself in the

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developing countries so quickly.

When an economy in the third world fails to grow as fast as it might, the harm is much greater than in a rich country. Even when the shortfall between actual and potential output is not literally a matter of life and death (as it often is), the result is poverty of a breadth and depth that the industrial countries have long since forgotten. Also, in many of the poor countries that are now undertaking reforms, the resulting extension of economic freedom is often (deliberately or otherwise) part of something bigger: an extension of civil and political freedom. This is most obvious in Eastern Europe and the former Soviet Union. But in many other poor countries as well, from China to Peru, more will be lost if recent economic changes go wrong than can be captured in figures for output and poverty.

Something old, something new

Undoubtedly, even on the most favourable assumptions, reform in some countries will indeed go wrong. It will happen for reasons that will vary widely from case to case. However, the question this survey will address is whether trouble of a grander and more dangerous sort may also lie ahead. Might development be halted once more as it was in the 1980s—not by failure here and there, with a variety of different causes, but by systemic and contagious failure, with financial distress in the leading role?

The best reasons to believe that this can be avoided lie in the changes already mentioned. The combination of enlightened economic policies and a more appropriate quality (as opposed merely to a greater quantity) of foreign investment marks a crucial difference between the early 1990s and the late 1970s.

The reforms that are under way in many developing countries cover the whole range of what might be called the standard neoclassical prescription, which for many years was denounced by third-world governments as irrelevant to their countries' needs. In macroeconomic policy, great efforts have been made to curb chronically high rates of inflation. Budget deficits have been brought under better control—in Latin America, long plagued by fiscal instability, to a remarkable extent (see table 1). This has been done not just by hacking away at existing spending programmes; in many countries, governments have tried to reform fiscal policy in a more coherent and fundamental way, through broadly based tax reforms and by rethinking the role of the state.

Strange but true 1

Non-financial public-sector balances (% of GDP)			
Overall balance	**1978-82***	**1983-1989**	**1990-92†**
Argentina	-11.9	-9.5	-0.9
Brazil‡	-5.6	-4.7	-1.2
Chile	1.9	-0.6	3.0
Mexico	-11.7	-11.0	-1.2
Venezuela	-5.4	-4.7	-0.2
Philippines§	-2.2	-2.7	-2.0
Primary balance			
Argentina	-7.3	-3.5	2.6
Brazil	na	0.5	2.1
Chile	2.7	1.9	5.3
Mexico	-6.5	3.6	5.9
Venezuela	-3.4	-0.6	5.4
Philippines§	-1.3	1.0	4.4

*1979-82 Argentina, Brazil, Chile and Mexico †1990-91 Chile and Venezuela
‡Operational deficit §Deficit of national government
Source: IMF

Governments have been equally active in microeconomic policy. Many have chosen to open their economies to trade for the first time. Tariffs have come down and non-tariff barriers to imports have been lowered as well. One of the most striking changes of the past few years has been the unambiguous reversal of the old presumption that the industrial countries were by and large in favour of more liberal trade, whereas the developing countries were sceptical about it. (That presumption is indeed written into the General Agreement on Tariffs and Trade: developing countries chose second-class citizenship of the GATT, accepting fewer rights in exchange for fewer obligations.) Lately, much the most radical trade reformers have been developing countries such as Mexico, or post-socialist economies in Eastern Europe, such as Poland. Within the space of a few years such countries have made themselves, in many respects, more open to trade than many rich industrial countries.

Microeconomic reform has extended far beyond trade policy. Governments have privatised state-owned enterprises. They have deregulated industry, commerce and domestic finance. They have adopted convertible currencies, and liberalised their exchange controls; governments that once discouraged inward investors now go to the rich countries' financial centres to advertise opportunities for foreign investment.

These comprehensive moves away from heavy state intervention towards more liberal economic policies help to explain why many developing countries now seem more attractive than before to suppliers of foreign capital. They also help to explain why the new pattern of inflows is different from before.

Today, a far smaller share than in the 1980s takes the form of bank lending; bond and equity finance are far more important than before, and the volume of foreign direct investment (FDI) is much greater (see chart 2 on next page). The decline in bank lending doubtless reflects the banks' memories of the wounds they suffered in Latin America and elsewhere. But the expansion of portfolio finance and FDI bears witness to new opportunities created by financial liberalisation, privatisation and better prospects of macroeconomic stability.

There are grounds for hoping that these two sorts of change—in economic policy, and in external finance—will continue to reinforce each other, forming a virtuous circle. The new methods of finance should prove less risky for the borrowing country; not least, they reduce the borrowers' exposure to changes in foreign interest rates. At the same time, by strengthening the private-sector links between the reforming countries and the international capital markets, they may encourage (and perhaps oblige) governments to consolidate their pro-growth economic reforms—a task that heavy public-sector debts, in contrast, often seemed to make more difficult.

Undeniably, however, there are risks. For a

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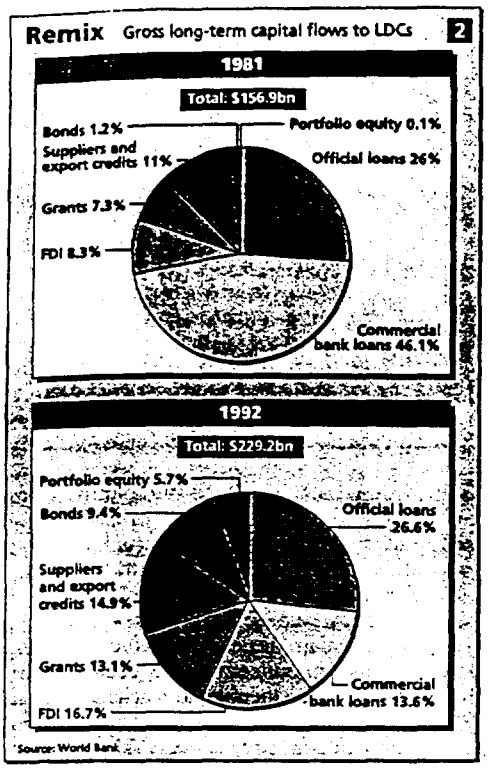

start, the debt crisis of the 1980s is not yet over for everybody. The danger that third-world defaults might cause a system-wide financial collapse has gone, and satisfactory growth is resuming in many middle-income developing countries. But the poorest economies, especially in Africa, are still confined in the debtors' prison of the 1980s. These continue to find it a struggle even to service their existing debts. Much if not all of any additional external resources, in the form of aid or loans, must be devoted to that purpose; little remains to pay for new productive investment. For these countries the 1980s were not merely, as the cliché has it, a "lost decade", but a time when they became substantially poorer. In the 1990s at least some of them will fall even farther behind.

Room for doubt

Even for the less poor, for the bold reformers, for the countries that the West is most anxious to help, for all those whose prospects look better than for years, much can still go wrong. And finance, the cause of so much pain in the 1980s, might yet be the reason.

The new pattern of external finance is encouraging: private borrowing is better than public borrowing; portfolio finance spreads risk more safely than bank debt; FDI brings technology, ideas and access to rich-country marketing networks, as well as hard currency. All this is good. But nobody should suppose that the debt crisis of the 1980s has cured financial institutions of their herding instinct—of their demonstrated preference for being collectively wrong rather than unfashionably right. For several years now, the "emerging markets" have been all the rage. One or two big embarrassments may well be enough to turn the West's portfolio investors against all third-world borrowers.

This illustrates a broader point, which is as true now as it was in the 1980s, regardless of the change that has meanwhile occurred in the mix of external resources: financial integration with the outside world involves costs as well as benefits, especially greater vulnerability to certain kinds of economic shock. And, as history all too amply demonstrates, the transition from a closed financial system to an open one is especially prone to shocks. Many of the reforming economies are now attempting this transition. No aspect of liberalisation has proved so consistently difficult.

Except, possibly, for its domestic counterpart—the transition from a tightly controlled system to a substantially deregulated one. This is a reform that has caused no end of trouble in the rich countries of late (witness the business cycles of America, Japan and Britain since the late 1980s); and these industrial economies have civil servants and central bankers who are supposed to know what they are doing. In many developing countries, and in all the economies of Eastern Europe and the former Soviet Union, these pitfalls of financial liberalisation are made infinitely more threatening by a large and growing stock of bad domestic debt. As a result, malfunctioning domestic finance has put economic restructuring, as well as macroeconomic stability, in jeopardy.

Financial systems that work are crucial for development, but when they go wrong, nothing else is nearly so good at spreading damage. Just as the structure of third-world finance has changed since the 1980s, so have the risks and opportunities that confront the developing countries.

Debtors' prison

THE third-world debt troubles of the past decade are an extraordinary episode in world economic history. They came, it seemed, from nowhere. Virtually without warning, the international debt "crisis" (that over-worked term was fully justified on more than one occasion after 1982) was squashing growth in dozens of countries around the globe and threatening the world's richest and most powerful economies with a financial breakdown worse than any they had seen for 50 years. What vast wicked conspiracy, what widespread and outrageous incompetence, could be the cause of so much harm?

The scariest thing about the debt troubles is that no great conspiracy, no huge incompetence, was to blame. Great damage was done, and far greater damage became entirely possible, because lots of small and easily understandable mistakes were aggregated and amplified by the international financial system. The story does offer lessons for today's investors and policy-makers—but because, even with the benefit of hindsight, no single cause of all

The chief lesson that the debt crisis of the 1980s teaches governments and investors is disappointingly vague: be careful

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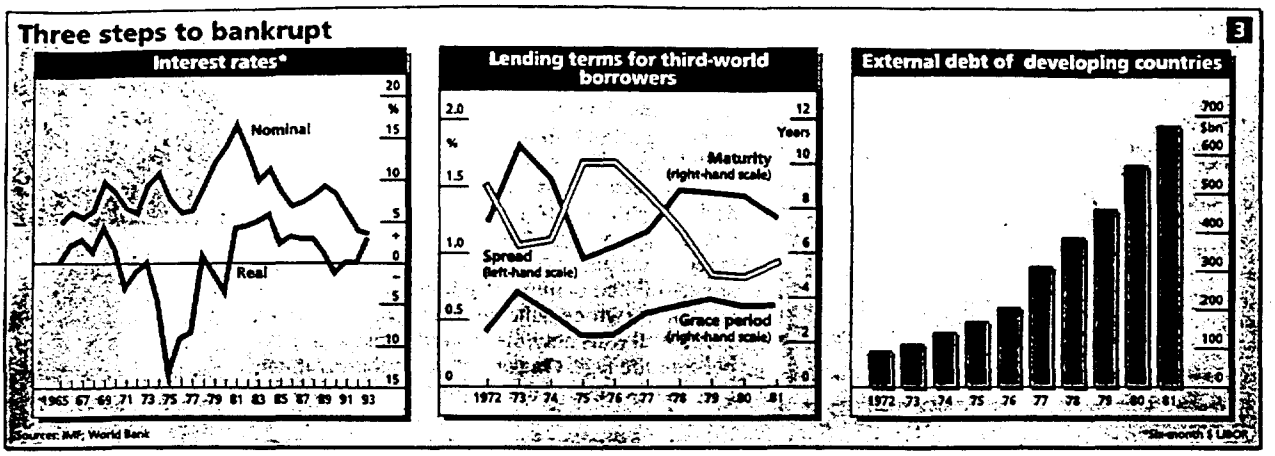


that distress stands out, the tale offers little reassurance that another such crisis can be easily avoided.

The debt troubles began with the enormous rise in oil prices of 1973-74. Oil exporters placed the larger part of the proceeds on deposit with the international banks; the banks needed borrowers, and lots of them, to enable them to recycle the oil money profitably. Another effect of the oil-price shock was a marked slowing of economic activity in the industrial countries in the mid-1970s. For both reasons, interest rates fell in real terms to their lowest level for years; for a time, they were actually negative (see first panel of chart 3).

At the same time the banks, competing vigorously for a big share of this growing market, made the terms of their loans more generous: as the 1970s went on, they offered the developing countries longer loan maturities and periods of grace, and narrower spreads over their own cost of funds (see second panel of chart 3). Under these circumstances, willing lenders found willing borrowers, and the external debts of the developing countries increased from less than $100 billion in 1972 to more than $600 billion by 1981 (see third panel of chart 3).

That sixfold increase, mainly in the form of syndicated commercial-bank loans, now looks reckless, especially since everybody knows what happened next. But it is worth remembering that, at the time, few thought it outlandish.

Despite the economic slowdown in the industrial economies, the developing countries' commodity exports were fetching higher prices in real terms. Over the course of the 1970s, the third world's real export prices went up by roughly 70%. As a group, the heavily indebted middle-income countries (mainly in Latin America) saw a somewhat smaller rise. But even in their case the price increase was enough to prevent much of a rise in the ratio of debt to exports—one measure of the severity of a country's indebtedness. In 1970 this ratio stood at about 150%; ten years later, despite that enormous rise in the dollar value of outstanding debt, it had risen only to 175%.

Moreover, the expansion of borrowing complied with another rule of thumb, likewise suggesting that there was little cause for alarm. The developing-country borrowers were increasing their output at a rate that exceeded the real interest rate on their debt. This had a reassuring arithmetical implication: so long as growth stayed high and interest rates stayed low, the debtors could continue to borrow without increasing the burden of debt in relation to the size of their economies.

The debt-to-exports ratio did not peak until 1987, five years after Mexico and a score of other big borrowers first announced that they could not meet their obligations; by then it had reached a colossal 350%. What had happened at around the turn of the decade to so transform the picture? The answer was the second oil-shock—and, more important, the industrial countries' response to it.

Trapped

The governments of industrial countries had allowed the first big rise in oil prices to cause higher inflation; they accommodated the pressure on domestic costs and prices by loosening their monetary policies. After the second oil-price rise, with inflation already too high, they chose instead to tighten their monetary policies. America's Federal Reserve led the way, its task made all the harder by President Reagan's relaxation of fiscal policy. Dollar interest rates rose sharply. And as demand slowed again in the industrial countries, the developing countries' export prices fell in real terms. With alarming speed, a financial position that had looked alright became plainly "unsustainable".

The result was a vicious circle. Banks suddenly became unwilling to lend. Governments therefore found that their earlier budget and current-account deficits could not be financed. To reduce these deficits, the governments were forced to adopt measures—sometimes brutal ones—to curb demand. This hurt growth straight away and, by causing investment to fall, damaged longer-term growth prospects, too. Yet the efforts to reduce budget deficits did not fully match the shortfall of resources, so the deficits were at least partly financed by domestic monetary expansion. Inflation therefore accelerated—and, with growth sluggish at best, servicing the existing debts seemed ever less feasible. So the banks became even less willing to lend. And so on.

The perversities of the debtors' situation seemed to multiply. Many of the debtor countries had long suffered from capital flight—the illicit transfer of money abroad. (Savers in developing countries have for many years done what they can

to protect their assets from high inflation and artificially repressed interest rates, a corrosive combination.) The World Bank has estimated that capital flight from Latin America between 1976 and 1984 roughly matched the increase in the region's external debt: as quickly as the banks put money in, it left for Miami in suitcases. So as the debtors' troubles grew worse, capital flight added another twist to the problem.

In addition, the banks found that their interests now diverged in the most awkward way. It clearly made sense for any individual bank, confronted with the possibility of default, to limit its exposure to the debtors, preferably by extending no further loans at all. But if every bank applied that view, the mere possibility of default would become a certainty, because the debtor countries needed to borrow—and heavily—just to keep up the payments on their existing loans. Collectively, if the banks were to maximise the expected value of their existing loans to the debtors, they had to keep lending; individually, most wanted only to bail out. This dilemma, the desire of each bank to "free-ride" at its fellows' expense, plagued all subsequent efforts to ease the debtors' plight.

Debtor governments, in deciding how to cope, also had to contend with peculiar incentives. Because the financial markets took the view that the debts were unlikely to be repaid in full, the value of the debt, when traded on the secondary market, was substantially marked down from its face value. In renegotiating their debts, the developing-country governments expected to capture at least some of this discount. (A deal that gave the banks more than the secondary-market value of the debt, but less than its face value, would arguably leave both sides better off.)

But suppose governments tried to service their debts in full (most likely squeezing consumption and investment as a result). The more successful they were, the higher the secondary-market value of their debt would rise—and the smaller the gain they could expect in any subsequent debt restructuring. In short, once the markets believed that the debts were worth less than their face value, the benefits of any fiscal reform undertaken by the debtor governments (or, indeed, of any resumption of growth in output or exports) would accrue largely to the banks. This was a point not lost on the electorates asked to make sacrifices in the name of "adjustment".

All these factors acting together threatened to trap the debtor countries in years of slow growth. Their immediate predicament was bad enough. Starved of external finance for new investment, with rising taxes, high inflation and diminished incentives for economic reform, the debtors were left to contemplate an even bleaker future.

The great escape

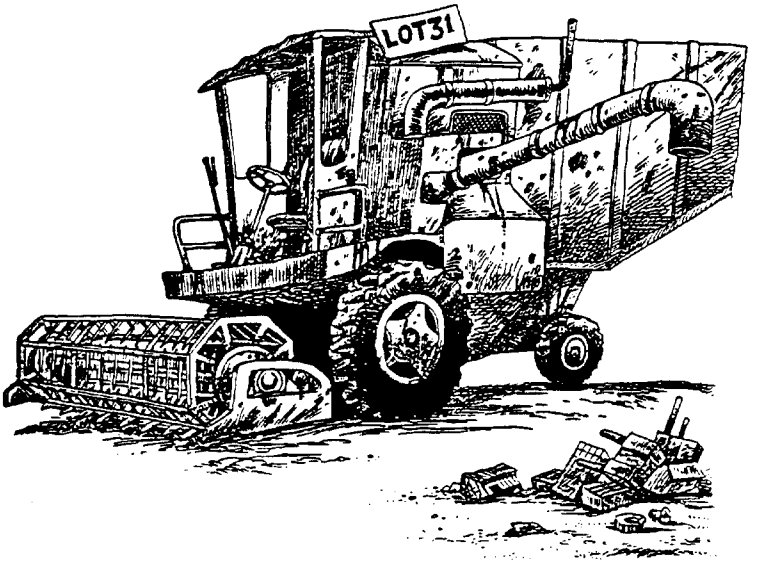
Somebody in the 1980s said that, in Latin America, "desperation is the only hope". So it proved, eventually.

For some time many of the debtor countries were reluctant reformers—though there were always exceptions. In Latin America, for instance, Chile consistently set its neighbours an example in the art of economic self-help. (Chile's debt problems were, moreover, less of its own making than were those of other countries: they were caused less by a big increase in borrowing during the 1970s than by an unusually severe fall in the price of copper, its principal export.) Most of the others required a mixture of outside pressure and encouragement to embark on economic reform. Only later, towards the end of the 1980s, did reform acquire an impressive momentum of its own in many countries; so much so that Mexico and Argentina, for instance, were in the end among the most radical economic liberalisers in the world.

The leading supplier of pressure and encouragement was the IMF. Its strategy for avoiding financial disaster changed repeatedly during the decade. Notwithstanding the costs to both sides, these efforts deserve to be counted a success; without them, the outcome would probably have been much worse for everybody.

In the early days the Fund was concerned mainly to forestall the threat of imminent default. It overcame the adverse incentives facing debtors and creditors alike by arranging deals under which it put up some of its own (ie, taxpayers') money. In return, nearly all the banks reluctantly maintained their flow of lending and the borrowers changed their policies (ie, tried to reduce their budget and current-account deficits) so as to improve their debt-servicing capacity. At first these arrangements were short-term, typically rescheduling debt for just two or three years. Big defaults were avoided, but in the process the countries saw their debts grow far larger, with little sign of improvement in the economies' ability to carry them. The IMF's first intervention had bought time, but the threat of (now bigger) defaults remained.

Soon the IMF was sponsoring "multi-year rescheduling agreements", which would shortly be under the terms of the so-called Baker Plan. These deals extended repayments over longer terms but, that aside, the ingredients were the same as before: IMF money, further involuntary lending by the banks, policy reform by the debtor governments. It became clear that this approach would not restore the debtors to creditworthiness; the scale of their



More money

THE new pattern of external financing for the developing countries has three main characteristics. First, flows of capital are now more concentrated in certain favoured countries. Foreign investors, it seems, are more discriminating than they were in the 1970s and 1980s. Second, on the supply side, a much smaller share of this capital nowadays comes from banks. Third, on the recipient side, much more of it goes to private firms, rather than to governments or state-owned enterprises. These changes, which are closely interrelated, are shifting the risks and incentives that influence third-world investors and their governments—shifting them, by and large, for the better.

To each, according to his means

At first sight, the most striking form of discrimination among borrowers is, in fact, nothing new: the poorest countries, as a group, continue to receive a diminishing share of international capital. These countries, mainly in sub-Saharan Africa, have long relied on grants and loans from industrial-country governments to provide external finance. Since the late 1980s these borrowers have received private flows, such as they are, that have been shrinking not just in relation to flows elsewhere, but also in absolute, inflation-adjusted terms. Over the same period, private flows to the middle-income developing countries, mainly in Latin America, have increased dramatically (see chart 5).

The reluctance of the private sector to invest in Africa is understandable. Much of the region suffers from bad (though improving) government, pitifully inadequate infrastructure, an under-educated and often under-nourished labour force, and a burden of debt that, despite the restructurings of recent years, remains insupportable. The nature of these difficulties is such that the initiative to start development moving in Africa rests with governments, domestic and foreign. The region's own leaders need to take their recent steps towards liberalisation much further, concentrating their efforts and meagre resources on providing infrastructure, and better education and training, instead of on trying to micro-manage markets and enterprises. The rich countries, and the multilateral institutions they control, need to be bolder in rewarding eager reformers with debt forgiveness, grants and technical expertise.

Perhaps for years, Africa's poor reputation among investors will continue to taint its individual economies, reformers and non-reformers alike. Until that changes, it will be difficult for the region's more promising economies to attract the private capital that they may, in due course, be able to use profitably. Difficult, but not impossible. That is the lesson of reviving flows of private capital in other parts of the world. Foreign investors in the developing countries may be more cautious than they were in the past, but their caution has not blinded them to opportunity.

The countries that are now attracting most of the capital from the private market have two main things in common. One is that their debt-service obligations look manageable, either because they avoided severe debt-servicing troubles in the first place (eg, China, Indonesia, South Korea) or because they have completed comprehensive debt-reducing agreements with their bankers (eg, Argentina, Chile and Mexico). The other is that their economic policies are conducive to macroeconomic stability and private enterprise—at least by the standards of the third world.

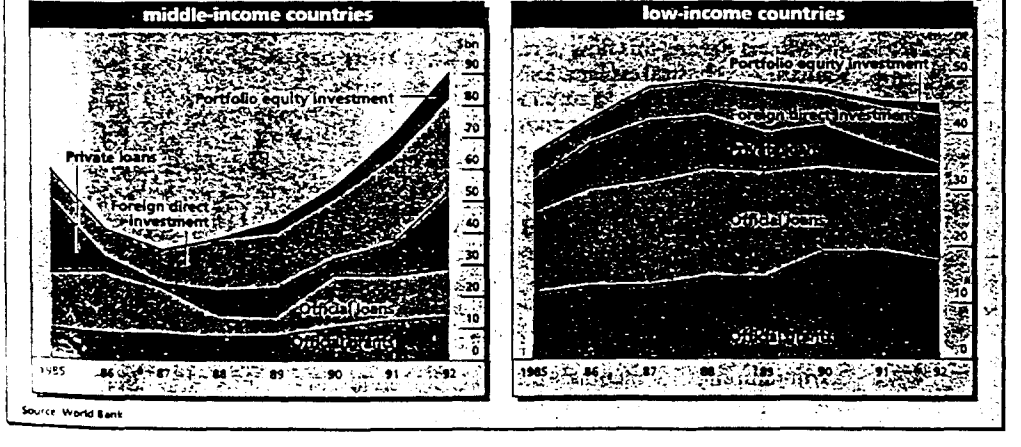
It is no coincidence that the countries that meet the first criterion also, by and large, meet the second. Countries that, throughout, had comparatively good economic policies tended to avoid debt troubles. And countries that did fall too deeply into debt had to turn reformist in order to win the IMF's support for debt restructuring.

A stake in management

The biggest single component of the renewed flow of capital to developing countries is foreign direct investment. FDI measures money spent on acquiring companies, or substantial parts of companies;

Capital flowing to the third world is moving less from banks to governments and more from capital markets to private firms

Win some, lose some Real aggregate net resource flows to: 5



Source World Bank

countries of East and South-East Asia. Add economic stability and creditworthiness, and you have a prospect that is difficult to resist.

However, many small countries (as table 7 showed) have succeeded in attracting FDI, too. Instead of consumers in the hundreds of millions, they may offer a strategically desirable location in a regional market; a good supply of skilled workers; a fairly liberal economic-policy regime (which leaves the private sector to go about its business); friendly rules for the conversion of foreign-exchange and the remission of profits abroad; duty-free imports of raw materials and intermediate goods (usually offered to investors setting up plants in export-processing zones); or other inducements (ranging from tax breaks to plain hand-outs).

By offering a selection of inducements from this list, even tiny economies with (it might seem) little going for them can attract plenty of FDI—and grow, as a result. Mauritius, a small island in the middle of a big ocean, relied on FDI to establish its textiles and clothing industries in the 1960s. More recently, aiming to become an offshore banking centre, it has succeeded in attracting investment in financial services. In the four years to 1991 its inflows of FDI amounted to $120m, or roughly 5% of the country's total investment. What Mauritius began to do a generation ago—welcome, indeed seek, foreign investors—many other developing countries have begun to do more recently. They are finding that hospitality pays.

A paper trail . . .

Taken together, portfolio flows of capital (investment in bonds, equities and related securities, certificates of deposit and commercial paper) provided the developing countries with another $37 billion last year (see chart 9). These forms of capital have increased, admittedly from a tiny base, even more rapidly than FDI.

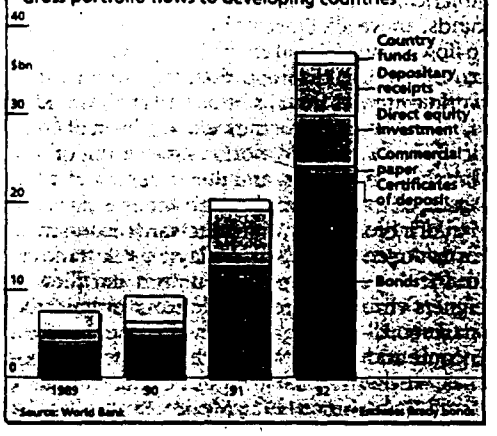
Why? In some ways, the change is unsurprising—if anything it is overdue. Most of the investment "fundamentals" that, in principle, ought to govern flows of portfolio capital to the third world have long been more favourable than the outcome would suggest.

Consider investment in equities. Developing-country stockmarkets offer, on average, higher returns than stockmarkets in the industrial countries. Market by market, these returns are riskier (as you would expect). Taken as a group, however, and used in combination with rich-country equities, the emerging markets actually offer investors the next best thing to a free lunch: higher returns with less risk. This is because the ups and downs of third-world markets are not strongly correlated with the ups and downs of rich-country markets. (In some cases, the correlation is negative: when stocks in the industrial countries go up, stocks in the third world go down.) This allows investors to diversify their portfolios of equities, and improve the balance that must be struck between profit and risk. According to such calculations, the rich countries have been under-investing in the third world for years. Only now are they starting to put that right.

There are probably four main reasons for this. To begin with, the same economic reforms that have attracted FDI in recent years—privatisation,

All on paper 9

Gross portfolio flows to developing countries



measures to promote macroeconomic stability, more liberal trade regimes, and so on—have brought many developing countries to the attention of portfolio investors, as well. Initially, repatriated flight capital formed a large part of the increase in "foreign" portfolio investment. The owners of this capital are particularly well-placed to judge the significance of any change in the economic-policy regime. Now other, truly foreign, investors are following their example. If the investment fundamentals have long been attractive, they are now even more so.

Second, a related point, many developing countries are now far more creditworthy than they were in the 1980s. In the past two years countries such as Indonesia, Chile and Turkey have been given "investment-grade" (ie, good) credit ratings by the main rating agencies. A variety of other third-world borrowers are rated at or near investment-grade (see table 10). Below that threshold, average ratings have improved since the late 1980s.

Good ratings matter a lot to all portfolio-investors; to bond-investors, who are promised a fixed rate of return with no participation in the value of the company, little else counts. The rules that rich-

Rather worthy 10

Credit ratings

	Moody's*	S&P*	EIU risk ratings latest†
South Korea	A1	A+	20
Thailand	A2	A-	35
Malaysia	A3	A	30
Hong Kong	A3	A	15
Chile	–	BBB	25
China	Baa1	BBB	30
Turkey	Baa3	BBB	50
Indonesia	–	BBB-	40
Czechoslovakia	Ba1	–	30
Hungary	Ba1	BB+	40
Venezuela	Ba1	BB	60
India	Ba2	BB+	50
Mexico	Ba2	BB+	55
Argentina	B1	–	55
Brazil	B2	–	70

*Investment grade: Moody's Baa or better, S&P BBB- or better
†Lower ratings indicate smaller risk
Sources: Moody's; Standard & Poor's; EIU

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country governments set for institutional investors make credit ratings especially important to big American investors, and to American pension funds, above all. Since portfolio investment tends to flow along regional channels, Latin America has so far gained disproportionately among third-world countries from its improved credit standing.

Another reason for the sudden growth of portfolio flows to the third world is the easing of some financial restrictions, and the tightening of others. Again, in many countries such changes have been part of a broader movement towards economic reform. Argentina, Brazil, Malaysia, Pakistan, Peru and Turkey are among the countries that allow foreigners virtually unrestricted access to their stockmarkets. All of these also allow free repatriation of income and capital. Many other developing countries, including Bangladesh, Chile, Indonesia, South Korea (since 1992), Mexico, Sri Lanka, Thailand and Venezuela allow foreign investors fairly free access to listed stocks—sometimes, however, with restrictions on repatriation. In these countries, and in others (where rules on foreign investment may remain more burdensome), the trend of late has been towards further easing. In countries such as China, Poland and the Czech Republic, stockmarkets now exist where none did before.

Surveys of rich-country investors suggest that restricted access to third-world stockmarkets is often less of a worry than limited information and poor regulatory standards. In many countries, these rules need to be stricter. Many third-world governments have recently begun to improve their regulatory systems, as much to attract more domestic investment as to appeal to foreigners.

According to the International Finance Corporation (the arm of the World Bank that concentrates on private-sector development, and advises many third-world governments on capital-market reforms), Brazil, Chile, Colombia, Mexico, India, South Korea and Malaysia have accounting standards and rules for the protection of investors that are regarded as being "of internationally acceptable quality". Governments in many other countries are taking steps in the same direction—not always at their own initiative. In China, allegations of insider trading and share-price manipulation led to riots in Shenzhen in 1992; soon after, the government set up a new agency to regulate the country's stockmarkets.

Finally, rules set by rich-country governments for their own investors and capital markets also affect portfolio flows to the third world. Most industrial countries restrict the extent to which their financial institutions, especially insurance companies, can invest abroad. Practice varies a great deal from country to country. In Germany, such barriers are prohibitive; the foreign assets of pension funds, for instance, must not exceed 5% of the total. In America, the rules differ from state to state. In some, such as New York, the limits are nearly as tight as in Germany. By these standards, Japan's rules are fairly liberal; so much so that they have not lately been binding. In Britain, further still along the spectrum, the government sets no ceilings at all on foreign investment, relying solely on prudential regulation.

The rapid increase in portfolio flows to the third world cannot be explained by any sudden change in these source-country regulations. However, one financial-market innovation, made possible by America's disclosure and registration requirements for equities, has made quite a difference. Using an American depositary receipt (ADR), issued under a procedure called Rule 144A, it is possible for a company from a developing country, in effect, to issue shares in America without having to comply with the rules usually insisted upon by the Securities and Exchange Commission. ADRs are tradable instruments, quoted in dollars and paying dividends in dollars. They are issued by American banks, which certify that the receipts are backed by a corresponding amount of equities, held abroad on behalf of the bank.

Many firms in developing countries have found this to be a cheap and effective way of raising money. The market for ADRs and GDRs (global depositary receipts, which are ADRs launched simultaneously in different markets) has grown rapidly in the past two years (as chart 9 showed). In 1991 Mexico raised more capital by issuing ADRs than through syndicated loans and bond sales combined.

. . . leading where?

Striking as these changes in the forms of capital flowing to the third world may be, they probably matter less than the change in its destination. In the mid-1980s the share of private enterprise in the receipt of external finance in the developing countries fell to just 16%. That, admittedly, was under the special circumstances of the debt crisis. Nonetheless, with governments pre-empting so much of the inflow of capital, private companies—always the chief source of growth in output and incomes—were starved of the foreign currency they needed for certain kinds of investment.

Since then, the flow of capital has revived, and the private sector's share of it has increased. In 1991, 30% of the developing countries' aggregate capital inflow went to the private sector. For certain instruments the change is even more dramatic. The private sector's share of bond finance, for instance, increased from 4% in 1989 to 47% in 1992. The causes of this transformation are, by and large, those already mentioned. The most important is the privatisation of state-owned enterprises. Beyond that lies the adoption of a broad range of other pro-business policies (from financial and industrial deregulation to lower taxes and tariffs).

The causes are the same as before because the change in the form of capital (from bank finance to capital-market finance and FDI) and the change in its destination (less to public-sector borrowers and more to private-sector investors) are really one and the same event. For the countries that have so far shared in it, this transformation is extremely encouraging. In rich and poor countries alike, it has aroused a mood of optimism concerning the third world's prospects that may for a time be self-fulfilling: pro-business policies attract capital, capital spurs growth, growth facilitates reform, and so on.

Often in the past, however, such optimism has ended in disappointment. Is that to be the developing countries' fate again?

Until the next drought

Things you should know about the reviving flow of capital to the third world

RECALLING the debt crisis of the 1980s, a first question to ask of the new capital flows to the developing countries is, will they last? Privatisation has played a big part in attracting inflows of both FDI and equity investment, especially to Latin America—but privatisation programmes do not go on for ever. A government in a hurry can sell its most appealing enterprises within a few years. What then? Also, you might argue, FDI and portfolio investment are notoriously volatile, even among industrial countries whose credit-worthiness is not in doubt. For both these reasons, some conclude, the new financial platform for growth in the third world is worryingly insecure.

The world of international finance is undeniably turbulent. It is not always easy to say how quickly, or how far, developing countries should expose themselves to this source of continuing economic volatility. Developing countries do need to be careful when they open themselves up to international finance; bungled or over-rapid liberalisation has often proved extremely costly. And once their economies are integrated with the global market for finance, governments can and should take steps to cushion some of the blows that are likely to follow.

More about that later. For the moment, put these issues aside, and consider what may seem a more pressing point—the danger that the recent increase in FDI and portfolio flows is, for whatever reason, a short-lived event, not a trend that can be relied upon in future.

Built to last?

Forecasting capital flows—even long-term, or "underlying" flows, such as FDI and most portfolio investments—is a hazardous business. Such flows are notoriously variable from year to year. They depend on a complicated mixture of factors in investing and recipient countries alike.

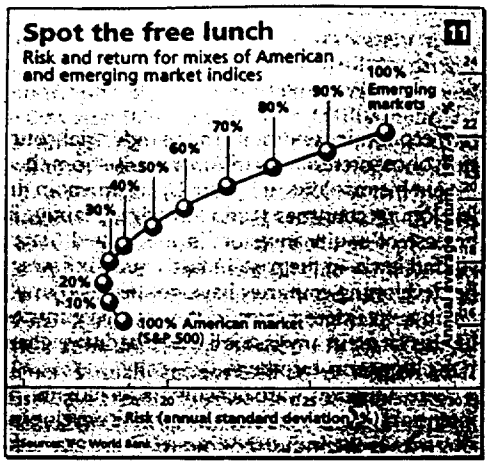
You might think that FDI, especially, should be fairly stable over time. For the firms concerned, this form of investment, more than any other, represents a long-term commitment to a chosen country, and is not one that can be quickly or easily reversed. It ought to be relatively immune to the short-term shifts in economic circumstances that you would expect to play havoc with, say, current-account balances and short-term credit flows. But it is not. The fall in global FDI at the start of the 1990s took many forecasters by surprise. Though the upward trend in FDI to the developing countries has remained comparatively steady (as chart 6 showed), it would be unwise to take this for granted.

Keeping this in mind, however, it is possible to put recent flows of FDI and portfolio investment to the developing countries into statistical perspective. The question is, what scope remains for further rises, not just over the next year or two, but over the next decade or two?

First, consider portfolio investment. It is often argued that the third world's inflows of equity investment, in particular, are at the mercy of short-term economic conditions in the industrial countries: once interest rates in America rise from their present historic lows, it is feared, investment in the developing countries (Latin America, mainly, in the case of equity investors in the United States) will fall back. In the past, in fact, equity inflows to the developing countries have not been strikingly sensitive to interest rates in the source countries. But this factor in any case is likely to be outweighed, in the long term, by others.

One straightforward benchmark for judging the potential scale of portfolio flows to the developing countries is the industrial countries' present stake in the emerging third-world stockmarkets, measured against the emerging markets' share of global stockmarket value. At the end of the 1980s the emerging markets' share of the global stockmarket doubled (because prices in those markets rose sharply) to about 6%. If investors in the rich countries increased their holdings in emerging markets enough to come into line with that ratio, the flow of equity investment into the third world would increase by roughly $40 billion a year. That would be a more than three-fold increase over the flow of equity and equity-related instruments in 1992; and it would make equity flows to the developing countries comfortably bigger than present flows of FDI.

In a way, that calculation exaggerates the prospects for equity flows to the third world, because equity investors everywhere tend to prefer their own home market to foreign markets (regardless of whether the foreign markets are in rich or poor



countries). But two important points argue the other way.

The first is that the emerging markets are likely to carry on growing faster than their rich-country counterparts. The ratio of emerging-market GDP to global GDP is 13%; recall that the ratio of emerging market value to global stockmarket value is only 6%. With time, the second number is likely to rise to meet the first. As it does, the rich countries' small share in third-world markets will rise too—or else be increasingly anomalous.

The second reason to expect equity flows to the developing countries to rise is that rich-country investors are still a long way from fully exploiting the benefits to be achieved through that sort of diversification. Investors have doubtless noticed that returns in third-world stockmarkets are higher than, and only weakly correlated with, returns in rich-country stockmarkets. That combination, as was argued earlier, enables investors to strike a better balance between risk and return, and is surely one reason why equity flows to the third world have been expanding. The point is that the process has barely started.

Between 1987 and 1991 American investors held less than 0.5% of their equity portfolios in emerging-market stocks. Calculations by economists at the World Bank show that if those investors had held 20% of their portfolios in such stocks, their average return would have been roughly one percentage point higher, and the risk of their combined portfolio would have been not higher, but substantially lower. Chart 11 shows the full range of possible combinations for that period. It plots annual return on the vertical axis and risk on the horizontal. Each point represents a portfolio. The lowest point on the line represents a portfolio with nothing but American stocks; the highest a portfolio of emerging-market stocks. The points between show the other combinations.

The rule that risk is the price you pay for a higher return is true over most of these combinations: it is true, in fact, wherever the line slopes upwards to the right. Thus, moving from a portfolio balanced 60-40 in favour of American stocks to another balanced 50-50, the chart shows that both risk and return go up. But the point is that in its lower reaches, the line slopes upwards and to the left, indicating opportunities to have both higher returns and lower risk—the gain to be had from a diversified portfolio.

On the basis of these returns (calculated, admittedly, over a short period), even the most risk-loathing investor should prefer to hold 20% of his portfolio in the emerging markets, for that is the risk-minimising mix. Investors willing to take on at least some risk in exchange for a better return—and all equity investors volunteer for at least some avoidable risk—should prefer to hold even more than that minimum in emerging-market shares. All this suggests that the scope for flows of equity investment to the developing countries is very large.

It all helps 12

Foreign direct investment into developing countries*, 1991

	$bn	Share of recipient GDI†, %
Mexico	4.8	7.4
China	4.4	3.3
Brazil	1.6	2.0
Malaysia	3.5	20.5
Argentina	2.4	15.1
Thailand	2.0	5.6
Indonesia	1.5	3.6
South Korea	1.1	1.0
Venezuela	1.9	19.2
Turkey	0.8	3.9
All developing countries	35.9	4.5

*Excludes Saudi Arabia †Gross domestic investment
Sources: IMF; World Bank

Consult a scenario

Is there room, too, for substantially greater flows of FDI to the third world? Or might this form of investment expand so far that, for any given country, no more can be profitably absorbed? Hardly. The rich countries, with their far greater stocks of capital, are still able to attract billions of dollars in FDI. It is absurd to fear that any parts of the third world could be anywhere near such a point of saturation. Also, in some of the developing countries that, by virtue of their size, have received a large share of global FDI, this inflow represents only a small fraction of their overall domestic investment. In 1991, China's $4.4 billion of inward FDI (more than a tenth of all such flows to the third world) was equivalent to only 3.3% of the country's gross domestic investment; Brazil's $1.6 billion was only 2% of its gross domestic investment.

Argentina, Malaysia and Venezuela show that it is possible for countries to finance much larger shares of their domestic investment through FDI (see table 12). These countries suggest that the scope for an expansion of FDI elsewhere in the third world is great. The World Bank has calculated that if flows of FDI amounted to 10% of gross domestic investment in all developing countries—a conservative number, just half of what Malaysia and Venezuela have lately attained—global flows of FDI to the third world would now be twice as big, or about $80 billion a year.

There is another way of looking at it—and the view from this new angle is equally encouraging. An analysis by DeAnne Julius (a leading authority on FDI, formerly the chief economist at Shell, now at British Airways) relies a bit more on economic principles. It takes into account the main factors that influence direct investment over a run of many years, and requires some computerised number-crunching. It too suggests that the scope for growth in flows of FDI to the third world is great.

Over the long term, Ms Julius argues, flows of FDI are likely to reflect global investors' judgments about where they can get the highest returns. In the short term—even over runs of several years—such judgments may be obscured by cyclical factors; in the end, however, likely returns on investment will carry the greatest weight. A rough measure of the long-term return on aggregate investment is given

by a statistic called the incremental output/capital ratio—the rate of economic growth divided by share of investment in national income. It shows, in effect, the increase in output achieved by a given amount of investment, which is a rate of return in the broadest sense. (It is only a rough measure because it implicitly assumes that all the increase in a country's output is due to investment, as opposed to, say, increases in the country's labour force.)

Taking the developing countries as a group, this ratio was 24% during 1965-80. In other words, a dollar invested in the third world earned, on average, a return of 24 cents. Over the same period, the industrial countries, with much larger stocks of capital, grew more slowly—as the law of diminishing marginal returns would lead you to expect. Their return on investment was therefore lower: on average, 19%, or 19 cents on the dollar.

In the 1980s, under the strains of the debt crisis, growth in the third world slowed, and the aggregate return on investment collapsed to 13%. (The return in the industrial countries fell too, but only to 15%.) This makes it unsurprising that the developing countries' share of global FDI, which had been 23% in 1971 and the same ten years later, fell to 13% by 1986.

How might investment returns in the third world change over the next two decades? It seems plausible to assume that they will be closer to the rates of 1965-80 than to those of the 1980s. For many developing countries, at least, the worst of the debt crisis is over, and economic growth is resuming. On top of that, dozens of countries have embraced economic reform more enthusiastically than ever before. A good many of these ought to grow at least as fast over the next 30 years as they did in the years before the debt crisis.

Suppose that the return on investment in the third world rises to 21% in 1990-2020. That is the cautious figure that Ms Julius arrives at with a mixture of judgment and computers. Though not as good a return as the developing countries achieved in 1965-80, it is a big improvement over their performance during the debt-burdened 1980s. Also suppose that the law of diminishing returns continues to reduce, albeit gently, the productivity of investment in the rich countries—to an average of 13%. Further assume that a higher return on investment in developing countries causes the amount of aggregate investment there to rise—to 27% of national income over the period (compared with 24% in the 1980s). For the third world as a whole, all this implies an average rate of economic growth of 5.7% a year between 1990 and 2020—about the same as in the 15 years to 1980.

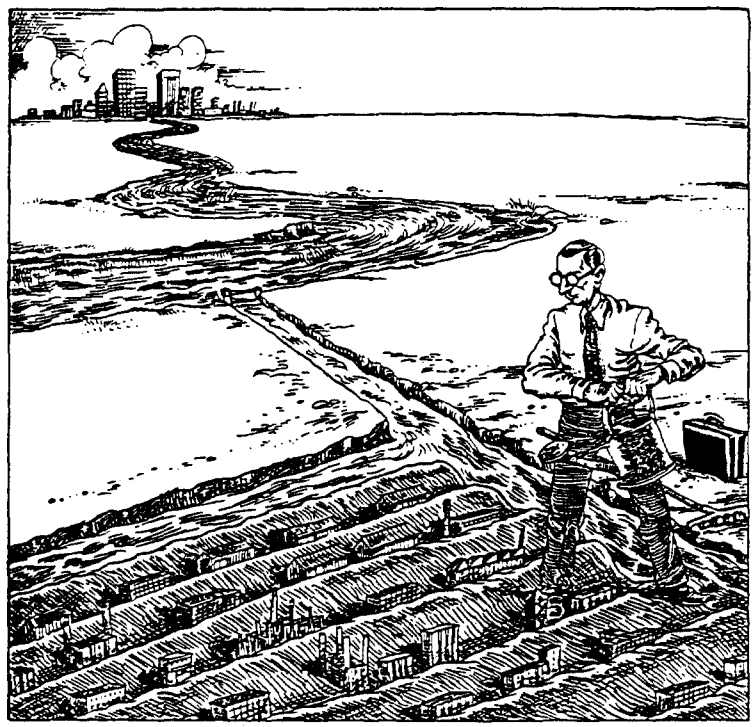
What does it imply for FDI? The computer, looking at the widening gap between returns on investment in the rich and poor countries (a gap that henceforth works in the poor countries' favour), concludes that FDI in the third world would increase from $40 billion a year now to more than $80 billion a year (in today's prices) by the end of the century and to roughly $400 billion a year by 2020. By then, today's developing countries would be attracting about half of the world's FDI, compared with about a fifth now.

At first sight, that looks like a remarkable increase. But if it happens, the share of FDI in the developing countries' investment would still be only 6%—a third more than now, but far less than many of the more successful developing countries are already achieving. If FDI is to play this enlarging role in promoting development in the third world, the recent trend towards pro-business policies and greater economic openness must continue. If that trend is checked, or goes into reverse, this scenario (which Ms Julius insists must not be called a "forecast") will not come true. All in all, though, it seems reasonable to conclude that there is no reason for the recent rise in FDI to the third world to stop abruptly, unless developing-country governments abruptly change their minds about the virtues of economic reform.

Small print

While contemplating these possibilities, it is right to bear in mind that foreign investment of either variety cannot secure faster growth for the developing countries by itself. And, indeed, that as forms of finance for the third world, foreign portfolio and direct investment have disadvantages (as compared with bank lending) that must be set against their benefits. However, the drawbacks are small whereas the advantages are large. And if more foreign investment is not a panacea, that is all right—nothing in economics ever is.

However, pause for a moment to consider those small drawbacks. FDI, it needs to be remembered, can be quite an expensive source of finance. If a firm in a developing country borrows from a bank, and then makes a profit, any surplus is at least initially retained in the country. If the firm is financed by inflows of FDI, all the profit, except for any that is reinvested in the company, returns to the foreign investor. Unlike a bank loan, FDI is, on the other hand, a risk-sharing financial contract: if the project fails, the "lender" gets nothing. But the typical



direct investment project does not fail—and the lender does very well.

In practice, this has meant that "net transfers" on FDI were usually negative between 1965 and 1980; that is, outflows of profit (net of any that were reinvested in the companies) were usually greater than the new inflows of FDI. This ceased to be true in the late 1980s, because new inflows surged and it will be some time before those investments become profitable. In time, though, profits will rise correspondingly fast—and net transfers may again turn negative. Because of that, a country would be unwise to rely on an increase in FDI as a way of bridging a balance-of-payments gap. For that purpose, it is a needlessly expensive form of finance.

All this, however, says more about the limits of the concept of "net transfers" than it does about the desirability of FDI. Even if none of the profits from FDI were reinvested in the host country—an extreme assumption—it would be absurd to argue that the recipient country had not benefited. At a minimum, FDI creates good jobs that would not otherwise have existed. In practice, the gains go far beyond this—provided only that the host country's economic policies are not so bad that they channel the resources into inappropriate uses. (And that caveat applies as much to investment financed out of domestic savings as to FDI.)

As a rule, FDI brings more than just finance to the country concerned. Because the investor has bought at least a share in the control of the enterprise, FDI usually involves a transfer of management skills, a resource which is in short supply in many developing countries. Often, access to rich-country technology is also part of the deal. As the new firm buys from local suppliers and sells to local customers, knowledge about rich-country business practices spread. And since the developing-country firm is a partner in an international business, FDI often attunes governments to the needs of exporters. Export-oriented policies have been shown to be extremely powerful agents of development. For all these reasons, FDI is good news.

The balance of costs and benefits in equity finance is finer. The long-term cost of equity, like that of FDI, is higher than that of a bank loan, and for the same reason: an equity investment is a risk-sharing arrangement. In return for that extra cost, the recipient country does not gain the inflows of knowledge and technology that FDI brings. But, in addition to less risk, it can expect to gain two other substantial benefits instead.

One, despite the fact that inward equity investment will usually be dearer than bank finance, is a lower overall cost of capital. The reason is that the cost of capital raised on developing-country stockmarkets falls when foreigners increase their demand for the country's equities. There is good evidence that this effect is not confined just to the shares in question. In other words, when Americans buy shares in a Mexican company, bidding up their price and lowering that firm's cost of capital, shares in other Mexican firms tend to rise somewhat, too.

The other great benefit that equity inflows have over bank lending (at least, as it was conducted in the 1970s and 1980s) is that private investors are selecting private firms in which to invest. This helps to channel resources to more efficient uses, and it puts the managers of those resources under firmer discipline to use them well. One of the clearest lessons from the history of development since 1945 is that it is not the quantity of investment that counts, but the quality.

Perils of openness

The third world needs the global market for capital—but cannot always rely on its co-operation

THE past ten years have been a time of great financial stringency for the debt-burdened developing countries. New productive investment has been squeezed and much-needed growth postponed. Rich-country suppliers of capital (until recently, the banks) had to have their arms twisted to maintain even a severely reduced flow of resources; meanwhile savers in the developing countries illicitly sent billions of dollars abroad. Now that many countries seem to be putting these financial problems behind them—they have regained voluntary access to new sources of foreign capital, and their own savers are bringing home their smuggled savings—it may seem churlish to complain. But some developing-country governments have found that their recent success has brought a different sort of difficulty.

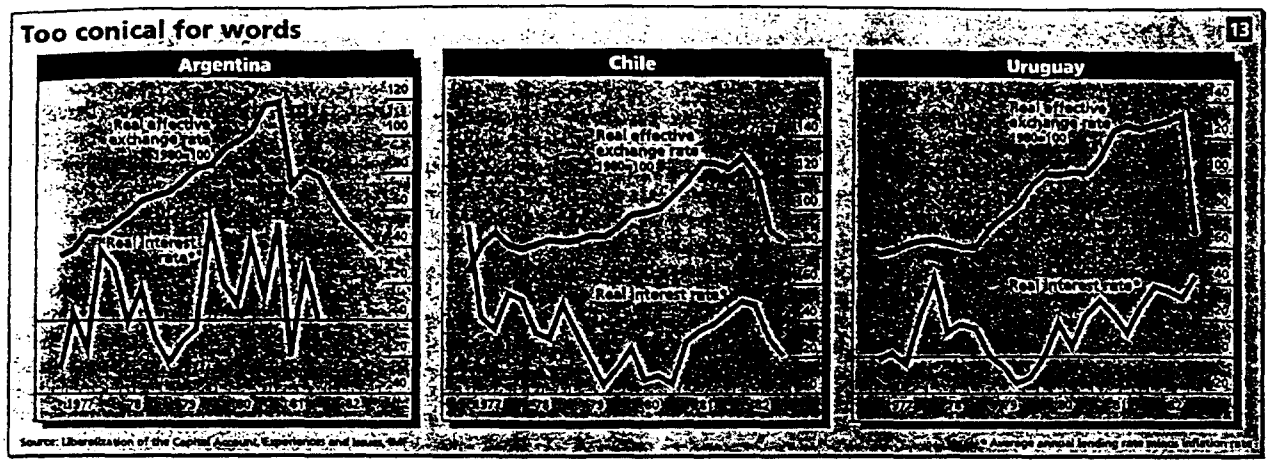
It is this: rapid inflows of foreign capital greatly complicate the conduct of macroeconomic policy. These complications can be so severe that the countries' broader efforts to reform their economies may come to nothing. The sorts of capital that are now flowing so freely to parts of Latin America and elsewhere in the third world are indeed superior in many microeconomic respects to the flows of bank lending of the 1980s; but in the challenge they pose to finance ministries and central banks in setting their monetary, fiscal and exchange-rate policies they are no less difficult.

That is why some economists fear that the financial breakthrough of the early 1990s may end, in due course, in another bust. Whereas the failures of the 1980s were (rightly, on the whole) attributed to failures of policy in the debtor countries, especially to large budget deficits and excessive intervention by the state, the next crisis, if it comes, may well be blamed on liberalisation. That would be a formidable setback to development throughout the third world.

Feels like old times

In fact, these difficulties are nothing new. One of the most notorious episodes in the recent history of economic development was the failure of attempts at financial reform in the Southern Cone of Latin America in the late 1970s and early 1980s. Economists are still arguing about what went wrong—with renewed urgency, now that some see parallels with more recent events.

Ignoring many important differences between



the three cases, what happened in Argentina, Chile and Uruguay is roughly as follows. During the 1970s all three countries embarked on a variety of reforms in their banking and financial systems. They removed their ceilings on domestic interest rates, giving their banks much greater freedom of action. Also, early on, Argentina and Uruguay removed most of their capital controls; Chile, moving more slowly in this respect (though faster in others) removed its controls only partially.

Over the following years, all three countries saw their interest rates rise, to more than 30% in real terms. Such levels were not brief "spikes"; they were sustained for months at a time, and in Chile's case for years. As a result, foreign capital flooded in, causing the countries' exchange rates to appreciate. Between the first quarter of 1977 and the first quarter of 1981, Argentina's trade-weighted exchange rate more than trebled in real terms (see chart 13). The countries saw their trade balances deteriorate, to such an extent that all three were forced to abandon their reforms, in varying degrees, in the early 1980s. (Chile quickly resumed its bold efforts at reform; Argentina and Uruguay turned reformist again only recently.)

The moral that most economists see in this history is this: do not open your economy to inflows of capital too soon in the process of economic reform—especially if you are unable to use other instruments of macroeconomic policy to deal with the exchange-rate consequences. Is that good advice for today's reformers, too? Is the revival of private capital flows to Latin America and other parts of the third world happening so quickly that, far from supporting those countries' economic reforms, it may jeopardise them?

The answer is maybe—though there are things that governments can do to reduce the risk. First, however, it is worth noting that the financial world has changed a good deal since the late 1970s. The consequence is that today's governments have fewer choices than their predecessors over the pace of their financial reforms. This, in turn, makes the Southern Cone syndrome harder to deal with.

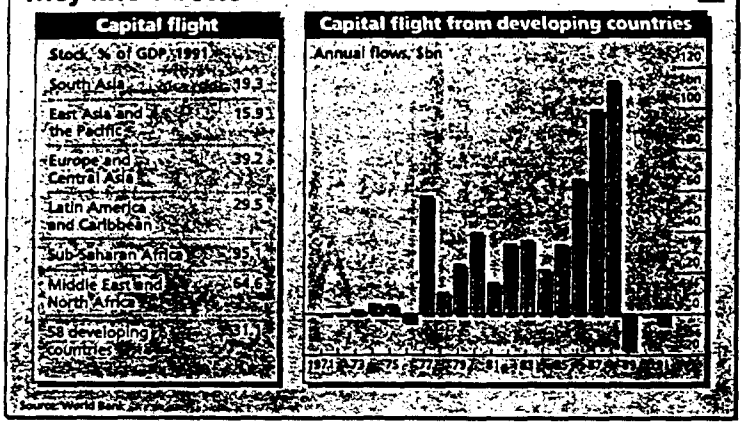
The recent surge in capital flows to parts of the third world is only partly due to a deliberate liberalisation of inflows by governments. Most developing countries (and, for that matter, most industrial countries) still maintain some controls of one sort or another. Usually, these take the form of restrictions on certain capital-account transactions (eg, rules forbidding residents to open foreign-currency bank accounts). More intrusive systems (still common in the third world) involve dual or multiple exchange rates; in effect, the price at which the government is willing to let people or firms buy foreign currency varies according to the purpose for which it is required. Despite such controls, capital flows to parts of the third world are on the rise.

Why? First, because capital controls are rarely intended to isolate a country entirely. Flows can therefore increase without a change in the restrictions. Second, because in many countries the rules have indeed been liberalised somewhat. There may still be controls on inflows of FDI, for instance; but, whereas the government once imposed extremely burdensome conditions on a would-be investor (eg, all its sales must be for export, only a small part of its profits could be remitted, the government must be granted a large shareholding), its conditions now, if any, are less demanding. Third, because capital controls no longer work as well as they used to.

Capital controls have always been leaky. A favourite way of getting round them has long been through false invoicing of exports and imports. For instance, an importer wishing to move money abroad could ask his supplier to write an invoice for more than the true price; the surplus, instead of going to the supplier, goes into a foreign bank. Through this and other methods, third-world investors were able to stash away billions of dollars during the 1980s.

According to the World Bank's estimates, at its peak in the 1980s the amount of capital illicitly flowing abroad from the developing countries was $100 billion a year. On these estimates, by 1990 the stock of flight capital was roughly $700 billion. Latin America's share of that outflow to the United States and elsewhere was equivalent to more than 30% of the region's GDP (see chart 14 on next page). It is impossible to be precise, but a good part of the capital that has lately flowed into Latin America is drawn from these illicit investments. The outflow and subsequent inflow had less to do with changes in capital controls than in the judgment of Latin American investors about the safety and profitability of investing their savings at home.

They knew better 14



Nonetheless, it seems certain that capital controls, always somewhat porous, are gradually becoming more so. As integration through trade increases, opportunities to evade controls multiply. Improvements in technology, especially advances in telecommunications, also make it ever easier to escape the state's financial clutches.

And that is why today's governments have fewer choices when confronted with a disruptively large inflow of capital. The obvious solution to the problems caused by a sudden inflow of capital is unlikely to do much good. Attempting to turn the capital away by strengthening controls is to swim against an ever more powerful tide.

This is not to say, as some economists do, that controls have no effect. They do, and that is why it is well worth removing them when circumstances permit. The case for a fully liberalised capital account is analogous to the case for free trade. Freeing capital privatises decisions about the allocation of resources, and promotes efficiency by fostering competition among suppliers. Even modest controls on capital have costs. They cause rent-seeking and corruption, and prevent scarce foreign exchange from being allocated to its best uses. Countries that have liberalised inflows of capital are often more cautious about liberalising outflows. This too is harmful. It forbids their financial institutions to seek the best returns, or to diversify their holdings of assets in risk-reducing ways.

So capital controls, in these ways, remain "effective". Unfortunately, they are likely to be better at twisting flows of finance into different, and often illicit, channels than at controlling inflows and outflows in the aggregate. Stronger controls, though they would be an even greater microeconomic nuisance, can no longer be relied upon as a macroeconomic remedy.

Crying all the way to the bank

The economics literature offers two sorts of advice to countries suffering, like the economies of the Southern Cone in the late 1970s, from an embarrassment of riches. The first applies to countries where the inflow is already pushing the exchange rate to troublesome heights; it concerns the proper response of macroeconomic policy. The other is more relevant to countries that do not yet face this problem—but may expect to, before long, as their economic reforms proceed. This sort of advice concerns, in the jargon, "sequencing"—how to reduce likely difficulties by getting your reforms in the right order.

Countries facing the immediate macroeconomic problem of an unmanageably large inflow of capital leading to a sharply appreciating exchange rate have six main options.

• Lie back and enjoy it. The other possibilities, some economists argue, are worse than doing nothing. So let the exchange rate appreciate: if it is fixed, let it float. This will put the country's exporters under tougher competitive pressure, but the news is not all bad. The resulting current-account deficit is simply the means for the country to import the foreign capital that is now available to it. After all, the whole point of a capital inflow is to allow the country to invest more than it saves (ie, run a current-account deficit). This is entirely appropriate for a poor country that needs to accumulate lots of capital.

Remember too that the obverse of a stronger currency is greater purchasing power over imports—in other words, an improvement in the country's real income. If the increase in capital flows is not a permanent thing, but merely a temporary inflow of "hot money", it might make sense to stop the exchange rate over-shooting, thus preventing needless strain on exporters and forestalling future balance-of-payments difficulties. But if the larger capital inflow really is a long-term change, the exchange rate will have to go up sooner or later. What is to be gained from postponing this appreciation—especially when it causes damage elsewhere to do so?

• Cut interest rates. This will discourage the inflow of capital and slow or stop the rise in the country's exchange rate. But the effects in the domestic economy could be dangerous. The same circumstances that have attracted the capital inflow may be fuelling an economic boom. Lower interest rates would increase domestic borrowing, adding to inflationary pressures.

• Tighten capital controls to discourage inflows. For the reasons explained above, this is harmful and unlikely to work for long.

• Liberalise capital controls to encourage outflows. This looks attractive, except for one thing: many of the countries that have done it have found that allowing more capital to flow out has encouraged even more capital to flow in. This happened in Britain in 1979 (and in Yugoslavia in 1990). Foreign investors may take the reform as a sign of better economic times ahead, and/or be reassured that having put their money in, it will be easier than hitherto to get it out. Whatever the reason, this experience adds weight to the view that liberalising capital controls is not a policy well-suited to influencing aggregate inflows or outflows.

• Sell more government bonds. This is known as sterilising the inflow: its effect is to reduce any effect that the surge in inward investment might have on the domestic money supply. Where the inflationary impact of the inflow is the most pressing worry, this may look like a good answer. The trouble is that if the sterilisation is conducted on a large scale, the government will have to raise its interest rates to make the bonds attractive. That will draw in more

foreign capital, calling for more sterilisation, and so on—a vicious circle. In the meantime, either the finance ministry or the central bank is running up a bill for debt service that is likely, in due course, to become a big problem in its own right.

• Tighten fiscal policy. This does two things. It reduces demand in the domestic economy, helping to meet any worries the government may have about rising inflation. Yet at the same time it is likely, other things being equal, to reduce interest rates, which ought to encourage a slower inflow of capital. This will mitigate the rise in the exchange rate and reduce the undue pressure on exporters' profits. That combination is exactly right—and the greater the proportion of "hot money" in the inflow, the more sense it makes to resist the currency's appreciation in this way. There are two drawbacks. In practice, it is extremely difficult to know how much of the inflow is hot, and how much not. And, by itself, a fall in public borrowing (or a rise in the public sector's surplus) will be nowhere near big enough to offset a really large-scale rise in inward investment.

Weighing these pros and cons, it seems that a mixture of three of the policies may be best. One, tighten fiscal policy with a judicious mixture of cuts in public spending and higher taxes. Two, partially sterilise the inflows—best of all, by privatising some state-owned enterprises, for that avoids the debt-servicing difficulties that may follow heavy sales of government bonds. And three, allow any remaining upward pressure on the exchange rate to cause a moderate appreciation. This is a good description of present macroeconomic policy in several Latin American countries, notably Mexico and Argentina (though Argentina's exchange-rate appreciation looks increasingly immoderate).

Better start from somewhere else

Dealing with the macroeconomic implications of a capital inflow in this way presupposes that the government has good control of its own fiscal policy. In many developing countries, where the tax base is insecure and public spending out of control, this is not the case. For governments just embarking on the path of economic reform, adequate fiscal control should therefore be a precondition for other measures that might encourage a bigger inflow of capital—including the liberalisation of capital controls.

But there are other preconditions, too. Indeed, the consensus among those who have studied the issue of sequencing is that freeing an economy's capital account should ideally come last. However desirable it may be to admit inflows and allow outflows once the economy has been substantially liberalised in other ways, these freedoms may be counter-productive in the early stages of reform.

Suppose, for instance, that the government's budget deficit has not yet been brought under control. Freeing capital controls under these circumstances not only risks, as already explained, a strong appreciation of the currency that would harm industry; it also makes it likely that the budget deficit will stay too big for longer. As long as the inflow of capital lasts, the government will find it easier to finance its own borrowing. Measures to curb the deficit, which are often painful and politically unpopular, are therefore likely to be postponed—so that the inevitable fiscal crunch, when it comes, will be all the worse.

Or suppose that capital flows are liberalised before trade in goods and services has been freed. High trade barriers, among other things, divorce domestic prices from world-market prices; the higher the barriers, the greater this distortion. Domestic prices, not international ones, guide firms in choosing how to invest. If cement manufacturers, for instance, are protected from foreign competition, their prices will be artificially high—and producing cement will be artificially profitable. New cement factories may be built that make money at local prices, but big losses if prices and costs are measured in the international market.

In some developing countries, and in parts of Eastern Europe and the former Soviet Union, distortions of this kind have been exceptionally severe. Investments have gone ahead which are not merely unprofitable at world-market prices, but "value-subtracting". A value-subtracting enterprise is one that would lose money even if its labour were supplied free of charge—in other words, it is an enterprise that takes in energy and raw materials and turns them into things that are worth less than they were to begin with.

When prices are this badly or even somewhat distorted by high trade barriers, so that investment is failing to earn the economy an appropriate rate of return, there is no case for liberalising capital inflows. In the most distorted economies, the new investment that will be financed by such inflows may even reduce the country's output (properly measured).

There are exceptions. Some countries have attracted foreign direct investment by creating enterprise zones within which producers pay free-trade prices for their materials and receive free-trade

prices for their products. A capital inflow of this kind may make good sense even in an otherwise distorted economy. And there are other ways to offset the effect of distorted internal prices on investment decisions. Much the easiest way of ensuring that capital inflows finance only sound investment projects, however, is to bring down trade barriers before letting the capital in.

Finally, suppose that the capital account is freed before the domestic financial system has been reformed. In many developing countries, banking systems have been either explicitly state-run or else subject to all manner of heavy-handed regulation. It is still common for the interest rates paid to depositors and by certain favoured borrowers to be much lower than the rate of inflation—so that the banking system is, in effect, taxing saving and subsidising some borrowers. As in the case of trade protection, this represents a price distortion—and the price of capital is an especially important one. Under these circumstances, inflows of foreign capital are likely to be inefficiently allocated.

For all these reasons, reformers in developing and ex-communist countries would be well-advised, whenever possible, to put the liberalisation of capital controls towards the end of their overall programmes of reform. Fiscal control, and hence low inflation and a background of macroeconomic stability, should come first. In some countries—and above all in Eastern Europe and the former Soviet Union—fiscal reform will be impossible without a parallel reform of the domestic financial system. Without undue delay, trade reform should follow. When all that is done, controls on capital outflows and inflows can be safely reduced.

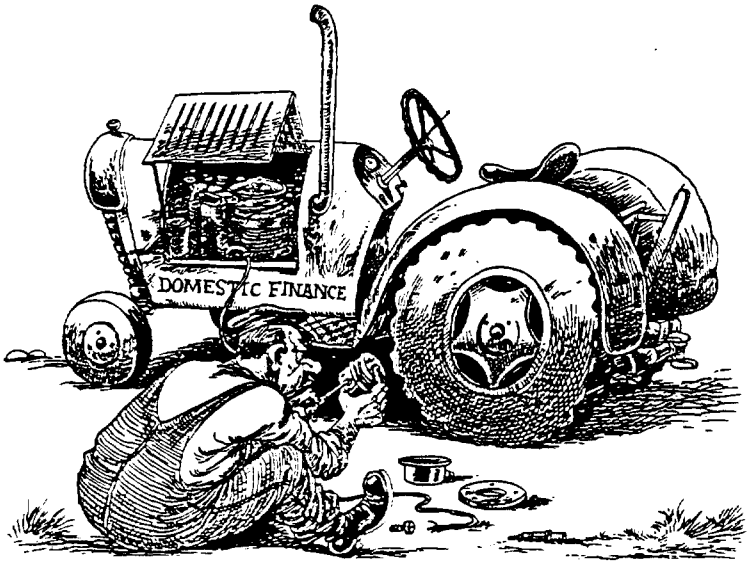
The trickiest prescription in this list (but one on which everything else may depend) is not fiscal reform or trade reform, difficult though these may be. The hardest task in many poor countries—witness the difficulties it has caused throughout the industrial world—is the reform of domestic finance. Private capital, whatever its source or form, is powerless to promote development unless the domestic financial system is doing its job.

Clarity starts at home

For any country, much the biggest source of private capital is its own savers

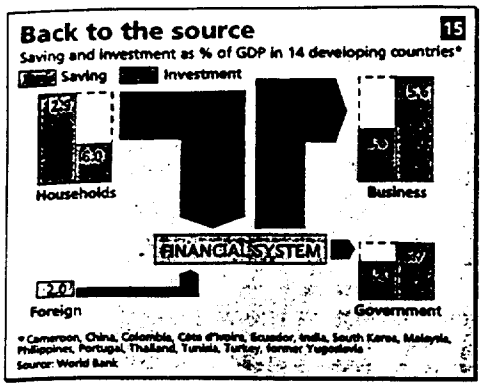
THE debt distress of the 1980s, which continues in many developing countries in the 1990s, made it clear how sensitively the third world's prospects depend on a secure and steady flow of finance from the industrial countries. So it is right that much of the debate about economic policy in developing and ex-communist countries turns on issues in international finance: the case for debt forgiveness; the best forms of borrowing; how to manage financial risk and exchange-rate uncertainty; the need for more aid; and so on. The result, however, is that domestic finance has, at least until recently, been neglected.

If that is changing it is partly because financial upsets in the big industrial economies (the savings-and-loan mess in the United States, the mountain of bad bank-debts in Japan) have brought the difficulties of financial regulation and deregulation to wider attention. It is also because of the financial plight of the ex-communist economies. In Eastern Europe and the former Soviet Union, the assets of state-owned banking systems are in many cases worthless. Yet the banks continue to extend credit to chronically loss-making enterprises for fear of causing an even more precipitous fall in output. Where attempts have been made to curb this process, enterprises have resorted to "borrowing" from each other—ie, to leaving their bills unpaid.



Domestic financial reform is therefore at the core of building capitalism in the former communist states—and hence more topical than it used to be. This new interest in the subject is long overdue, however. Many developing countries have suffered for years from domestic banking systems that are grossly inefficient. In some cases, the hidden problem of bad debts—caused by many years of inefficient and imprudent lending—may stand comparison with its counterpart in the ex-communist countries. That is because many developing-country governments have used their financial systems as heavy-handedly as the governments of Eastern Europe, suppressing the price mechanism in the allocation of credit as ruthlessly, and directing the flow of resources from the centre as ham-fistedly.

Domestic finance matters, above all, for one overriding reason: it is quantitatively much more important than foreign investment, even in those countries that are most successful at attracting capital from abroad. Development economics has traditionally emphasised the gap between the third world's capital requirements and the savings it can generate for itself; the World Bank and its sister organisations exist to fill this gap and encourage others to do so. This preoccupation with the scale and form of capital flows from the industrial countries to the third world is justified only up to a point. It matters more that the developing coun-



tries put their own savings to better use.

The domestic financial system plays the crucial role in channelling these savings (and, for that matter, much of the inflow of foreign capital) among competing uses. To put this function of the financial system in perspective, it is misleading to consider gross flows of savings. Households save, but then invest much of the proceeds for themselves without the intermediation of the financial system. (For instance, cash spent on acquiring a physical asset, such as a house, is simultaneously saving and investment.) The same is true for businesses, which invest out of their own savings ("retained earnings") as well as out of other people's; and for governments, which invest out of their surplus of taxes over current (as opposed to capital) spending. In short the financial system is concerned with financial surpluses and deficits.

Data on these are patchy, but by way of illustration chart 15 shows figures calculated from a sample of 14 developing countries, using information from the 1970s and 1980s. On average, households saved 12.9% of GDP and invested nearly half of it directly themselves; the surplus of 6.9% of GDP was intermediated through the financial system. Businesses saved 8.6% of GDP but invested 15.6%; their deficit of 7% of GDP was bridged by means of the financial system. Governments, too were a drain on the financial system, to the tune of 1.9% of GDP. To balance the books, foreign investors provided a (comparatively small) surplus of 2%.

From these numbers two things are obvious. First, a small increase in the household saving rate will do more to increase the availability of capital for investment than a big increase in foreign investment. If this sample is any guide, to match an increase in the household saving rate from 12.9% to 14.9%, other things equal, the foreign surplus would have to double. Second, the savings of both of the sectors in surplus—households and foreigners—will be wasted unless the financial system works well. In practice these points are closely linked, because a common side-effect of a badly functioning financial system is that the supply of household savings available for investment by business is smaller than it would otherwise be.

Finance matters . . .

The usual way in which developing-country governments impede the workings of their financial systems is by placing a low ceiling on interest rates. Until quite recently the same policy was used in many industrial countries too, though not to such outlandish effect. Many developing countries have maintained low nominal interest rates despite high inflation, so that bank deposits quickly lose their value. The rationale is simple: by keeping down the cost of credit, firms will be encouraged to invest. The policy goes wrong because artificially low interest rates discourage saving—perhaps not in the aggregate (controversy surrounds this question) but pretty clearly as measured by that part of household saving which is entrusted to the financial system.

Mild "financial repression" may not do much harm. Some of the countries that practised it have done rather well (South Korea, before it liberalised, to name one). But severe repression—meaning a real deposit rate sustained at, say, minus 5% or less—is strongly associated with financial underdevelopment (ie, with slow growth in bank deposits relative to total saving). More important, severe financial repression hurts the quality of investment and retards growth. In the sample of countries just referred to, the productivity of investment was roughly four times higher for those with moderately positive real interest rates than for those with strongly negative ones—and their output grew three times faster (see table 16).

Why? One reason may simply be that savings intermediated through a financial system, however imperfect, are used more efficiently than savings invested directly by parts of the economy that are in surplus. This is plausible. Some of the savers who invest outside the financial system presumably do so not because they can earn a high return that way, but only because the system has failed to offer them anything better than a mugging.

Another reason is the converse of this. In countries with artificially low interest rates, the demand for credit is artificially high. At substantially negative real interest rates, substantially loss-making investments may be profitable, so everybody wants to borrow as much as they can. Since the ceiling on interest rates forbids this excess demand to be rationed by price, it must be rationed in some other way. Typically, bureaucrats do the job, directing credit to the uses they judge most useful. Whether because of incompetence or corruption or both, they appear to do a bad job. The result is investments that are markedly less productive than in systems where prices do the rationing.

Now that all this is increasingly well-understood, many developing countries are trying to reform their financial systems. The trouble is, the right way to carry through a financial reform is anything but clear.

Recall the disastrous efforts at financial liberal-

A fair price for money 16

The economic effects of interest rates in two groups of developing countries*

	1965-73		1974-85	
	1	2	1	2
Real interest rate	**3.7**	**-13.7**	**3.0**	**-13.0**
Financial development*	18.7	6.4	16.6	-0.9
Productivity of investment†	36.7	21.7	22.7	6.2
GDP growth rate	7.3	4.6	5.6	1.9

*Countries were drawn from a sample of 14. Those in the first group had positive real interest rates. Countries in the second group had real interest rates of minus 5% or less. †Ratio of change in real M3 to real saving **Ratio of change in GDP to interest rate
Source: World Bank

isation in the Southern Cone in the 1970s. Chile, Argentina and Uruguay not only opened their economies to inflows of foreign capital, but also substantially deregulated their domestic financial systems. That, in the view of some economists, was the greater mistake. Banks, freed to compete for deposits by raising interest rates, did so with unforeseen enthusiasm. The results were memorably bad—enough for many developing countries to put financial reform off the agenda for nearly a decade. Financial deregulation in the rich countries has also gone badly, often creating as many problems as it has solved. On this subject, America, Japan and the others are in a poor position to give the third world advice.

... but what to do about it?

The difficulty is that the analogy between free trade in goods and free trade in finance is not quite right. In markets for goods, domestic or international, it is hard to have too much rivalry. The paradigm of perfect competition envisages so many suppliers that profits are tightly squeezed and no individual firm can exert any influence whatsoever on prices. In finance, in contrast, it seems there may well be such a thing as too much competition.

Among several reasons for believing so, the most important is deposit insurance. Many governments in both developing and industrial countries have formal schemes of this kind: if a bank goes bust, the state makes good all (or nearly all) of the depositors' losses, usually up to some ceiling. The economic rationale is plain. If depositors start to doubt the soundness of a bank, some may withdraw their money and put it elsewhere. As they do so, fear that the bank may fail spreads and becomes self-fulfilling. Even if the bank had been sound to begin with, a run may start that drives it under. On occasions in the past, runs have spread to many banks. This is extremely dangerous: if the payments system that banks provide is destroyed, the result is a deep depression.

Deposit insurance is designed to prevent this by stopping runs before they start. It works, but at a price. Imagine a bank that is in trouble because it has lent unwisely in the past. It is losing money and its assets (ie, its loans) look shaky. It may be tempted to restore its fortunes by taking more risks—lending to less creditworthy borrowers at high interest rates, attracting the money it needs by paying depositors, in turn, higher interest rates.

Without deposit insurance, there is a check on this temptation: depositors know (or anyway may suspect) that they are receiving more interest to compensate them for the greater risk of losing their shirts. The higher the rate, the greater the risk, and the fewer the willing gamblers. With insurance, the depositors have no reason to refuse those high interest rates. If the bank's owners themselves have little to lose—and they don't, because their bank was on the point of failing anyway—the incentive to lend ever more recklessly is irresistible. A process of this sort lay behind America's savings-and-loan fiasco. The same factors may also have played a role in the Southern Cone, helping to explain why interest rates there, once deregulated, soared to such improbable heights.

As yet, no country in the world has come up with an entirely satisfactory answer. To abolish deposit insurance, even if that were desirable, is not so easy. Even in countries that lack formal schemes, depositors may suspect (usually rightly) that the government would compensate them if a bank failed: deposits are implicitly insured even when they are not explicitly insured. Careful bank supervision is essential—the quid pro quo for deposit insurance. But it has proved insufficient to stop reckless lending even in countries such as America and Japan, where competent and honest regulators are not impossible to recruit.

It is unrealistic to expect even that inadequate standard of supervision in many parts of the third world—least of all in Eastern Europe and the former Soviet Union. There, many banks are insolvent, so the moral hazard of implicit or explicit deposit insurance is at its greatest; bankers lack the necessary training and experience in credit appraisal; and the skills for adequate supervision simply do not exist.

Adding to the difficulties in the ex-communist countries is the unusually weak state of many enterprises. Often they are borrowing not to invest, but merely to pay wages and stay in business. In one way or another this mounting burden of debt could end up bankrupting government—either because finance ministries are eventually obliged to acquire the banks' worthless assets, or because they take over the task of subsidising chronically loss-making firms themselves, or both. Where that happens, the only alternative to widespread defaults is to accommodate the fiscal pressures through inflation—in effect, printing money to pay for the industrial subsidies. In those ex-communist countries where very high inflation is most persistent, notably Russia, this process is already under way.

This link between bad banking and fiscal breakdown has led one top economist—Ronald McKinnon of Stanford University, a pioneer in the modern theory of finance and development—to suggest that, for the time being, credit in Russia and other ex-communist countries should be banned altogether. A less draconian proposal, as advanced in a recent paper by Gerard Caprio (an economist at the World Bank) and Lawrence Summers (formerly the Bank's chief economist, now an undersecretary in the United States' Treasury) is to restrict the number of banks tightly. By deliberately allowing less competition, governments would be ensuring that banks could be profitable, thereby giving them something to lose if they continued to lend recklessly. In this way, it is argued, the banks can be given a reason to be more prudent.

First steps

In the face of all these difficulties, and remembering how many experiments in financial liberalisation have gone wrong, neat blueprints for banking reform cannot be offered with any confidence. But this should not obscure the first steps that many developing and ex-communist countries urgently need to take.

Undoubtedly the top priority must be to achieve fiscal discipline. This means that governments must build a tax base capable of paying for most of their spending (including implicit as well as explicit subsidies), so that any remaining deficit

This survey has drawn on a variety of published and unpublished sources, especially: "Global Economic Prospects and the Developing Countries 1993", "World Debt Tables 1992-93" and "World Development Report 1989", all published by the World Bank; "World Investment Report 1993", published by the United Nations; "Liberalisation of the Capital Account", IMF Occasional Paper 103, by Donald Mathieson and Liliana Rojas-Suarez; "Finance and its Reform: Beyond Laissez-Faire" by Gerard Caprio and Lawrence Summers, mimeo; "Liberalisation, Foreign Investment and Economic Growth" by DeAnne Julius, mimeo; and "The Order of Economic Liberalisation" by Ronald McKinnon, published by Johns Hopkins Press.

can be easily financed without recourse to the printing presses. Support for industry on non-commercial grounds must be taken away from banks and put on to governments' budgets, then gradually scaled down. Regulated interest rates should be allowed to rise, so that severe financial repression stops. But they should not be freed altogether until banks' balance sheets have been made sound (partly by restricting entry), and until at least a rudimentary capacity to supervise has been created.

Paying for growth

In the new world of finance, opportunities for many developing countries outweigh the risks

WHETHER governments like it or not, domestic financial systems are gradually merging into a single worldwide capital market. The extraordinary increase in capital flight during the 1980s (despite strict controls) and the explosion of open private finance in the 1990s (despite, even among the most zealous reformers, only partial liberalisation) bear witness to that. Yet it remains true that the benefits of this transformation, and the benefits of the individual trade, industrial and public-sector measures that many economies are undertaking, will be small, at best, unless they happen as part of wider-ranging programmes of reform.

Put the technicalities of sequencing to one side. The crucial point is this: the undoubted difficulties of deregulating finance should not be an excuse for delay. With time, to a significant degree, international finance is deregulating itself. So it is all the more urgent that governments press ahead with the policies needed to take advantage of that fact: fiscal control, macroeconomic stability, trade reform, reform of the banks.

Of these, fiscal control and macroeconomic stability come first; without them, little else can work. Beyond that, in both trade reform and financial liberalisation, there is a good case for pursuing reform more gradually. In the case of finance, where new skills and institutions need to be created, and where the paradigm of an entirely free market is anyway not the right goal, governments need to be especially cautious. But for the many developing and ex-communist countries that start from a position of severe financial repression, there need be no hesitation over the first steps, and governments should leave their economies in no doubt about the direction of reform.

The transformation of international finance has implications, too, for the policies of the industrial countries and the multilateral institutions (the IMF, the World Bank and so on) towards the third world. A variety of apparently small changes could help to move the revolution forward in desirable ways.

As explained earlier, greater portfolio investment by rich-country investors in the third world is a change that could benefit the rich countries as much as the developing ones. Governments in the industrial countries could encourage it by making it easier for firms in developing countries to list shares on the rich countries' stockmarkets. A good way to encourage FDI in the third world—another positive-sum game—would be to arrange more double-taxation treaties with developing-country partners. (This would also meet one of the anxieties that developing countries have about liberalising capital outflows: that their tax base of investment income would shrink.)

A helping hand

A bigger question is what these financial changes mean for aid to the third world. For years there has been a good case for concentrating aid on the world's poorest countries. (About a third of the aid that the rich countries provide still goes to middle-income countries.) The revival of private finance strengthens this case even further. The poorest countries are not participating in the revival of private finance. Foreign investors see few profitable opportunities there. Even where economic policy is improving (as it is in some) much investment in badly needed economic infrastructure will continue to require support from foreign donors.

Middle-income countries with improving economic policies need aid less and less; they can make their own pitch for resources in the global capital market. Where policies are bad, so that the pitch falls on deaf ears, the humanitarian case for aid is far less compelling than the case for helping, say, sub-Saharan Africa. Increasingly, developing countries are finding that the best sort of help is self-help. Increasingly, they are finding that international financial markets are willing to reward and invest in countries that are pursuing growth.

In such a world, the best way for the rich countries to help the poor would be for the rich, too, to favour a species of self-help—by opening their markets to the developing countries' exports. Then, as the third world grows richer, its imports from the industrial countries will rise in tandem. In development, freer trade is the biggest positive-sum game of all.

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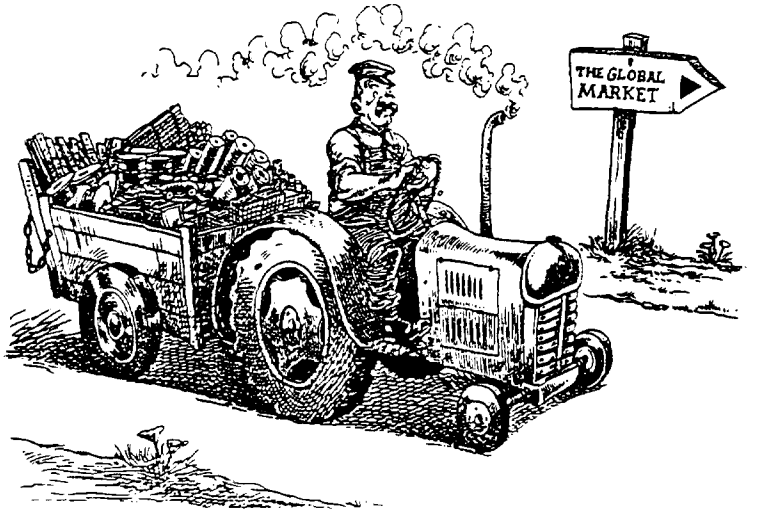

monitor performance and keep management up to the mark—and management has more incentive to listen. Private pension funds in Chile do this well: they now hold more than half of all the corporate bonds issued by privatized companies and a significant percentage of their equity as well. Findings of research on the effects of institutional investors are, however, ambiguous: some studies, for instance, argue that the ease with which institutional investors can move their shares from firm to firm leads them to focus on short-term profits (see, for example, Black 1992; Porter 1992).

Conditions for Success

Two factors are paramount in determining the strategy and influencing the outcomes of privatization for economic productivity and consumer welfare. The first is country conditions, in particular the extent to which free entry is allowed by the macroeconomic and regulatory policy framework, markets are competitive, resources are allocated on the basis of marginal returns, and the regulatory and supervisory institutions are effective. The second is the nature of the market into which the enterprise is divested, that is, whether the market is competitive or potentially competitive as opposed to noncompetitive (see table 3). (A potentially competitive market is defined as one in which relaxation of legal or regulatory barriers to entry would reasonably be expected to produce, in the short to medium term, either domestic or foreign competitors.)

COUNTRY CONDITIONS. Privatization of both competitive and noncompetitive SOEs is easier to launch and more likely to yield financial and economic benefits in countries that encourage entry and free trade, offer a stable climate for

Table 3. *Privatization: A Framework for Decisionmaking*

	Enterprise conditions	
Country conditions	*Competitive*	*Noncompetitive*
High capacity to regulate; market friendly	*Decision* • Sell	*Decision* • Ensure or install appropriate regulatory environment • Then consider sale
Low capacity to regulate; market unfriendly	*Decision* • Sell, with attention to competitive conditions	*Decision* • Consider privatization of management arrangements • Install market-friendly policy framework • Install appropriate regulatory environment • Then consider sale

investment, and have a relatively well-developed institutional and regulatory capacity. The advantages of creating the right policy and institutional framework are illustrated by successful privatizers such as Chile and Mexico, which began macroeconomic and public sector reforms well before privatization. Chile, for example, reduced tariffs to 10 percent across the board, eliminated its budget deficit through tax reforms and expenditure cutbacks, and introduced a stabilization program that reduced inflation from 380 percent in 1974 to 38 percent in 1979 (Corbo 1993). Such reforms attract private investors and ensure that privatization expands competition and productive efficiency, rather than simply transferring rents from SOEs to private owners.

In low-income countries, privatization of both competitive and noncompetitive SOEs is a challenge. In addition to the usual social and political obstacles, such countries often face macroeconomic distortions; thin capital markets; limited interest from foreign investors; and weak legal, regulatory, and institutional capacity. Poorly conceived and badly managed privatization in such settings has compounded the problem. Terms and conditions of sale granting excessive sweeteners such as new monopoly rights or overly generous tax and duty exemptions, have reduced competition and efficiency, as in Guinea, for example (see Suzuki 1991). In other instances, privatized enterprises have gone bankrupt, although closures do not necessarily indicate that the policy of privatization is misguided. Many of these firms had not been viable when they were state owned but had been kept alive by government protection and subsidies. Few developing countries can afford to subsidize, at the expense of all of their citizens, the relatively small number of people in unproductive SOE jobs. The demise of loss-making firms (public or private) can free assets for more productive use, eliminate a burden on the economy, and allow investments and job creation elsewhere.

The distributional effects of privatization in low-income countries are yet to be thoroughly analyzed, but a concentration of assets in the hands of a small elite is a legitimate concern. Sales without competitive bidding, at predetermined concessionary prices or into protected markets, have helped enrich small groups of well-connected individuals. The examples cited earlier show that privatization in low-income countries can yield significant economic gains in those (unfortunately few) cases where it is well managed, but the fact remains that the weaker the economy and the governing institutions, the more difficult it will be for privatization to yield benefits.

MARKET CONDITIONS. Privatizing enterprises that produce tradables—in competitive or potentially competitive sectors such as industry, agriculture, and retail operations—is easier because regulation is not required. If privatization also expands competition—a likely outcome because, for reasons cited earlier, governments find it hard to maintain a level playing field for their SOEs—then solid and rapid economic benefits will result (as long as there are no economy-wide distortions that hinder competition). In countries where markets prevent

monopolistic behavior and provide incentives for efficiency, successful privatization may require little more than adequate attention to transparency. Even in countries where markets are weak, privatization may still be beneficial if it reduces the fiscal burden of SOE subsidies and exposes fully the costs of the distortions. In such circumstances, rapid privatization of competitive firms, accompanied by liberalized trade and prices and strengthened institutional and regulatory framework, should be feasible.

Privatizing SOEs that operate as monopolies, such as power, water, or telecommunications, is harder in any setting: the enterprises are larger, the stakes higher, foreign investment issues more sensitive, and regulatory questions more salient. Nonetheless, the research cited above shows that privatizing such enterprises has yielded benefits in Chile, Mexico, and the United Kingdom (Galal and others forthcoming). A regulatory framework that sets out the tariff regime, establishes goals for universal service, develops targets for minimizing costs, and has credible regulatory institutions that can supervise the established procedures and resolve conflicts is essential to clarify the rules of the game and create a stable and predictable operating environment for private investors. Such a framework also helps allay fears about equity and political opposition, allowing decisionmakers to erect mechanisms to defend transparency, competition, and the public interest. Chile's well-developed regulatory framework ensured that sale of its power companies increased efficiency without harming consumer interests. Tariffs were structured so that large consumers with high demand at peak periods, who cause the system to expand, would pay a higher price than consumers who do not cause this expansion; these would pay a price equivalent to the short-run marginal cost. Suppliers to large consumers have to compete in this segment of the market.

Privatizing utilities and other natural monopolies is especially difficult in low-income countries, where private investors are few, capital markets thin, and the institutional and regulatory framework inadequate. In such instances, privatizing management is often a step in the right direction. Even where monopolies remain state owned, competitive activities can be separated out, and services provided in-house can be competitively bid for, as in Venezuela, where a private company collects tariffs for the public water company.

What, How Much, and How Fast to Sell

Most divesting governments—including Chile, Jamaica, Mexico, the Philippines, Poland, Togo, Tunisia, and the United Kingdom—began by selling small and medium-size firms that operated in competitive markets. Such sales require little prior restructuring, entail minimal political risk, are more easily absorbed by local private investors, and help prepare for subsequent sales of large and complex SOEs. The firms can and should be privatized quickly in order to put the assets to productive use. The Mexicans see this as the main lesson of their successful experience. They recommend starting with the small

firms to learn how to do it, to educate the public, and to minimize risks—in the words of Pedro Aspe, Minister of Finance in Mexico in 1991: "If one makes a mistake selling a night-club or a bicycle factory . . . it is not as tragic as if these mistakes are made while selling the largest commercial bank in the country, the telephone company, or a major airline"(Aspe 1991: 8).

But there is no universal strategy. The choice of where to begin depends on investor interest, government capacity, and which sectors and SOEs most need new investments and improved efficiency. Some countries choose to privatize public utilities first, despite the complexities involved. The window of political opportunity may be open but briefly, and the most important cases may best be tackled before conditions change. Large privatizations give the policy instant credibility and send clear signals of commitment to financial markets and investors. The potential economic and financial benefits of privatizing the utilities first may make it worth the risks: privatizing badly managed utilities that provide critical goods and services can help accelerate modernization and growth. Latin American countries (Argentina in particular) have taken this course with good results.

Privatizing Management

A big advantage of sales over divestiture methods that do not privatize ownership is that sales transfer property rights to profit-oriented owners who have an incentive to improve performance. But outright sales may not always be financially or politically feasible, particularly in low-income countries or in enterprises, such as railways, water, and power, that require a big investment in modernization. In such instances, one option is to bring in private managers and allow the SOE to operate much like a private firm, even if the assets remain state owned.

Management contracts have worked well in sectors such as hotels, airlines, and agriculture, where contract negotiation and monitoring are routine and where there is an ample supply of experienced managers. But management contracts have disadvantages. Typically, contractors do not assume risk, and losses are borne by the state. Flat fee-for-service arrangements, payable regardless of performance, provide little incentive to improve efficiency and maintain the value of assets (Hegstad and Newport 1987). Properly drawn contracts can minimize these problems, but that—particularly in low-income countries—usually requires strengthening government's capacity to monitor and enforce contractual obligations. Once again, the dilemma surfaces: in low-income countries, the very factors that block privatization also impede alternative solutions.

Leases overcome some of these drawbacks because the private party, which pays the government a fee to use the assets, assumes commercial risk and has more incentives to reduce costs and maintain the value of the assets. Lease arrangements have been widely used in Africa in sectors that have difficulty

attracting private investors: water supply in Côte d'Ivoire and Guinea, power in Côte d'Ivoire, road transport in Niger, port management in Nigeria, and mining operations in Guinea (Triche 1990). The gains have been substantial. In Côte d'Ivoire, for example, the leased water company improved technical efficiency, new connections, and billing and collection of receivables—and reduced the number of highly paid expatriate staff members by 70 percent.

Concessions, in which a private operator is responsible for capital expenditures and investments as well as existing assets, are more desirable for the government but less feasible than leases because private financing (or willingness to finance) tends to fall short of the needed investment, particularly in sectors or countries where political and economic risks are high. Concessions have been successfully used in the recent telecommunication and railway privatizations in Argentina.

Analysis of the experience with private management arrangements emphasizes that governments should avoid interfering in management and should concentrate instead on accountability. SOE management can be held accountable by various mechanisms: business plans, properly staffed and empowered boards of directors, contract plans and performance agreements, and performance evaluation and incentive systems. All are costly and difficult to install; none are foolproof methods of improving performance. Managers could be given incentives to improve operations and enhance the long-term value of the assets by linking fees to performance, encouraging equity investments, or allowing managers to purchase some or all of the assets or shares when the contract or lease expires. (Obviously, this last option must not link market value at the end of the lease period with purchase price, or the lessee would have an incentive to run down the value of the enterprise.) Finally, private management arrangements are likely to work best when they are a step toward full privatization, because it is change in ownership that checks government interference and brings in badly needed investment capital.

Full or Partial Sale?

Selling minority shares has sometimes worked well, particularly when competition is introduced; when managerial control is transferred to competent core investors; when government's voting rights are limited; and when the minority share offering is a prelude to a majority share offering. In Malaysia, partial sale of the port operations significantly improved behavior and enhanced productivity (Galal and others forthcoming). In Indonesia the public offering of 27 percent of equity of a state-owned cement company reportedly changed operational behavior for the better. Management reported that the need to meet listing requirements on the stock exchange led the company to hire private accountants, which improved transparency; managers also claimed that, to maintain share values, they implemented cost-cutting measures that had previously been avoided (authors' field notes, October 1992). In Japan the sale of

33 percent of shares of Nippon Telephone and Telegraph (NTT) to 1.6 million small shareholders (with a further government commitment to sell up to 67 percent of total shares), combined with increased competition and the appointment of a new chief executive officer from the private sector, resulted in higher profits and improved service for NTT despite reduced long-distance tariffs and staff cuts of 20 percent over five years (Takano 1992).

But the NTT case also illustrates the limits of partial privatization. Most shares remain state owned, and enactment of NTT's Corporation Law has allowed the government to remain involved in company operations—in some areas, even more than it could when NTT was a state-owned company. For example, the regulatory ministry can approve or reject appointments to the senior executive corps, even after such appointments have been approved by the shareholders' meeting; the ministry also has the authority to approve or reject NTT's business plan (Takano 1992).

Implementation

Once the commitment to privatize has been made and a strategy planned, the details of implementation present their own challenges to policymakers. The principal issues are the preparations needed for sale, pricing and valuation, financing, and managing the process.

Preparing for Sale

Experience shows that small and medium-size competitive SOEs can and should be sold rapidly through competitive bidding without much restructuring. But selling large enterprises requires considerable preparation, for example, legally transforming public entities into corporate forms that permit private shares (such as joint stock companies), breaking up large firms and monopolies into viable and nonviable units, separating competitive from noncompetitive activities, and identifying peripheral assets (such as real estate holdings, sports teams, and restaurants) that can be sold as separate concerns. Many such actions have been taken in the former East Germany and elsewhere in Eastern Europe and Central Asia, as well as in Argentina (railways, steel) and Mexico (steel).

Successful large privatizations—the utilities in Chile, Mexico, New Zealand, Venezuela, and the United Kingdom are examples—have also entailed the appointment of *new managers*, often from the private sector, with different attitudes and approaches and increased autonomy to prepare for privatization.

SOEs are typically encumbered by large debts. Private buyers are usually reluctant to take on the debt, and governments are rarely willing to discount the sale price by the amount of the debt; *debt write-downs* are standard practice of divesting governments the world over. Such debt relief should occur only

when ownership and management change hands, and not before, otherwise there is a real risk that arrears will simply recur. The extent of the write-off varies. The governments of Argentina and Venezuela assumed debts of $930 million and $471 million, respectively, upon the sale of their telephone companies. In Germany government assumes, on average, 70 percent of the old debts of the companies sold.

Many SOEs have significant potential *environmental liabilities*, an issue particularly germane to Eastern Europe and Central Asia. Inappropriately disposed waste can be cleaned up before sale or by the purchaser as a condition of sale.

Preparation for privatization can also involve *downsizing* the labor force, as occurred in Argentina, Japan, Mexico, New Zealand, Tunisia, the United Kingdom, and elsewhere. Large-scale labor shedding is best handled by the state, particularly for large firms or when liquidation precedes sale of assets. Private investors would rather avoid contentious and highly visible labor disputes; and the government is better able to design social safety net measures such as retraining, severance pay, and unemployment insurance.

Some governments, in the interest of speed, have sold large firms with their labor force intact. This strategy has worked well in telecommunications and other high-growth industries able to absorb excess labor. In some instances governments have limited the latitude for private owners to make labor decisions, but such restraints have reduced investor interest (as in Pakistan, where there were twelve-month restrictions on layoffs) and have invited demands for subsidies to cover costs (as in the case of jute mills in Bangladesh). Moreover, restrictions may not be easy to enforce. As noted, in Germany the selling agency, the Treuhandanstalt, places employment maintenance clauses in the sales contracts with stiff monetary penalties for noncompliance. But these are hard to enforce because the monitoring party—the Treuhand itself—is working its way out of existence as fast as possible, and the threat of repossession lacks credibility.

Labor opposition to privatization is common, understandable, and sometimes intense—but it has been muted where employees understood that the alternative was liquidation. Campaigns to explain the costs and benefits of privatization were critical in Japan, New Zealand, Tunisia, and Venezuela—indeed, in just about every country where divestiture has succeeded. Attractive severance packages have weakened opposition and created a social safety net. In Tunisia, generous severance packages, beyond those provided by law, induced so many voluntary departures (90 percent of all redundancies) that there was little need for outright dismissals. Employee ownership schemes are useful too, although employee ownership at too high a proportion can lead to difficulties in employment and wage restructuring and make it hard to attract buyers. In Chile it has been argued that workers' shares helped raise the price paid for SOEs because the buyers regarded the workers' stake as reducing the risks of renationalization (see Luders 1990). The governments of Argentina, Chile,

Pension Fund Study

Opportunities and Global Trends
In Pension Fund Reform and Privatization

Draft

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I. INTRODUCTION

The United States Agency for International Development (USAID) has a long tradition of helping developing countries provide basic human needs to their populations and promoting sustainable development. This assistance has usually taken the form of supporting educational and health programs, helping to develop infrastructure and providing social programs. More recent attempts to reduce poverty have concentrated on promoting private sector development through economic and legal reforms which liberalize trade and strengthen democratic institutions. Many countries are now actively promoting a free market economy and private sector development.

Pension fund reform encourages broad-based economic growth and promotes the traditional goals of USAID. For the purposes of this paper, pension fund reform encompasses efforts to create or improve the coverage and capitalization of pension funds. The ultimate purpose of pension fund systems is to provide adequate income for the elderly, the sick, and the poor. This goal can be achieved by introducing a sensibly capitalized pension fund program, which in turn develops a strong domestic market for new financial instruments, promotes economic democracy by broadening equity participation to large segments of the population and generally stimulates economic growth and development. A natural complement to pension fund reform are privatization programs, which increase domestic investment opportunities and can be partly financed through the participation of pension fund portfolio managers.

Social security systems across the world are suffering from similar problems. They tend to absorb a large portion of current revenues and depend heavily on state subsidies. Trends for the future only show that without fundamental reform, financing social security will place an ever greater burden on the economies of rich and poor countries alike. Most of these troubles can be linked to the same causes. Pension funds are often under-capitalized, with contributors paying for current beneficiaries, instead of accumulating reserves which can be invested for each pensioner's future needs. They are also usually run by the state and inefficiently managed, often not with a view to maximize returns, but to pursue other political agendas.

Pension and social security reform will usually lead to better services provided at a lower cost. The implications of such reforms are vast however, because of the sheer numbers involved. There are telling statistics on the Chilean system which underwent radical reform in the early 1980s. In 1970, the social security budget absorbed 65% of the State's current revenues. Today a self-financing capital base of $12.2 billion has been accumulated by pension funds, equivalent to more than 25 % of Chile's GNP and over 50% of its external debt. The Chilean success has inspired many other countries to follow this example and USAID has already been involved with reform programs in, for example, Bolivia and Indonesia.

Three main types of reform are possible: financing, administration and program design. A financing reform would address the funded or unfunded nature of the system. This sort of reform would only be directed at defined benefit plans since defined contribution plans are always funded. Administration can be reformed by moving the investment management and/or account maintenance to the private sector. The final type of reform is one of scheme design: defined

benefit or defined contribution. The features and risks involved with these two pension fund variants are discussed in more detail in Section III.A.

In the current environment of decreased resources and competing needs, foreign aid must be prudently allocated. *Research suggests that foreign aid used to finance the reform of pension systems has a greater impact per dollar paid than most other forms of assistance.* Beyond the long-term objectives of reform, there are shorter term implications which magnify the positive impact of reforming pension funds. Encouraging the accumulation of a large capital base which will finance future pension claims helps to strengthen financial markets in developing countries. This in turn provides easier access to credit for an emerging private sector and a source of finance for the purchase of state owned assets when and if the government wishes to privatize them. As pension funds invest in the country's equity base, share ownership is broadened and large segments of the population acquire a vested interest in the general prosperity of the economy. This broad shareholder base tends to pressure governments to manage macroeconomic policies in a sensible and prudent manner. Over time, these factors contribute to higher economic growth and general prosperity.

Section II below provides a description of the general characteristics of pension funds and reviews reform trends in selected countries. In Section III, an analysis of key policy issues which impact pension fund development and administration are highlighted. Section IV presents conclusions and program implications for foreign aid. Annex A at the end of this paper summarizes principal facts and issues on pension fund reform.

II. DESCRIPTION OF EXISTING SYSTEMS

A. General Characteristics

1. Public Pension Funds

In many countries, public pension funds take the form of social security pension programs which provide benefits to retired workers from the formal sector. These programs are typically defined-benefit schemes with pension benefits based on a formula which includes worker's salary and years of service. They are calculated independently of the amount of contributions the worker paid into the system. These plans tend to be under-funded. In other words, pension liabilities generally exceed the plan's assets. An important reason that social security pension programs are often under-funded is because governments often recognize prior work experience at the time social security is adopted. As a result, there is no money in the system at inception, but pensions must be paid almost immediately. Consequently, social security programs tend to be funded on a pay-as-you-go (PAYG) basis.

Under PAYG programs, active workers' payroll taxes fund retired workers' benefits. PAYG allows governments to meet pension obligations with reasonable tax rates as long as there is an adequate ratio of workers to retirees and little evasion of payroll taxes. Because current

contributions are used to pay current pension benefits, a small amount of funds accumulates under state-managed social security pension programs.

In some countries, state-managed social security pension programs tend to invest funds in hospitals, roads, and other infrastructure projects which do not usually earn investment returns comparable to those available in the capital markets. In countries with budget deficits and current social security surpluses, there is a strong temptation to divert workers' pension fund contributions to other government purposes.

However, trends such as changing demographics (aging of the population, increased longevity, lower birth rate, early retirement, migration) or increases in benefit levels, can cause financial difficulties for PAYG systems. For example, the Organization for Economic Cooperation and Development projects the European Union population to peak in the year 2000 to about 330 million, and then decline by 50 million over the next 50 years. This trend implies that fewer workers will be available in the future to support retirees and thus financial problems for the PAYG system will arise. When these financial problems are encountered, the short-term solution may be to raise the retirement age, increase contribution rates (payroll taxes), increase coverage (reduce evasion), or limit benefits. Improving the investment performance of assets may be another alternative if the pension fund system has reserves. If not, more ambitious reform, like the privatization of social security undertaken by Chile, may be warranted.

2. *Private Pension Funds*

Private pension systems operate at the company or individual level. Both systems can coexist, or the country may, as a matter of policy, decide to go for one or the other. Private pension funds may also coexist with public pension funds. In the United States, for example, both private and public funds coexist. That is to say, in addition to drawing on personal savings, a retiree may receive a social security pension and a company pension at retirement.

Private pension systems may be either defined-benefit or defined-contribution plans. Defined-benefit programs promise to pay a specific benefit to covered workers on their retirement. Under defined-contributions plans, a worker accumulates funds in an individual account managed by a professional investment manager. The amount of the pension benefit depends on the amount in the individual account at the time of retirement. Under both types of private pension systems, funds tend to be invested in the capital markets to achieve optimal investment returns. One important difference between these two types of private pension systems is that, while defined-contribution systems are always funded, defined-benefit systems may be under-funded if contributions are not regularly reassessed.

Under company run pension schemes a strong regulatory framework is critical. As the recent Maxwell scandal in the U.K. illustrates, particular care must be taken by regulators to prevent the board of companies from abusing their roles as fund trustees and managers. The temptation to use their power for ends other than maximizing the return for their pensioners is great and needs to be brought under close public scrutiny by very stringent regulations. When the employer

happens to be the state, the potential for conflict of interests is greater still and it becomes all the more important to separate the management of potentially very large assets from the political agenda.

B. Trends in Selected Countries

A trend towards instituting and operating privately managed pension plans characterized by funded defined-contribution schemes is taking place in countries around the world. From the U.S. and Chile to China and Australia, nations are being forced, by the twin pressures of relieving hard-pressed social security pension systems and stimulating local economies, to adopt privately managed and/or funded pension programs.

1. United States of America

In the U.S., public and private pension systems coexist. The public system is in the form of a mandatory social security pension program characterized by a defined-benefit scheme. It is financed by a 7.65 percent tax levied on wages, with a matching amount paid by employers. An employee must contribute a minimum of 10 years before being covered. Benefits are calculated according to salary and years of work and do not depend on the amount contributed. Current contributions pay for current retirees' benefits. Any excess social security tax receipts are deposited in the U.S. Treasury along with other taxes and are accounted for by crediting federal bonds. The ratio of workers to retirees is however worsening and as mentioned previously, the current PAYG system is forecast to become insolvent by the year 2036.

Private pension programs are voluntary and involve defined-benefit or defined-contribution schemes. But the past 20 years show a drop in the number of pension participants in defined-benefit plans from 87 percent to 68 percent and a growth in defined-contribution plans from 13 to 32 percent. Both types have been in existence for many years, financed by employers and supplementing the pension received from the U.S. Social Security pension program.

In order to protect the interests of the participants and beneficiaries of private pension plans, the Employee Retirement Income Security Act (ERISA) was enacted in 1974. ERISA does not require that employers provide pensions, but those who do must meet minimum standards and provide prudent management of pension funds. A special body, the Pension Benefit Guarantee Corporation (PBGC) acts as an insurer for defined-benefit plans in case of bankruptcy. Private pension assets account for US$2.9 trillion in 1992 (from US$295 billion in 1975), US$51 billion of which are considered under-funded and in risk of needing to be subsidized by PBGC or the Government.

The trend towards defined-contribution plans has been attributed to a number of reasons including: (i) the shift in the U.S. economy from unionized manufacturing firms, that typically provide defined-benefit plans, to private sector service firms, that typically provide defined-contribution plans; (ii) the risk of underfunding associated with defined-benefit schemes which, in turn, increased the stringent legal and actuarial requirements and made these plans more

expensive to administer; and (iii) the establishment of numerous tax incentives for defined-contribution plans such as the deferral of current income taxation on salary foregone for contribution to a defined-contribution plan.

A number of defined-contribution plans are available in the U.S. Each type of plan shares one trait : a deferral of current income taxation on salary contributed to a pension plan. But rules governing eligibility, contribution, and withdrawals vary significantly.

One of the most popular defined-contribution plans is the 401 (k) plan. In 1990, 20.8 million workers were covered by 401(k) plans. This number represented 23 percent of all private sector workers. A 401 (k) plan permits employees to elect a contribution of a part of wages on a tax deferred basis to a plan that may offer several investment options. Employers usually make contributions, which also are treated as tax-deferred income for employees. The typical plan includes employer matching of employee pension fund contributions. In one such plan, the employer puts in 50 cents for each dollar of employee contributions up to 6% of salary. Annual individual contributions are limited to US$9,240 in 1994.

2. *Chile*

In 1981, Chile introduced a private pension program based on a defined-contribution scheme that replaced the previous pay-as-you-go state-managed social security system.

Under the new system, 10% of the worker's paycheck is deducted and forwarded by his or her employer to a pension manager chosen by the employee. Participation in Chile's system is compulsory, but employees can freely switch from one fund to another. Upon retirement, the employee buys an annuity from an insurance company with the proceeds from his/her account or opts for a programmed retirement pension paid out of his accumulated fund according to a government defined formula based on his life expectancy, the current rate of return and size of the fund.

The system in Chile is tightly regulated. For example, funds are required to have less than 30 percent of their assets in the stock market. In addition, both debt and equity investments must be approved by the Superintendent of Pension Fund Management Companies, and a fund cannot have more than seven percent of its assets invested in the securities of any one company.

The accumulated pension savings of US$20.0 billion in 1994 has already satisfied much of Chile's demand for capital. The Chilean private pension system significantly altered the shape of the domestic capital market. Until the late 1980s, Chilean companies, like most in Latin America, could borrow money only for very short periods at very high interest rates. As late as 1989, with Chilean sovereign debt trading at 60% on the dollar, foreign banks were not lending new money in the country. Since then, pension funds have absorbed $5 billion of long-term corporate bonds with maturities as long as 27 years, creating the first long-term debt markets in Latin America.

Chilean pension funds have been active investors in the local capital markets. Currently, the corporate pension funds own over 10% of the total market capitalization of the Santiago Stock Exchange. They are important players in the privatization process and have helped to reduce the country's dependence on foreign capital.

3. Mexico

Under a decree that was enacted in 1992, privately managed pension schemes were created to operate alongside the existing state-sponsored system. These pension funds were designed to supplement the social security system. In addition to paying social security taxes to the state system, as of May 1992, employers were required to contribute a percentage of employees' wages to a new form of individual retirement savings accounts. These new accounts are invested with the central bank, offering a guaranteed yield of two percent above inflation.

Unlike the Chilean system, the Mexican scheme allows the worker to maintain his/her investment in government securities. Today, workers have the option of transferring their accounts to investment management operations run by banks and other entities, including stock brokers. However, it is expected that many people will be lured by the potential of higher yields in other investment vehicles.

4. Peru

Peru passed legislation to create private pension funds in 1993. This new system, which follows the Chilean model of pension fund reform, will be supervised by a government body known as the Superintendencia de Fondos de Pensiones.

In the new scheme, individual employees can contribute, on a voluntary basis, up to 10 % of their salaries to a pension scheme. So far, 759,000 individuals have chosen to join. In addition, employees will be able to join any private pension fund and switch funds at will. Individuals participating in the government-run social security system will also be able to switch to the new private system. By doing so, these individuals will receive a bond equivalent to their previous contributions to the state system that they may choose to invest in any private pension fund. The Peruvian government has provided for a two-year transition between private and state systems. It seems at the present time that the transfer is not as smooth as was the case of Chile. Difficulties encountered are more than normal growing pains and linked to some fundamental choices made in the formulation of policy and regulatory framework. These unexpected problems are expected to provide interesting research material into understanding how pension fund reforms can best be tackled and the kind of tradeoffs which must be made.

5. Bolivia

Bolivia has prepared a draft law and regulations to reform its social security pension system. The legislation is expected to be presented to Congress in 1994. The impetus of the pension fund reform has two parts: to address the financing of the social security pension system and to

improve pensions for Bolivians participating in social security. Under the reform, private pension fund administrators will handle investment and pension fund management. The system has prudent disclosure requirements and investment limits, and establishes fiduciary responsibilities. The new pension fund system will be supervised rigorously by a pension superintendency to be established by the Government of Bolivia (GOB). USAID has provided significant support in the privatization and reform process

The Government of Bolivia plans to link privatization of several of the largest state-owned entities to the pension fund reform. The GOB proposes to distribute half the shares of these firms to all adult Bolivians via pension funds. This move has interesting implications for capital market development and corporate governance although the logistics of the plan are not yet fully resolved.

6. *Eastern Europe and NIS*

Many of these countries are eager to institute private pension fund programs. They are trying to cut expensive social insurance costs and create an internal pool of capital.

Most recently introduced mass privatization programs already include the creation of investment funds and the basic legal framework necessary to develop emerging capital markets. It is interesting to note the synergies which could be further developed between these countries privatization programs and the introduction of a privately managed pension system. One of the reasons why the Bolivian government chose to link the sale of its largest state-owned entities with the pension funds is that it did not want the public to expect short-term returns from these loss making companies. Pension benefits are for the future and taking a long term perspective on these investments was probably the only way to hope to salvage them as going concerns. This reasoning may apply to many enterprises in the ex-communist block and could help to bring expectations of dividends and capital returns, to more realistic levels. Another reason for the linkage is to distribute the national patrimony to the people. This innovative approach addresses certain criticisms of privatization programs as selling the country's patrimony to foreigners.

Even though Eastern European countries still lack legislative frameworks to create private plans, some individual companies already have established their own plans. In Russia, for example, there are more than 550 pension funds created under a September 1992 Presidential Decree. Most of the necessary legislative framework is still lacking however and most pensioners still only receive the state minimum guarantee of approximately $15 per month. The existing funds offer their contributors no guarantees of transparency or integrity. The reform of the social security system in Russia is very high on the political agenda, because it is clear that the situation is close to a crisis. Pensions have not kept up with inflation and the financial situation of the program may be precarious. In October 1993, the Russian State Fund was taken out of the control of the Parliament and brought under the responsibility of the government. Given the country's political balance of power, this suggests that reform may be tackled seriously in the near future.

7. Africa

Many African countries are initiating reforms in their social security programs to develop nationwide, defined contribution systems. The International Labor Organization and the United Nations are both at the forefront of many of the proposals, but the initiative for reform is coming from the governments themselves. The most common reforms involve shared contributions from the employer and employees alike, of between 4 and 10% of the employee's salary.

Kenya's National Social Security Fund, for example, is exploring options for converting its Provident Fund into a formal national social security system. Employees and employers would both be required to pay-in 5% of the employee's annual salary, with benefits payable at retirement either in a lump sum plus 8% annual interest, or in annuity payments.

Gambia is attempting to establish a similar system, transferring the management of its National Provident Fund to the Social Security and Housing Finance Corporation (SSHFC). This system will likely operate the same way, but with a 10% mandated employer contribution. Both countries also have separate pension systems for public sector employees.

The vast majority of retirement plans in Zimbabwe are defined contribution rather than defined benefit. The government is currently reviewing the National Social Security Scheme (NSSS), which is designed to cover all workers in commerce and industry, though the many private pension plans already in existence will continue. New benefits to be added are old-age, survivors, and disability coverage. The NSSS will likely be funded by a 4% contribution rate by both employees and employers. The system will be required to invest 55% of its portfolio in government securities.

8. Indonesia

Indonesia has a social security system in the form of a provident fund that makes a lump sum payment at retirement. In addition, private companies, state-owned enterprises, and Government entities have pension funds. In April 1992, a new law established a framework allowing a wide degree of pension arrangements and a choice in plan design. The law introduced various requirements for disclosure, trustees, investment policy, plan valuations, funding requirements, and other elements. Prior to that time, no comprehensive set of regulations regarding pension fund operations existed in Indonesia. Over the past two years, the regulations which accompany the law have gradually been issued. As a result, while some pension assets have shifted to professional investment management in the private sector in response to the law, the full impact of the reform has yet to be felt. USAID has provided assistance in the privatization/reform process.

9. Far East

In the Far East, many countries are encouraging the development of private and funded pension schemes. While Thailand is providing tax incentives for only the contributions made to privately

managed defined-contribution schemes, Singapore has just introduced enabling legislation for the creation of private plans. These pension funds would supplement the state-run Central Provident Fund, which collects 20% of the pay of each employee, with a matching contribution from each employer. Hong Kong tried to introduce a modest PAYG, defined-benefit scheme which has recently been rejected by public opinion.

China is about to embark on a reform of its state-owned enterprise pension funds, many of which have serious financial difficulties. One alternative under consideration is to launch a mandatory defined contribution scheme for SOE workers. Funding conversion of the system is one important issue which would have to be addressed under such a reform.

III. POLICY ISSUES TO CONSIDER

A. Defined Contributions and Defined Benefits

1. Summary Features

One of the main distinctions in pension funds is between defined contribution and defined benefit systems. There are tradeoffs under both, but defined contribution pension funds seem to be more successful at attracting large amounts of capital and achieving the ultimate objective of payment of benefits. But funded defined benefit programs can achieve the same policy objectives and in certain cultural and political contexts may be a more appropriate choice. The principal advantage of a defined benefit program is that the participants know what they will receive upon retirement. The main risk is that the fund will turn out eventually to be under capitalized. This is true whether it is publicly or privately managed because benefits are not tied to contributions. The only way a defined benefit scheme can operate is if the level of contributions is re-assessed each year or more frequently if necessary. The pension provider (state, employer, private fund manager), must be able to impose increases in the level of contributions in order to keep up with the defined benefits. If he cannot, the fund runs the risk of being unable to fulfill its obligations. This means that either the beneficiaries will not receive their entitlements or that the state will have to bail the fund out with public subsidies. A second risk for pensioners exists if benefits are not indexed, and inflation erodes the fund's purchasing power.

Defined contribution systems, on the other hand, are more likely to accumulate large amounts of capital. By their nature, they give different incentives to workers. The participant's pension is closely linked to that person's effort to save for retirement. By contrast, the defined benefit pension is primarily a function of salary. Also, in a relatively stable macroeconomic environment, a defined contribution system has a more stable equilibrium than a defined benefit system. The funded nature of the system is the principal reason for this feature. Finally, the defined contribution system shifts more of the risks from the government or employer to the individual.

2. Analysis of Some Specific Risks

a) Investment Risk

Any funded pension system -- whether defined benefit or defined contribution -- runs the risk of under-capitalization through inadequate investment returns. Poor pension fund investment returns may be due to defaults, changing interest rates, inappropriate portfolio diversification, bad judgement, or poor investment conditions in the country as a whole.

Most individuals approaching retirement will probably want to receive a pension equivalent to 65 to 75% of their latest salary level. Pension benefits under defined-contribution plans are highly sensitive to the rate of return achieved over the working life of the contributor. If returns fall below a certain rate, workers will receive lower pensions than expected.

b) Employment (Density of Contribution) Risk

A related risk common to many countries undergoing adjustment is the employment risk associated with making the difficult transition to a market economy. Individuals whose wages are too low or suffer long periods of unemployment may not be able to accumulate sufficient funds or years of experience to receive an adequate pension. For this reason, pension funds in countries which experience significant employment shocks or chronic underemployment are vulnerable to under-capitalization. It is critical, therefore, that adjustment programs such as privatization address this issue through some form of social safety net.

c) Default Risk

Both defined benefit and defined contribution systems rely on regular collection of pension fund contributions and on reliable payment of benefits. The former implies strong collaboration from employers and a high degree of trust in the system, to prevent systematic evasion. The latter is a somewhat more tenuous assumption, since it implies faith in the process over a period of more than 40 years. The PAYG system may be a more sensible policy for those who do not believe that the next half century will enjoy peaceful periods of economic prosperity and growth for the world. It is conceivable that different parts of the world may have different perceptions and opinions about this point.

d) Conversion Efficiency

The efficiency with which accumulated savings are converted into an annuity or a programmed pension at retirement affects the total funds available upon retirement for both benefit and contribution plans. For example, insurance companies charge a fee for establishing an annuity. Such fees will reduce the size of the funds on which the pension can be based. The main differences between the two systems pertain to the choice of the provider and the negotiating power.

Under defined benefit, employees often must use a provider chosen by the employer. By contrast, under defined contribution they are free to shop among various providers. Whether or

not the pricing is transparent or people actually understand what they are buying is another matter. Pensioners may receive better prices for annuities under defined benefit plans because the provider is guaranteed a certain number of clients. Under defined contribution systems, the individual has a weak bargaining position vis-a-vis the annuity provider. His or her basic option is to transfer to a competing program offering a "better deal", if available.

e) Risk of Personal Misfortune

The level of contributions may vary in a person's life time, due to personal misfortunes, such as a low paying job, unemployment, sickness or injury. Under a defined contribution system, the level of benefits will be reduced with the contributions, unless the state has a mechanism to subsidize payments in certain defined cases of hardship. Ironically, another danger for the beneficiary is that he or his dependents may live longer than expected and have to make do for a longer time with a fixed amount of resources. Under a defined benefit system, periods of forced unemployment or job changing may cause some workers to lose potential pensions because they are not yet vested in the pension plan. Under the defined contribution plans, pension funds are portable, so the worker does not lose past contributions.

f) Fiduciary Risk

The pension fund managers may be dishonest, incompetent or simply unlucky. Strict regulations can at least ensure that portfolios are sufficiently diversified, assets prudently invested and fund managers' behavior permanently scrutinized for impropriety. Transparency in the operations of a privately managed pension fund scheme is vital to its credibility and long-term success. The role of the state in establishing clear and sensible rules and monitoring compliance is extremely important in mitigating these risks.

g) Bad Government Risk

Even under a privately managed pension fund system, beneficiaries may still be vulnerable to the risk of being badly governed. Capital market regulations must be sensibly drafted. Portfolio diversification and risk reduction rules can easily be abused by governments and used as excuses for achieving other ends. For instance, a country may require that a large proportion of assets be invested in government bonds, because they are supposed to be the lowest risk assets available. This requirement helps to finance government deficits, but ignores the implicit inflation tax which has historically shown government bonds to be far from risk free.

Regulations may also prohibit fund managers from investing any significant amount outside of their own country. Even the European Union countries were not able to do away with this provision in 1992 when the Single Act supposedly abolished all restrictions on the free movement of capital. Pension fund performance will therefore be very closely correlated with the general economic performance of the country and the way it is governed.

h) Risk for the Government

Under a privately run pension scheme, the state can also run certain risks, depending on what kind of guarantees and commitments it has made. In some schemes, the government is responsible for financing the cost of the change in the system and its maintenance in the future. Such financing includes: (i) the cost of providing the "recognition bonds" given to workers who transferred from the old to the new system, such as the case in Chile and Peru; (ii) the cost of liabilities arising from state guarantees covering the collapse of pension funds. In some cases, the state must continue to finance deficits incurred by the old scheme as long as it continues to operate.

B. Framework and Environment - Economic and Legal Prerequisites

Before a private pension fund system can be put into a place a comprehensive assessment of the existing pension system, if any, must be performed. Some countries have an existing state-financed scheme in place which may need reforming or replacing. Others may be starting from scratch, as in Hong Kong. In fact, many of the least developed countries have little more than a limited retirement program for civil service employees. Often, pension fund systems exist in name only and have not functioned for some time. Zaire, for example, has a general scheme covering workers in the private and semi-public sectors, and a special scheme covering government officials and other civil service employees. Together, these schemes cover less than 10% of Zaire's population, and in practice, neither function reliably.

Special issues concerning the transition from an old system to a new one must be addressed. Usually the state will have to finance old entitlements, either until they expire (which could be several decades after the reforms), or by paying "recognition bonds" as the Chilean government chose to do. This cost may be partly paid for by the proceeds of a privatization program, particularly if newly capitalized private pension funds are able to participate.

Policy issues to consider include whether the pension system should be voluntary or mandatory, and whether the transfer from the old system to the new should be progressive or immediate. Investment limits and supervision of pension funds are also important policy considerations. Investment restrictions imposed on newly privatized pension funds can progressively be modified to reflect the growing size of the capital market. In Chile for example, there were initially very few equity investment opportunities and fund managers were required to invest most of their portfolio in government bonds. Gradually, long term corporate bonds and commercial paper became more common and the privatization program provided more and more equity investment opportunities. After more than a decade, there is already some concern that the accumulated capital of the private pension funds may exceed the country's capital requirements and the government has started easing its restrictions on foreign investments.

The other major prerequisite for successful pension plan reform and privatization is that the appropriate legal framework be put into place. As discussed above, it is vital that private pension fund managers be strictly regulated and monitored. Financial sector laws and regulations governing the banking, capital markets, and insurance sectors are also necessary to support the pension fund system. Sound capital market laws must include, among others: clearly defined

fiduciary responsibilities; rules prohibiting insider trading, self dealing and conflicts of interest; a regulatory body such as the SEC; disclosure requirements for funds and publicly quoted companies; proper accounting standards; depository and transfer mechanisms to encourage liquidity and secondary markets, etc.

Modern banking and insurance laws must also be adopted. Custodial laws must clearly distinguish between the property of pension fund beneficiaries, pension fund managers and bank assets. When annuities are to be purchased upon retirement from insurance companies, proper actuarial rules, capitalization requirements and risk management must be put into place to ensure the integrity of the system.

Above all transparency in the operations of all the players will be critical to the success of reforms.

C. Other General Considerations

1. Absorption of funds by the capital markets

The magnitude of funds accumulated by the pension plans might have beneficial macroeconomic effects and produce higher rates for economic growth. But they may go further than this if the supply of funds is greater than the amount that can be readily absorbed by the local capital markets and existing investment opportunities. Experience however has shown that by increasing the demand for financial instruments, capital markets very quickly respond by supplying new investment vehicles. This has certainly been the case in Chile, which has seen a remarkable increase in investment opportunities. If local capital market absorption presents constraints, the Government may consider allowing a certain percentage of assets to be invested abroad in the first years of the system. This investment limit could be decreased over time. It is worth mentioning that investment limits are best placed as maximums, not minimums. A ceiling on investments abroad rather than minimum investment requirements domestically will reduce the possibility of pension funds financing government deficits.

2. Governance

Many of the new pension schemes will rely heavily on the efficient operations of private pension funds. This reliance will require: (i) the funds' compliance with regulations covering their operations; and (ii) competition among the funds to minimize costs and promote productivity. The first responsibility will reside with a regulatory body. Prompt and full compliance by two other groups is equally important: workers and employers, who are responsible for forwarding contributions; and the funds and insurance companies, who are responsible for processing claims. Another essential element concerns the government's obligation to ensure good economic management. Low or negative real interest rates, a weak labor market or a decline in the relative size of the formal sector would all rapidly make new private pension schemes unattractive.

3. Informal Sector

In many developing countries, a high percentage of the population consists of low-income "casual" workers, rural workers, the unemployed and the destitute. These groups remain outside of most social security and pension fund systems. They rely to a large extent on public assistance for income in retirement (and on support from the family in certain cultures). Governments which decide to subsidize the replacement of the old with the new private pension schemes will have fewer immediate resources available to increase benefits for those who cannot afford to contribute to the new funds. In the longer term, however, higher rate of returns achieved by the new pension funds may alleviate the need for government subsidies, freeing up government resources.

A combined privatization program may be one answer to help alleviate this cost for the government. Social safety net programs which are designed to compensate short-term losses against long-term gains made through efficiency gains have been common components of successful adjustment programs. Privatization revenues have been used to fund such programs in order to promote macroeconomic stability and to facilitate labor retrenchment during transition. The setting up of a solidarity fund financed through the contributions of the working population is another such example. The informal sector may require some tax and labor law reform to give incentives for businesses to join the formal sector. Other alternatives may be envisaged, such as job retraining or public works programs.

IV. Conclusion and Program Implications for Foreign Aid

The primary focus of national pension systems, and any pension system reform, should be the provision of pensions to retirees to enable them to enjoy a reasonable level of income, and subsequently health, well being and dignity in their post-work years. Savings, whether they are voluntary or obligatory, are best invested and administered by the private sector. Private management promotes efficiency in administration and investment management, maximizing returns and minimizing costs. The redistributive elements, such as providing pensions or other social welfare benefits to the destitute, disabled, or informal sector workers are matters of public policy and should be handled by the state. Such programs will depend on the priorities and resources of each country.

Many developing countries that attempt to privatize and/or reform their national pension systems will require assistance from the international donor community to finance both technical assistance and transition costs. A principal long-term objective of pension fund reform which is to alleviate poverty and provide for those who cannot provide for themselves corresponds to the main purpose of USAID. Shorter term impacts also promote USAID goals of encouraging economic growth, liberalizing markets and sustainable development.

USAID assistance to privatize and/or reform pension systems has the potential for achieving a greater impact per dollar of assistance than many other types of assistance. Once the structural adjustments have been made, the accumulated capital in the pension funds will contribute to finance the continued development of the country, thereby creating a virtuous circle. The billions of dollars accumulated in pension funds will eventually dwarf the assistance that can be provided

by USAID and the international donor community, providing a truly sustainable source of development capital.

Areas of USAID intervention might include:

- Enabling environment reforms such as developing laws and regulations for new pension fund systems; creating regulatory entity; and selecting and training staff for such an entity.

- Institutional restructuring which might include outsourcing elements of existing operations such as administration; implementing management information systems; streamlining operations and procedures; and training in operations, portfolio management, investment analyses, etc.

- Technical studies such as diagnostic and change integration analyses.

- Case studies of a long-standing, defined-contribution program (such as Chile's) and analyses of various schemes, identifying the advantages and disadvantages of each one, to determine which type is appropriate for a given macroeconomic environment.

ANNEX A

QUESTIONS & ANSWERS

What are Pension Funds ?

- Pension funds are systems which may provide payments to retirees, survivors, and the disabled.
- Pension systems can be characterized by how benefits are determined:
  - Defined Benefit plans are based on salary and years of service.
  - Defined Contribution plans depends on the amount accumulated in each contributor's retirement account.
- Pension systems can be characterized by type of funding:
  - Funded: At any point in time, the system has enough money to meet obligations. Examples : defined contribution systems and some defined benefit systems.
  - Unfunded: The system does not have enough resources to meet obligations. Examples : Pay As You Go (PAYG) Social Security Systems such as in most developed countries.

Why Might Pension Fund Reform be Necessary ?

- The pension fund system does not provide adequate benefits to participants.
- The pension fund system is causing large Government deficits.
- The pension fund system is operating inefficiently.
- The pension fund system allows for abuse which harms participants.

What are the Types of Pension Fund Reforms ?

- Financing
  - Short-term remedies include raising retirement age, increasing contribution rates, reducing benefits, improving investment performance (only an option if reserves exist).
  - Long-term remedies include requiring funding of the system, reducing evasion, improving supervision and regulation of system, improving legal and regulatory framework for capital markets and banking.
- Operations
  - Automate administration.
  - Contract with private provider for record-keeping, investment management, other services, e.g. New Zealand.
- Change the System
  - Change from defined benefit to defined contribution, e.g. Chile.
  - Shift responsibility from Government to private sector.
  - Create a supplementary system, e.g., Mexico
  - Change from Pay-As-You-Go to Funded system.

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Many of these reforms may be undertaken separately or in concert.

What are Some of the Benefits of Pension Fund Reform ?

- Improvement of social welfare: An appropriately funded and administered pension fund system may help assure that people can receive adequate pensions.
- Generate internal savings: Pension fund reform, particularly if funded systems are established, promotes domestic capital accumulation. As these internal savings are invested in the country, they support economic growth and development. Under the best circumstances, a virtuous cycle of savings and investment is created. External financing requirements decrease and sustainable development is achieved.
- Democratization of capital markets: Pension funds/social security systems pool together the assets of people form many socioeconomic sectors. As pension funds invest in capital markets, ownership of securities broadens to include all pension fund participants. On their own, many of these pension fund participants would not accumulate sufficient funds to invest in the capital markets.
- Privatization : As institutional investors in the capital markets, pension funds may help support privatization programs, e.g., Chile.
- Improved efficiency and effectiveness: May separate investment and management decisions from the political agenda.

What Type of Reform is Appropriate ?

- Type of reform needed depends on economic, social, and political context.
- Diagnostic assessment can help identify the appropriate type of reform.

What are the Potential Projects ?

- Technical studies
  - Diagnostic study to determine what to do.
  - Studies to support proposed changes to the system (if proposals already exist)
- Institutional restructuring : making the existing system work better.
  - Outsourcing parts of existing operations, such as administration.
  - Installing management information systems.
  - Streamlining processes and procedures.
  - Training.
- Systemic reform : change the system.
  - Draft laws and regulations for new pension funds systems
  - Create regulatory entity.
  - Select and train staff for regulatory entity.

COUNTRY	TYPE OF PENSION SYSTEM	SOURCE OF FUNDS	PENSION BENEFITS AT RETIREMENT	ADMINISTRATIVE ORGANIZATION	COMMENTS
Bolivia	State-Managed Social Security System based on a defined benefit scheme	**Insured Person**: 5% of earnings **Employer**: 2.5% of payroll	30% of average earnings in last 6 months of contribution (24 months for workers with earnings over a specified amount), plus increment of 2% of earnings for each 12 months of contribution beyond 180 months. Minimum and maximum pensions are set at a given rate.	Ministry of social Security and Public Health, general supervision. bolivian Social Security Institute, responsible for coordination, planning, control, and evaluation of program. National Social Security Fund, administration of program.	The government is currently addressing the financing of the social security system. It is considering the creation of private pension schemes to operate along-side the existing state-managed system.
	Complementary Funds	2.5% - 17% combined contribution (average 6%)	Defined benefits based on final salary and years of service	Funds organized by economic sector each with own administration. Regulated by Ministry of Social Security.	Inefficient. Inequitable benefits result. Serious financial problems in some funds.
Chile	State-Managed Social Security System based on a defined benefit scheme	**Insured Person**: 20.15% of earnings. **Employer**: None	1/35 of final base salary times years of contribution	Ministry of Labor and Social Welfare, general supervision. Superintendent of Social security, administration of program.	In 1981, the government instituted the mandatory private pension system in order to phase out the state-managed social security system.
	Mandatory Private Pension System based on a defined contribution scheme	**Insured Person**: 10% of earnings. **Employer**: none	Insured's contributions plus accrued interest. Minimum pension guaranteed by government. At retirement, insured may buy annuity from private insurance company.	Superintendent of pension Fund Management Companies, general supervision; individual pension fund management companies, administration of program.	Launched in 1981.
Indonesia	Provident fund social security system (lump-sum benefits only)	**Insured Person**: 1% of earnings **Employer**: 1.5% of payroll	Lump sum equal to total employee and employer contributions paid in, plus accrued interest.	Minister of Manpower, general supervision. Public Corporation for Employees Social Insurance, administration and operation of program.	As a result of a new law issued in 1992, a wide choice of pension arrangements is allowed. So far, some pension assets have shifted to privately managed pension schemes. However, the full impact of the Law is yet to be felt.
	SOE/Occupational Pension Funds	**Insured person**: varies (5% avg) **Employer**: varies (5% avg)	Monthly pension based on final pay and years of service	Usually the SOE or firm itself	Same as above. Trend toward private investment management.

COUNTRY	TYPE OF PENSION SYSTEM	SOURCE OF FUNDS	PENSION BENEFITS AT RETIREMENT	ADMINISTRATIVE ORGANIZATION	COMMENTS
Italy	State-Managed Social Security System based on a defined benefit scheme.	**Insured Person**: 7.29% of earnings **Employer**: 18.93% of payroll.	Based on average annual earnings in last 5 years (with earnings in first 3 years revalued for changes in the cost of living).	Ministry of Labor and Social Welfare, and Treasury, general supervision. National Social Insurance Institute, administration of program through its branch offices; managed by tripartite governing body. Separate institutes or funds administer special systems.	The government is considering adopting a defined-contribution scheme to replace the existing systems arrangements. Recently, government has clamped down on evasion.
Mexico	State-Managed Social Security System based on a defined benefit scheme	**Insured Person**: 1.75% of average earnings (rate will rise gradually each year to 2% by 1996). **Employer**: 4.9% of payroll (rate will rise gradually each year to 5.6% by 1996).	35% of average earnings during the last 250 weeks of contribution, plus 1.25% of earnings/year of contribution beyond 500 weeks.	Ministry of labor and Social Welfare, general supervision. Mexican Social Insurance Institute, administration of program through regional and local boards in areas to which coverage extended; managed by General Assembly, Technical Council, Oversight Commission, and director-General.	The privately managed pension system was created in 1992 to operate along-side the state-managed system. Broader reform of state system under consideration.
	Privately-managed pension system based on a defined contribution scheme	**Insured Person**: none **Employer**: 2% of payroll (mandatory)	Contributions plus accrued interest	Private. Individuals may choose between government and private investment funds.	
New Zealand	National Superannuation Fund/Guaranteed Retirement Income (GRI) covers general population	Financed out of general revenues.	Income-tested, state-provided universal benefit.	New Zealand Income Support Service (NZISS), administration of pensions through district offices.	Eligibility age being phased up from 62 to 65.
	National Provident Fund (NPF) and Government Superannuation Fund (GSF) covers public sector employees		GSF is largely unfunded except for member contributions.	NPF administration and funds management are contracted out. Privatization of GSF has been discussed.	NPF is now closed to new members.

COUNTRY	TYPE OF PENSION SYSTEM	SOURCE OF FUNDS	PENSION BENEFITS AT RETIREMENT	ADMINISTRATIVE ORGANIZATION	COMMENTS
Peru	State-Managed Social Security System based on a defined-benefit scheme.	**Insured Person**: 3% of earnings; (self employed 9% of earnings). **Employer**: 6% of payroll.	50% of highest average earnings in last 12, 36, or 60 months (whichever is more favorable); plus 2%/year beyond 15 years (men) or 1.5% (women) for each additional year of contributions up to 5 years.	Comptroller General of the Republic, general supervision. Peruvian Social Security Institute, administration of program through 9-member governing board and executive chairman.	The privately managed pension system was created to operate along-side the state-managed system.
	Privately-managed pension system based on a defined-contribution scheme.	**Insured Person**: Up to 10% of earnings (voluntary) **Employer**: 1% of earnings.	Contributions plus accrued interest.	Superintendent of Pension Fund Management, general supervision; individual pension fund management companies, administration of program.	Set-up problems still being addressed.
Russia	State-Managed Social Security System based on a defined benefit scheme.	**Insured Person**: 1% of earnings **Employer**: 28% of salary	Defined benefit based on salary, years of experience, nature of work performed.	Pension Fund of the Russian Federation for collection. Federation Ministry of Social Protection administers benefits.	Government continues to subsidize, but privatization is making coverage uncertain for many employees.
	Federal social safety net	Government revenues. Employers pay in 2% of payroll for unemployment.	All Russian citizens are entitled to a base entitlement. Citizens who worked receive additional benefits based on factors such as nature of work, years worked.	Federal Employment Service	Safety net continues to be achieved through enterprises
	Private pension systems	**Insured person**: voluntary	Depends on value of the fund.	Management Ministry of Social Security through the Inspectorate of private pension funds, general supervision and administration	No investment restrictions. Number of funds grew from zero to 800 in 3 years.
U.S.A.	State-Managed Social Security System based on a defined-benefit scheme.	**Insured Person**: 7.65% of earnings. Self employed, 15.3%. **Employer**: 7.65% of payroll	Based on average earnings over period after 1950 (or age 21, if later) up to age 62 or death, excluding 5 years with the lowest earnings.	Health and Human Services, general supervision. Social Security Administration, administration of program. Collection of Social Security taxes through Internal Revenue Service, payment of benefits, and management of funds.	State-managed social security system is projecting financial difficulties because of its unfunded status.
	Private pension systems based on defined-benefit or defined-contribution schemes.	**Insured Person**: vary by type. **Employer**: vary by type.	Vary by type.	ERISA (Employment Retirement Security Act) requires employers to provide prudent management of pension funds. The Pension Benefit Guarantee Corporation (PBGC) guarantees pension payments if the plan sponsor goes bankrupt.	Share of employees covered by defined-benefits plans dropped from 87% to 68% (1975-87), defined contribution plans jumped from 13% to 32%.

PRIVATIZATION ISSUES AND EXPERIENCE[1]

INTRODUCTION

During the 1990s privatization has been recognized as one of the critical components of economic growth and reform strategies worldwide. It has become a widely-held belief that privatization, when effectively designed and implemented, is essential to relieving governments of poorly managed enterprises. Privatization is not a panacea for much of what ails the state sector. But recent experience implementing privatization programs suggest that privatization does lead to increases in investment and improved performance in former state enterprises, allowing government bureaucracies to focus political and management resources on pressing public sector issues.

Privatization lies at the crossroads of economic growth, government reform, financial sector development, and social sector development. Thus, the privatization process must be viewed broadly.

The 1990s has also been a period of tremendous innovation and learning for governments undertaking privatization programs. Wholesale, or mass, privatization programs, were introduced in Central and Eastern Europe and the former Soviet Union and variants are now being designed and considered in Latin America and Africa. Governments and technical assistance agencies have deepened their understanding about the linkages between policy and legal development and the roles of emerging financial markets, and successful privatization implementation. In addition, governments have gained experience in organizing public sector programs to mitigate the social costs of economic reform programs.

The tendency, when discussing privatization, is to focus on the "deal" or the transaction, whereby operating, investment, and/or ownership responsibilities are transferred to a private party. But, as suggested above, "getting the deal done" is only part of the privatization process. Important

[1]This paper has been prepared by Price Waterhouse LLP for the *Economic Growth Training Workshop*, sponsored by the United States Agency for International Development, September 18-21, 1995.

issues, such as the creation of an appropriate legal and regulatory framework and addressing issues of labor displacement and dislocation, among others, need to be considered if the newly privatized entities are to operate efficiently and if the public interest is to be served.

The purpose of this paper is to provide policy and decision-makers with a framework for discussing privatization program design and implementation issues. To help support the issues highlighted in the paper, we have included illustrations of privatization initiatives in a variety of country environments. The illustrations presented are intended to emphasize one aspect of an entire privatization program; they are not meant to imply that the success or failure of a program hinged entirely on the point described.

This paper is divided into three parts:

- **Part 1:** *Privatization Policy and Development* describes common privatization techniques, discusses their applicability to a wide range of sectors and country environments, and outlines the policy framework necessary to encourage and implement privatization.

- **Part 2:** *The Privatization Transaction* describes basic elements of an effective transaction-- from educating the public, to creating transparency in the transaction process.

- **Part 3:** *Implementation Issues* describes the roles donors can and have played in improving the effectiveness of privatization program implementation.

PART 1: PRIVATIZATION POLICY AND DEVELOPMENT

1.1 Privatization Choices

In general, it is said that privatization will work best in countries that have a well developed institutional and regulatory capacity, offer a stable climate for investment and encourage free entry and trade. Moreover, in general, privatizing enterprises that produce tradeables -- in competitive or potentially competitive sectors such as industry, agriculture and retail -- is generally considered easier, because regulation is not required.[2]

But in the 1990s, new privatization techniques and bold political leadership, created opportunities for privatization in countries and markets where such activities would have been unthinkable in the past. Over 20,000 medium and large enterprises have been privatized in

[2]Sunita Kikeri, John Nellis, Mary Shirley, *Privatization: Lessons Learned from Market Economies*, **The World Bank Research Observer**, vol. 9, no. 2 (July 1994), pp. 241-272.

Russia, Ukraine, Moldova, Kyrgyzstan, the Czech Republic, Slovakia, and the Baltics through mass privatization, a technique which facilitated wholesale ownership transfer. This was done, in most countries, without many of the institutional, regulatory and macroeconomic reforms introduced prior to privatization in Chile or Mexico, for example.

New Privatization Techniques

Privatization in the 1990s has moved well beyond traditional ownership transformation techniques. The emerging market economies in Central and Eastern Europe and the Newly Independent States of the former Soviet Union, (CEE/NIS) have led the way in terms of innovations. As noted above, mass privatization programs have been, in terms of sheer numbers of enterprises transferred to the private sector in a record time, one of the most successful of these innovations.

Mass privatization programs are best described as non-cash share distribution programs. By allowing management and employees and the general public an opportunity to easily (and cheaply) acquire ownership of former state companies, the programs have encouraged support of the privatization process. They have helped create a new class of investors and owners in countries where the idea of private property and ownership had not existed for decades. Mass privatization programs have usually been accompanied by cash auctions. In many cases, the objective of the cash auction is to bring in strategic investors, with expertise in the market and the capital required to help restructure the newly privatized entities.

Mass privatization has focussed on larger companies. Other techniques have been developed to help the state divest itself quickly of hundreds of thousands of small scale enterprises. In the city of Nizhny Novgorod in Russia, which boasts one of the more innovative programs for privatizing medium and small scale enterprises, companies were auctioned using a variety of techniques, including leases (usually for 15 years), with provisions for subsequent buy-outs, closed tenders and investment competitions.[3] Political support for these and other programs were obtained by providing special breaks to workers' collectives wishing to tender, usually a 30% price discount and 3 month grace period to start payments on the lease.

Yet another technique, used with increasing frequency in a wide range of countries, from Argentina and Mexico, to Ukraine and Guinea, is sectoral privatization. This technique targets SOEs that, because of their strategic importance to the country and/or the characteristics of the industry in which they operate,[4] have traditionally been considered "unprivatizable." The privatization technique combines some element of mass privatization (or some other type of

[3]In investment competition, bidders are requested to suggest investment programs to restructure the business.

[4]For example, in the case of industries where there are "natural monopolies," when one provider can serve the market at a lower cost than two or more providers could. This happens when there are significant economies of scale.

program that makes shares in the to-be privatized entity widely available to the public at a discount) and a strategic investor with the capital and the savvy to improve enterprise efficiency and value.

Expanding opportunities for private participation

The sale or transfer of government-owned assets to the private sector is one of several options for harnessing private sector resources, capital, expertise and technology to meet privatization program objectives. Another option is the concession. Although the particular form of a concession may vary, the basic concept is simple: a private party or "concessionaire" leases assets from a public authority for an extended period. In return for user fees, the concessionaire is responsible for providing service, financing specified new fixed investments, and bearing commercial risk during the term of the concession. At the end of the concession period, the assets revert to the public sector. A concession arrangement is a public-private partnership and is defined by the manner in which the public and private sectors share risks, responsibilities and rewards. Concessions are appropriate where a market has substantial unmet demand and promises high growth, but outright privatization is infeasible for legal, economic or political reasons.

Concessions are one of many methods of involving the private sector in the provision of services viewed traditionally as publicly provided. Other methods include management contracts, leasing arrangements, build-operate-transfer ("BOT") and build-own-operate ("BOO"). These four examples of involving the private sector may be thought of as occupying a continuum between public ownership (with minimal private involvement) and private ownership (with minimal public involvement). In a management contract, for example, the private party assumes no commercial risk and may be compensated according to productivity. The government, on the other hand, owns and finances improvements to fixed assets, investments and working capital.

A leasing arrangement demands more private involvement than the management contract. In a leasing arrangement, the private party collects user fees, advances working capital and finances short term assets while the government maintains responsibility for major capital expenditures. Further along the continuum to private ownership is BOT, where the developer receives a franchise to finance, build, operate and collect user fees on a facility for a specified period of time, after which the facility is transferred to the public sector. Finally, in BOO, the private developer finances, builds, owns, and operates a facility in perpetuity subject to regulatory constraints.

In the continuum, where management contracts represent the least amount of private involvement and BOO the most, a concession arrangement would be situated between a lease and BOT -- unlike the lease arrangement, the concessionaire has the responsibility and assumes the risk for making long term capital improvements and unlike the BOT arrangement, the concessionaire is not responsible for, and assumes no risk in connection with, the construction of the facility.

Privatization, regulation, or competition?

Many analysts believe that regulation and competition are more important than ownership transfer in determining economic performance. But the experience of recent years suggests that in fact, privatization, competition and regulation must all be part of efforts to improve economic efficiency in a sector, particularly those sectors that have elements of a natural monopoly or public good.

In the case of natural monopolies, legislative changes prior to privatization are often required to introduce competition in the sector and facilitate the process of regulating the monopoly, whether public or private. Legislation is often introduced to help separate those segments of an industry which are natural monopolies from those which are not. This process, called unbundling, is common in the power and telecommunications industries.

For example, in the United Kingdom, and more recently in Ukraine, electricity generation has been separated from transmission and distribution (vertical unbundling). Whereas transmission, by nature, is likely to remain a natural monopoly, the generation and distribution segments offer a variety of opportunities for the introduction of competition. In telecommunications, the operation of radio-based cellular services is typically separated from the provision of traditional telephone services.

National railways can also be unbundled. In Japan, the national railway was re-organized and split into six regional passenger operators and one freight operator that rents time from the regional railways. The Polish national railway is scheduled to be divided according to region and type of service.

Once sectors have been unbundled, usually through legislation, competition can be introduced several ways to increase efficiency and ensure the monopoly provider meets the needs of its clientele and the government:

- Competition from substitutes. Energy and transport are the two most important areas where competitive substitutes can bring pressure on the monopoly supplier. While a natural gas supplier or railway can be monopolistic, for example, government policy can help ensure that other alternatives to these services are available to consumers.

- Competition from other suppliers in the same market. Infrastructure markets with numerous suppliers are rare, but even introducing a second supplier can have extremely positive effects on service quality and prices. Unbundling cellular from traditional phone services allowed competition to flourish in many countries in what was once considered a monopoly segment. For example, in 1993 Sri Lanka licensed four cellular operators, leading to tariffs among the lowest in the world.

- Competition for the market. Where direct competition is not possible, efficiency can be increased by means of competitive management contracts, ranging from simple contracts

for specific services to long-term concessions that require the private contractor to take over maintenance, operation and facility expansion. While there is only one provider, competition is created between private contractors for the original right to this contract, and then when the contract/concession expires.[5]

Where monopolies persist because unbundling is impossible and substitutes cannot be made available through segmented deregulation, privatization can still introduce efficiencies not possible under government ownership. For example, the privatization of infrastructure monopolies in electricity generation and distribution and in telecommunications in Chile produced substantial welfare gains because private owners overcame constraints on investment the government had imposed on the SOEs, and because the new private management operated the companies more efficiently.

But in cases where monopolies are likely to persist, the privatization process must be accompanied by the development of a transparent regulatory process and structure that will create appropriate efficiency incentives for the entrepreneur and protect the public interest. Governments can impose regulation through enforceable contracts or through changes in the legislation. If statutory regulations prove politically impossible to implement (typically getting laws changed and legislation passed takes years, and the window of opportunity for privatization is limited--see the discussion in 1.2.b), enforceable contracts are often a reasonable alternative. The design of statutory regulation may and often does benefit from the contractual experience of early entrants. Even if competition can be introduced, regulation will be important as a tool to sustain competition. For example, in Mexico, regulatory action was required to ensure fair interconnection by cellular operators into fixed networks.

1.2 The Framework for encouraging and implementing privatization

Irrespective of the techniques selected, privatization cannot proceed unless:

a. There is government commitment to privatization and a sound institutional framework. Saying that success in privatization requires political will seems self-evident. But what do we mean by government commitment? Whose support is required for privatization to occur? At a minimum, experience suggests that privatization must be supported by a strong executive. Agreement from additional branches of government (i.e. legislative), will move the process forward more smoothly, but privatization programs can go a long way without congressional approval. For example, in countries such as Russia and Ukraine, the privatization program was a presidential initiative, bitterly opposed by powerful members of the legislature.

[5]For more examples and a more in-depth discussion of these issues, refer to the **World Bank development Report, 1994**.

In addition to senior level commitment, implementing privatization requires a lead agency which is truly empowered to implement the privatization program (see point 1.2.b below).

Russia Mass Privatization Program: strong leadership does make a difference under a highly bureaucratized environment. The momentum for reform initiated by President Yeltsin after his rise to power in 1991 was instrumental in forcing the implementation of a mass privatization program that transferred ownership of 14,000 enterprises into the hands of the public over a 21-month period. Under his direction, the program was advanced by the State Committee of the Russian Federation for the Management of State Property (GKI). The two key "champions" in the process were Chubias and Vasiliev, Chairman and Deputy Chairman of GKI, respectively. These individuals, in particular, were able to effectively wield the necessary commitment and authority that was essential to the program's success. While Chubias was able to promote policy decisions through his direct access to President Yeltsin, daily access to Vasiliev and his staff gave the donors and technical advisors the backing they needed to move the program forward. Strong resistance to and attempts to derail the program emanating from other ministries and the parliament, other deputies within the ministry, enterprises, and the public, was minimized by coordination at the most senior levels of government.

Burundi Office National Pharmaceutic (ONAPHA): political indecision at the top can lead to the failure of even the best prepared transaction. In 1992, the Government of Burundi agreed to privatize ONAPHA, the national pharmaceutical company. Burundi's privatization program was stalled and needed at least one well-prepared, successful transaction to revive the program. Therefore, this transaction was of particular importance to the government. The decision was made to make the ONAPHA transaction a "model" for future transactions, both in terms of technical preparation and in terms of process management.

The transaction was approached broadly. Significant resources were spent evaluating the sector structure as a whole, including issues such as the availability of affordable drugs, the viability and impact of the sale on the national state-owned insurance company. The transaction structure also made considerable efforts to include all stakeholders and competing interests, including management, employees, the insurance companies, and private pharmacists, who stood to lose their income from the sale of imported drugs should the transaction go through.

But when the bid documents were finally prepared, few bidders showed up. The reasons for the failure were varied. But it was clear that key senior officials in the GoB had never been fully behind this transaction. There was a very long delay between the time when potential investors were contacted, and the first press conference held, and the time when the tender was actually launched. The delay was in part a function of a highly fluid and unsettled political situation. The privatization process coincided with the preparations for the first democratic elections in Burundi. The government was distracted, and it showed, in terms of indecision, or poor decisions regarding the structuring of the bidding. Moreover, once the bidding commenced, the newly elected president was assassinated, further throwing the process into confusion and disarray.

b. There is a basic legal structure to govern the privatization process.
Privatization program implementation proceeds most smoothly if a basic set of laws are in place. At a minimum, these laws should seek to establish (i) a transparent and well understood decision-making process for identifying, selecting and preparing enterprises for privatization, and (ii) a basic set of guidelines to govern the behavior of newly privatized enterprises.

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(i) *Legislation establishing a clear decision-making framework for privatization should at a minimum:*

- designate a government entity to oversee the privatization process, assigning responsibilities, authority, and a budget to that entity, and clarifying responsibilities and authority among related government entities (i.e. privatization, finance, banking, industry, taxation, auditing, securities regulation, judicial, and other departments). This entity also serves as a useful forum for the resolution of inter-ministerial issues and should have representatives from the highest ministerial levels.

  To be effective, the agency's mandate and scope must be clearly articulated. This means in part ensuring that the lines between the privatization agency's authority and jurisdiction and the authority and jurisdiction of other related agencies (i.e., audit, tax, finance, industry-specific, etc.) are clearly delineated. Often, however, the government may choose to be deliberately vague regarding what agencies are to be included in privatization decisions, such as which enterprises are to be put up for privatization, or how the assets are to valuated, or who is authorized to negotiate and approve the process of negotiating the price. In these cases, a "champion" within the privatization organization, someone who has a direct line to the president, can be instrumental in clarifying privatization responsibilities and objectives, and resolving bureaucratic jurisdictional problems (see the textbox on the Russian mass privatization program).

- define the requirements of the privatization process, including corporatization of the enterprise(s); documentation such as enterprise information, public announcements, protocols of results, enterprise preparation (valuations, financial disclosures); the membership of an oversight committee to evaluate bids and negotiate on behalf of the government; the bidding process and requirements or limitations for submitting a bid; the criteria for calculating, evaluating, and determining bid results; and public notification of the results. Provisions for enterprise liquidation, if considered to be a potential option, must also be included.

(ii) *Legislation establishing the rules of the game for private enterprise should include*

- corporate governance procedures to regulate newly-privatized enterprises including requirements for maintaining a share registry, notifying shareholders of corporate events, providing disclosure of financial and management operations, etc.

- enabling legislation for government institutions such as industry regulatory agencies, capital markets agencies (securities exchange commission, investment

fund regulators), bankruptcy agencies, anti-monopoly agencies, enforcement agencies, etc.

- enabling legislation authorizing the existence of public-interest groups such as broker associations, shareholder rights associations, consumer protection groups, and others.

- expeditious contract enforcement and dispute settlement mechanisms, tax codes and regulations with accompanying rules, tax collection mechanisms and investment incentives, antitrust and competition laws, intellectual property protection laws, bankruptcy laws.

- social safety nets (e.g. labor laws and social welfare legislation, environmental protection legislation).

Decree or legislation?

The privatization process can be effectively delayed for months or years if the enactment of the required legislation is delayed. Delays can lead to the gradual erosion of public support for the privatization process and loss of investor interest. Thus governments often choose to issue presidential decrees rather than wait for all the necessary legislation to be put in place. On the other hand, decrees can be easily overturned by a subsequent President with yet another decree, and are therefore often insufficient to instill confidence among potential investors (especially foreign investors).

What is the right timing for introducing this legislation?

A key set of choices facing policy makers pertains to the timing between the privatization and the legal/regulatory reform process. What minimum requirements, in terms of laws and regulations governing private enterprise, must be in place before the privatization process begins? What can wait until after ownership transfer is concluded? How these questions are answered can spell the difference between success and failure for an entire privatization process. Unfortunately, there are no clear-cut answers to these questions.

The issue of timing depends on the social and political landscape, the type of financing required for the privatization transaction, the nature of the enterprises or sectors being affected by the privatization process. For example, throughout Central and Eastern Europe and the former Soviet Union, the privatization process has preceded basic changes in the laws and regulations governing private enterprise and relationship between the private and the government sector. As a result, privatization has not always enhanced private sector performance, and private sector managers end up operating in a legal and institutional vacuum. But, many would argue that without the rapid advancement of the

privatization process, many critical changes in the legal and regulatory framework governing private enterprise in these countries would have been impossible.

Nicaragua Telecommunications (TELCOR) Privatization: a government deadlock over legislation can delay a privatization transaction for more than two years. The first phase of the Nicaraguan privatization program was designed and implemented according to presidential decree. It was considered to be a success, largely because it focused on the sale of primarily non-strategic state-owned enterprises through the National Public Sector Corporations (CORNAP). However, the second phase of privatization, which included the sale of several strategically-sensitive enterprises, was significantly delayed by Congress.

A 1993 presidential decree declared the government's original intent to privatize TELCOR, with its privatization scheduled for June 1994. Over the 1993-1994 period all necessary preliminary work was conducted and completed in a timely manner, including a diagnostic study, terms and criteria for bidding, preparation of a prospectus, invitation to prospective bidders to perform due diligence, and the drafting of two necessary laws, including a draft telecommunications law prepared to restructure and regulate the sector and formally end the state monopoly of basic telephone services. But then the process stalled in mid 1994.

In a bid to gain some control over the process, the Congress passed a general privatization law requiring congressional approval of the privatization process for critical public utilities, including TELCOR. Subsequently, Congress withheld approval of the draft telecommunications law for more than 12 months when differences with the President surfaced over the unrelated issue of constitutional reform.

The telecommunications law was finally passed in July, 1995. But a second law to specifically approve the TELCOR transaction is still pending. By the time both of these laws are in place, more than two years will have passed since the government began the privatization process for TELCOR. Much of TELCOR's information will have to be updated, the pre-qualification process will begin again, and the bidding process will be re-started.

Mass Privatization and the Legal/Regulatory Structure. The Mass Privatization program in Russia is a good example of a transaction process that runs well ahead of creating a legal and regulatory structure. As a result, critics of the program in Russia point out that privatization has not led to improved enterprise efficiency. Moreover, the absence of clear rules of the game has led to widespread cynicism and distrust of "capitalist" structures. Widening disparities between the 'winners' and 'losers' in this economic game and deteriorating standards of living have hurt the credibility of the reform process.

On the other hand, there are many reasons why privatization had to precede the creation of a legal and regulatory framework for private business. A key reason was political. To have waited to develop the appropriate legal and regulatory structures would have meant delays, and perhaps costly expenditures of political capital to get regulations and laws passed. Given the political situation at the time, the choice was clear--build momentum for the privatization process and then worry about the legal and regulatory infrastructure.

Moreover, once companies were privatized, the government reasoned, they too could become advocates for changes in the legal and regulatory structures to permit them to operate efficiently. Indeed this happened with several corporate governance and capital market regulations and laws. For example, some of the largest privatized companies in Russia became strong advocates for improved laws and regulations affecting shareholder registries and voting procedures at General Meetings after scandals involving foreign investors led to negative press coverage and dampened investor interest in the country.

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Additional readings in privatization techniques and privatization policy framework:

Sunita Kikeri, John Nellis, Mary Shirley, *Privatization: Lessons Learned from Market Economies*, in **The World Bank Research Observer**, vol. 9, no. 2 (July 1994), pp. 241-272.

The World Bank Development Report, 1994

Jeffrey Schwartz and Zoanne Nelson, *Techniques of Mass Privatization: Implementing the Voucher Auction Program: October 1992 to June 1994*, in **Russia: Creating Private Enterprise and Efficient Markets** (World Bank, 1994).

PART 2: THE PRIVATIZATION TRANSACTION

2.1 Moving the transaction forward

Once the government has made a commitment to sell, a privatization strategy planned, privatization approaches selected, and the basic legal and regulatory infrastructure is in place, implementing a typical privatization transaction will require that several steps be taken. Some of these basic steps, which include preparing the enterprise for privatization (including most often some sort of restructuring, especially financial restructuring), corporatization, valuation, and preparing the bidding documents, have been discussed above. But the transaction process varies according to the political landscape, the macroeconomic conditions and the dynamics of the market and the sector.

In the case of smaller enterprises, governments do not usually choose to spend much, if any time, on restructuring, valuation, or information memoranda. In the case of mass privatization, enterprises were rarely, if ever, restructured at any level prior to privatization. Valuations relied on book value and were used to provide benchmark prices for the share or asset auctions.

Irrespective of the type of transaction being highlighted, however, those responsible for managing the privatization process must ensure:

a. Key stakeholders are provided the right incentives. Governments and their advisors often fail to fully understand or anticipate how incentives to accomplish certain objectives for privatization in one area can compromise their ability to accomplish other objectives. As a result, the overall effectiveness of the program can be seriously compromised.

For example, in Poland, sector advisors had all the incentive to perform case by case transactions, and little incentive to guide their enterprises through other available

privatization methods. In The Gambia, the management contractor put in place to turn the company around prior to privatization was remunerated in ways which were in direct conflict with the government's desire to increase the company's value by increasing its cash flows. In a third example, during mass privatization in Russia, the issuance of bearer-held vouchers and development of voucher investment funds created an environment in which most investor energies were directed towards voucher speculation rather than making investments in the enterprises.

Poland Sector Advisors. In 1990, the Polish government established a Ministry of Privatization (MOP) and enacted legislation which gave enterprises several options for privatization including public offering, trade sale, mass privatization, asset sale/leasing, and others. To facilitate this multi-track program, a "sector approach" was adopted to analyze and privatize 600 enterprises in 35 sectors. By focusing on sectors, the MOP intended to enhance the long-term prospects of Polish industry, raise revenue for the treasury, generate world-wide investor interest, improve privatization transparency, and prevent SOEs from competing for investors.

Private consulting companies were selected to manage the privatization process in each sector. The private contractors' mandate required them to evaluate and make recommendations on all companies included in each sector. A subsequent phase, focussing on implementation, provided the selected advisors with a success fee for all trade sales completed. The result of this process was that the advisors had little incentive to take action on those enterprises in their sectors that were not appropriate candidates for trade sales. In addition, the highly bureaucratized structure within the MOP made it difficult for advisors and MOP staff members working in the sectoral program, being run out of the Department of Capital Privatization, to secure the cooperation of and information from other departments and other ministries.

The Gambia Produce Marketing Board (GPMB): a government-led restructuring effort gone wrong. As the largest parastatal concern in The Gambia, GPMB represented a government-led monopoly for the marketing, decortication and oil pressing of groundnut. During the 1980s, GPMB went from being a "cash cow" with large cash reserves, to acquiring D67 million in domestic debt as a result of declines in world groundnut prices, drought, rising oil prices, in addition to government borrowing and interference in the operations of GPMB.

By the late 1980s the Government of the Gambia, responding to donor pressure began to prepare for GPMB's sale. The government's plan called for restructuring prior to privatization. It awarded a management contract to a private contractor with the hopes of increasing the value of the company prior to soliciting bids from potential strategic investors.

The contractor selected was given responsibility for management of the company, rehabilitating plants and other assets, and preparing of the company for privatization. The management contract stated that in addition to a management fee, the contractor would receive a 20% bonus for pre-tax profits realized in accordance with the business plan, and a 30% bonus if pre-tax profits were exceeded. Rather than striving to improve the company's cash flow prior to privatization, the contractor was thus motivated to set a price that would maximize short-term profits. But the price it offered turned out to be too low given the price being paid to farmers in neighboring Senegal. The company ran into cash flow problems as inventory piled up. This drove down the government's negotiating abilities and reduced subsequent revenues from potential strategic investors.

b. The privatization process is transparent. Lack of transparency and loss of public faith can seriously derail the privatization process, taking away what may be the government's main base of support. Transparency is created through:

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- enactment of decrees, laws, and/or regulations which clearly describe and govern the privatization process;

- guaranteeing that all regulations, deadlines, and enterprise information memoranda are announced and published in the national press in a timely manner;

- opening the process to all interested parties, and ensuring eligibility requirements and/or ownership limitations are clearly defined prior to initiation of the process, and procedures are applied fairly to all investors;

- ensuring that centers established for the acceptance of bids are accessible to all investors and are publicly announced (necessary in mass privatization);

- ensuring that the calculation or determination of winning bids is conducted by a neutral committee and the procedures are known to the public; and

- announcing results to the public soon after the conclusion of the bidding process.

c. The public is educated. Public relations campaigns target both potential investors and the general public.

Investor public relations campaigns require the preparation of prospectuses, orchestration of road shows, and the like. All this involves considerable time and expense. But reaching for a higher number of investors willing to bid on a company generally results in increased competition and a more favoreable price.

The general public is often skeptical of the government's intentions and wary of international buyers that might usurp or abuse their country's assets. An effective public relations campaign seeks to address each of these concerns in an open and systematic manner. An effective campaign can mean the difference between success or failure for a government's privatization program, as the example below suggests.

The Gambia Produce Marketing Board: privatization bidding gone wrong. Donor funding provided the government with the necessary technical assistance for the analysis of transaction options, company valuation, preparation of an information memorandum and bidding procedures, distribution of the memorandum to targeted potential investors, and publication of the sale in the international press. Despite the USAID's mission offer for continuing support to the transaction, the government decided to manage the bid evaluation and selection process without the assistance of outside advisors. Of the five bids received by the National Investment Board (NIB) Task Force, three were selected for further discussion. From meeting notes obtained after the fact, it appeared that the Task Force favored one bidder, a joint venture proposal with a major foreign groundnut producer and marketer and a major local concern with strong business ties to the GPMB. Initially, this bidder's offer was the lowest. The NIB Task Force gave it an opportunity to raise its offer--an opportunity denied to the other bidders.

The joint venture clearly had serious intentions for returning GPMB to profitability. Yet, it brought many positive changes to the company, though the turnaround is still in progress and the final results are unknown. But, much of the political capital the government could have gained from real improvements in the enterprise operating efficiency, and improved salaries, was obscured by the prevailing view that the privatization process was tainted.

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Additional readings in privatization transaction issues:

Sunita Kikeri, John Nellis, Mary Shirley, *Privatization: Lessons Learned from Market Economies*, in **The World Bank Research Observer**, vol. 9, no. 2 (July 1994), pp. 241-272.

Mary Shirley and John Nellis, **Public Enterprise Reform: The Lessons from Experience**. Washington, DC: The World bank, EDI, 1991.

Privatization: Lessons from Market Economies, in **The World Bank Research Observer**, vol. 9, no. 2 (July 1994), pp. 256-261.

PART 3: IMPLEMENTATION ISSUES

In this section, we examine special implementation issues. We also highlight some areas in which donors can and have been effective in terms of helping to promote more effective privatization transactions.

3.1. The provision of technical assistance. The past ten years have witnessed a significant increase in the world-wide base of knowledgeable technical advisors to privatization programs, providing more opportunities for donors to offer such support to host countries. Advisors are expensive, so the advantages and drawbacks to their use in the privatization process must be carefully weighed.

Some of the ways that they can be effectively utilized include:

- **assistance at the privatization program planning stages** with respect to design and implementation support for an appropriate institutional and legal framework; policy development to strengthen the enabling environment; procedures and processes development to ensure transparent and technically strong privatization program operations

- **assistance during the life of the privatization program**, with an emphasis on capacity building/on-the-job training activities in three key areas: (1) transaction cycle (company diagnostic, valuation, sales and marketing strategy, negotiations support) (2) accompanying policy measures for the particular privatization (sector restructuring, price liberalization); and (3) public relations/ education for the public, labor, unions, opposition (directed both at the program overall and for particular transactions which may cause public concern).

Privatization is normally a long-term process. Supporting this process requires consistency. Advisors can provide for a continuity of assistance to a host country's privatization program. Such continuity is important in environments where the host country government decision-makers,

donor technical staff, and local operational staff frequently change. Where USAID's assistance is multifaceted and includes short-term inputs, advisors can help implement USAID's technical assistance agenda in a manner which effectively identifies and responds to host country needs. Finally, for programs in which USAID's financial commitments are significant and therefore USAID is highly accountable for results, advisors can provide reliable and frequent information on the program status.

But using advisors can be counterproductive:

- if the government simply is not committed
- if there is a strong, anti-foreign sentiment - if the use of a resident advisor(s) would lead the public to view the privatization program as an "American" or alien one, it is not an appropriate choice
- if the government does not have the capacity to absorb the resident advisor(s) - situations where numerous donors are providing numerous long-term advisors result in chaos and limited indigenous capacity-building
- if the advisor(s) has an "agenda" which differs from that of the sponsoring agency's - something that is an all too frequent occurrence

An illustration of heavy USAID financial support and use of advisors is the privatization program of Morocco.

Morocco Privatization Program. USAID/Rabat has been providing assistance to Morocco's privatization program since its formative stages. Its assistance geared up in 1991 and as of 1995, has included about $5,000,000 in technical assistance and $20,000,000 in grant funds. This represents one of USAID/Rabat's larger, more visible programs.

Most of the technical assistance funds have been issued to an institutional contractor (Price Waterhouse LLP) through a series of buy-ins to the Privatization and Development Project. The TA project is multi-faceted and includes both long- and short-term assistance. Long-term assistance is in the form of resident expatriate advisors and long-term local consultants. The two expatriate advisors specialize in policy/economics and transaction advisory services respectively. The three local consultants specialize in the legal, public relations and financial analysis areas respectively.

Benefits from the deployment of these long-term consultants have included: assistance to develop the institutional and policy framework for privatization as well as day-to-day advice and input, resulting in the sale of 35 companies to-date.

Constraints have included limited capacity building - because of limited resources, the consultants are "worker bees" as opposed to "advisors". In addition, there is confusion over who the consultants report to given that the Ministry hired them while USAID is financing them and Price Waterhouse is the contracting vehicle. Finally, agendas of selected consultants have differed from USAID's and have consequently not contributed to the overall institutional development objectives of the USAID technical assistance program.

3.2 Promoting knowledge sharing, capacity building, and training. Knowledge transfer is frequently a priority for governments, though they often fail to build sufficient incentives to ensure this takes place. When technical advisors are brought in to focus on the initial transactions, time pressures, language barriers, and other constraints may put knowledge transfer on the back burner until the advisors are gone and capacity is found to be deficient.

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There are various mechanisms available to the government to ensure that training and knowledge transfer does take place. These include establishing concrete, specific goals and criteria for the fulfillment of training or capacity-building tasks; requiring the development of procedure manuals, training materials, and other forms of how-to documentation; carefully selecting privatization advisors with a proven track record or commitment to this process; and training selected individuals from the local staff responsible for training others in the organization (e.g. through "train-the-trainers" seminars).

Aside from knowledge transfer through on-the-job training, formal training programs for government decision-makers and employees and management in affected enterprises, can be a very effective means of alleviating technical or political obstacles to privatization, as the Poland case below illustrates.

Executive training courses designed and taught by privatization practitioners can be leveraged through distribution to home-country training schools or academies for further dissemination to others.

Poland Privatization Program: a nation-wide training program that has provided key regional stakeholders with a forum to discuss the impact of privatization and build consensus on the appropriate privatization path for an enterprise. Despite ambitious privatization plans initiated by Poland in 1990, its program has not progressed as quickly as planned due to political differences in the administration, the strength of labor parties and unions in the decision to privatize, territorial disputes within the ministry, etc. Poland's vovoidships, or provinces, lacked both information about privatization and market economies, and forum whereby primary stakeholders in the privatization process could meet each other and openly discuss their often conflicting objectives.

In late 1993, the government was provided assistance with USAID funds to design and implement a training program which would be conducted in each of fourteen regions over the next year. The program, called "Basic Business Skills" (BBS), would bring company management, labor, and regional ministry representatives (responsible for negotiating and selling the state-owned companies) together in one location for seven straight days of lectures, case analysis and presentations. The objective of the program was to create a common vision of the challenges ahead as the economy liberalizes, as well as consensus among the three groups--vovoidship privatization officials, SOE management and Workers' Councils, on the need to privatize. The training program is to be followed by technical assistance, funded by EC-PHARE, to help prepare the enterprises for privatization.

With three months left towards completion of the project, over 1,100 participants have attended the course. The majority have indicated a significant appreciation for the opportunity to discuss privatization with their peers and the ultimate consequences of becoming a privatized enterprise in a competitive, market environment. The EC-PHARE-funded consultants report a noticeable difference in attitude and cooperativeness between those enterprises that have gone through the BBS training and those that have not.

Video-based courses and other programs help leverage donor funding for training. Donors are exploring alternatives to traditional in-country and participant training programs which rely heavily on foreign experts, as both of these can easily become expensive. Donors are placing increasing emphasis on training trainers, rather then participants directly. Donors are also exploring means to replace, at least in part, traditional "live" training sessions. For example, in light of the large and continuing demand for guidance regarding corporate governance, especially in countries implementing mass privatization, USAID has funded the development of a corporate governance video-based training program. Armed with the video, and a brief program to on how to use it effectively in a training program, local training institutions are able to take over corporate governance training activities in-country.

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3.3 Addressing labor and social safety issues. Since privatization on a world-wide scale began, a chief concern of governments, enterprise management, and the employees themselves is how to downsize predominantly over-staffed enterprises without cutting off employment and social benefits from what can be a sizeable percentage of the population.[6] In fact, privatization reform in Poland has been slower than expected because of the strong presence of labor unions and their opposition to any measure that risks unemployment.

Rather than leave employment issues for new enterprise owners to resolve, many governments have developed guidelines of their own, seeking to have the privatized enterprises share the responsibilities for labor retrenchment. In Bolivia and Ghana, the privatization process might have been derailed by the population if the government had not taken this stance.
Short-term provisions for assisting displaced workers center around:

- *financial compensation.* This includes severance pay packages, bonuses for early retirement, unemployment benefits, employee stock ownership, and/or mandatory full employment for a pre-determined period of time. The issue here is who pays: the government or the new employer? The government's basic stance should be that the employer pays, but in this case, these pre-conditions should be clearly stated up front.

- *outplacement assistance.* Job training and education, employment information services and counselling, time off for job searching, relocation services, etc. are forms of outplacement assistance that could be offered through the government or enterprise. Many employers have willingly undertaken these types of programs, increasingly with donor support.

- *entrepreneurial development.* The combination of enterprises seeking to divest social assets, and employees seeking new job opportunities, can create a potential entrepreneurial base to provide goods and services in a market environment that were once controlled by the enterprise. Start-up capital at low interest rates, and/or management/leasing contracts offered by the enterprise or state, can spur the development of "spin-off" enterprises. Again, donors have become active in this area.

- *public works.* Government-sponsored public works programs are considered more expensive than many other options, but they have proven to be viable options in certain situations where the government is able to effectively utilize the introduction of labor-intensive public works projects to offset rising unemployment. The long-term effects

[6] According to World Bank research conducted in 1991-1992, the widely-held belief that workers in privatized enterprises suffered from the consequences of privatization was disproved in the analysis of twelve privatized enterprises in Chile, Malaysia, Mexico, and the UK. In all cases, workers were not worse off than before privatization. In three cases, workers benefitted substantially (Kikeri, Nellis, and Shirley, Privatization: The Lessons of Experience, p 28).

should be carefully considered, however, since one of the eventual outcomes is a continued build-up, rather than reduction, of state supported employment.[7]

Long-term solutions to the provision of social safety nets include basic unemployment compensation and other social benefits. These take longer to develop and implement, given government budget constraints, changing political views, evolving societal needs, and are generally considered the responsibility of the government.

Labor displacement is, of course, not the only type of social impact privatization brings. For example, privatization of many basic infrastructure services often requires some type of tariff "re-balancing," so that the price for the service reflects the full economic costs of that service. In the absence of this basic re-balancing, subsidies will continue distorting usage decisions, and potential investors will be reluctant to bid on the concession. But tariff re-balancing can mean over time hardship for disadvantaged sectors of the population. There are several mechanisms available to governments for addressing this issue, including the creation of tiered tariffs and other special breaks targeting specific groups of users. Donors such as the World Bank have at times been willing to help subsidize the difference between the full economic costs of the service and the consumer rate over a limited period of time, in an effort to facilitate the adjustment process.

Severance Schemes in Bolivia and Ghana. These examples illustrate the importance of analyzing the financial impact of proposed severance schemes. During the mid-1980s, the Government of Bolivia reached agreement with Central Bank employees on a severance scheme that would be implemented for 600 of its 1000 employees. The scheme was based on a careful cost-benefit analysis of future savings from a reduced workforce which not only allowed for generous severance payments for departing employees, but also provided merit-based pay increases to the staff. Overall personnel costs were reduced, while efficiency and productivity increased.

In Ghana, on the other hand, a severance payment agreement negotiated between the government and worker collectives proved to be more generous to the workers than the government could afford. Although profits from privatization were intended to support severance payments, the amount of the agreed-upon benefits grew 100% within the first six years of program implementation, representing between four and seven times the country's per capita GNP. The government was forced to reallocate funds from the central budget. The consequences of this action were delayed payments to employees, and serious delays in the privatization process due to the wariness of private investors to inheriting government obligations, and a reluctance on the part of the worker collectives to renegotiate with the government, knowing that a reduction in benefits would result.[8]

3.4 Financing privatization. Do donors such as USAID have a role in privatization finance? Many would argue no. After all, while the growth of official sources of financing has remained more or less stable, the amount of foreign, private capital invested in the emerging markets has

[7] Mathieson, Yeung, and Normand, SRI International/IPC. Mitigating the Social Impact of Privatization, pp. 15-20.

[8] Mathieson, Yeung, and Normand, "Mitigating the Social Impact of Privatization," p. 16.

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grown significantly in recent years. Altogether, international sources of finance (foreign direct investment, portfolio flows, bank loans, debt and equity issues) increased from $30 billion in 1990 to $100 billion in 1993 for 45 developing countries tracked by the IFC. Much of the growth in local stock market capitalization can be traced directly to privatization, especially in a few key sectors, i.e., energy and gas, utilities, banks, and telecommunications. These tend to be high profit sectors with great potential for expansion.[9] Privatization in each of these sectors has often included a strategic investor (foreign in most cases) whose objective is to acquire controlling shares, restructure the company prior to making a public offering of securities. This model of privatization has been particularly popular and successful in the telecommunications sector.

Reliance on foreign sources of financing for privatization is a double edged sword for most governments since political opposition can be quick to accuse government of "selling out to foreigners." Governments are looking for mechanisms and techniques to mobilize domestic capital. And it is in this area that much work remains to be done, and where donors can be very effective.

Many developing countries are discovering that, given certain reforms and types of privatization, the pool of investment capital created by the pension fund system can be tapped for long-term investment. Privatization activity has opened up new and attractive investment options for these funds. Pension fund investors have become important institutional investors in Chile, Malaysia and the Philippines. For example, in an effort to improve the liquidity of the local exchange, the Malaysian Ministry of Finance announced on June 1995 that it would permit the Employee Provident Fund (EPF--worth an estimated $35.2 billion at the time) up to 15% of its holdings in local shares, up from 9% previously. Searching for safe investments with long maturity and higher expected returns than what government paper was yielding, the EPF invested billions of Malaysian dollars into corporate securities.

Bolivia, with donor support, is implementing an innovative approach that blends mass privatization and pension reform as a mechanism for mobilizing local capital to finance the privatization of major infrastructure companies. The government is enacting a plan whereby eight of the largest SOEs, such as gas, electric and telecommunications, will be sold in part to a strategic investor who will be given administrative control. Fifty percent of the shares in these companies will be set aside to be distributed to every Bolivian citizen over the age of 21.

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[9]Such infrastructure privatization activity has also created enormous growth in local capital markets. Argentina's market capitalization increased from $3 billion in 1989 to $30 billion in 1993, in large part due to the listing of two telecommunications companies; these two companies now comprise nearly 40% of total market capitalization. A recent report by the IFC ("Financing Private Infrastructure Projects") reported that total capitalization of developing country stock markets increased from $599 billion in December 1989 to $1399 billion in December 1993. Much of this growth came from new listings of infrastructure stock and share appreciation in secondary market trading. In Morocco the capitalization of the stock exchange grew by 500% in a three year period, also as a result of increased privatization activity. It is now the second largest bourse in Africa.

Shares will be held in accounts administered by private financial institutions and will be exchangeable for pension benefits only upon the citizen's retirement, disability, or death. Citizens may transfer their shares among accounts at these institutions and may voluntarily contribute funds from their paychecks as well.

Donor support, through technical assistance and training, has been very effective in creating and strengthening basic institutions, including stock exchanges and the clearing and depository industry, critical to facilitating the mobilization of capital in a country. Such actions, as the preceding descriptions suggest, can have enormous impact on the success of privatization programs, and can create a virtuous cycle, helping local capital markets grow.

Pension Funds and Privatization Finance. The element of risk in long-term infrastructure financing deals has been the largest obstacle to greater pension fund participation. The absence of brokers and other market makers in emerging markets who can underwrite and re-package privatization financing deals often precludes contractual savings institutions (whose portfolio risks profile is tightly monitored and regulated) from participating in infrastructure and other privatization transactions.

However, an increasing number of countries are developing innovative risk sharing options. For example, the Philippines social security system provides financing for power projects through a 4 billion peso loan fund. It loans up to 200 million peso (about US$ 7 million) for up to 15 years to commercial banks, which then lend to the power projects. This mechanism shields the social security system from the project risk, allowing the banks to re-package loans as risk capital.

Mass Privatization in the CEE/NIS Region. Mass privatization programs from Russia to Kyrgyzstan, from Moldova to Slovakia, have differed in terms of how they have been implemented. But they share a fundamental characteristic: ownership transfer requires no or a minimum of capital. Throughout the NIS/CEE region literally hundreds of thousands of enterprises have been privatized in record time through mass privatization.

Mass privatization owes much of its success to the emergence of the investment funds as market makers in the region. In the Czech Republic, it was one investment privatization fund (IPF), Harvard Capital (started by a young Czech returning from his MBA studies in the US), which sparked the public's interest, guaranteeing a 1,000% return to those who chose to entrust their privatization vouchers to his fund. Suddenly, what had been an apathetic public, began to take a keen interest in the mass privatization program. Citizens began claiming their coupons by paying a nominal fee. Harvard Capital never gave its investors a 1,000% return, but it, and other Czech and Slovak IPFs have become major players in the newly privatized enterprises. The results of the first wave of privatization in these republics indicated, for example, that 72% of all voucher points held by the public had been invested in IPFs. These IPFs are actively seeking strategic investors to bring capital and know-how to their portfolio of companies. Their success will depend on how well and the financial market infrastructure in the country, including share registry, clearing and depository systems and the like, develop and mature.

3.5 Coordination in the donor community. In an era of limited resources, and enormous unmet needs, no donor cam hope to be able to address all areas of the privatization process. Donor coordination has become critical. There are several mechanisms to facilitate this coordination, from informal monthly donor roundtables to more formalized government funded agencies established to coordinate assistance. The choice of mechanisms will depend on the size of the privatization program, the size and diversity of donor efforts, as well as the internal politics

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prevailing in the country. The Russian Privatization Center is among the most effective of bureaucratic mechanisms created to coordinate donor efforts in this area (see below).

Russian Privatization Center. During the rush to implement a mass privatization program in Russia, the Russian government and donor agencies quickly recognized that the size and long-term potential of Russia within the global marketplace was attracting a high number of donor agencies eager to participate in the process of economic reform. Political reality exempted any one agency from dominating a coordination effort among donors. Thus, certain donors developed a proposal with the Russian government to establish a Russian non-profit, non-government organization to oversee the allocation and management of foreign aid. Consequently, the Russian Privatization Center (RPC) began operations in 1993 during the highly publicized period of public voucher auctions.

The RPC is currently working with several donors to target aid effectively in the post-privatization environment. Although the REC cannot force participation and cooperation among donor agencies, it has become a facilitator of an in-country support network for privatization and post-privatization initiatives. Its present and future success hinges on the RPC's ability to maintain a distance from the unstable political environment, *market their services to and attract potential donors, and effectively serve the donors, newly privatized enterprises, and other selected stakeholders in the post-privatization arena.*

Additional readings in the special privatization topics discussed above:

Price Waterhouse LLP, International Privatization Group. *Privatization in Africa: Lessons and Opportunities*, November 1994.

Mathieson, Yeung, and Normand. SRI International/IPC, *Mitigating the Social Impact of Privatization*, prepared under the Privatization and Development (PAD) contract, April 1994.

Third World Finance: New Ways to Grow., in **The Economist**. September 1994.

Carol Graham. **Safety Nets, Politics and the Poor: Transitions to Market Economies**. Washington, DC: Brookings Institution, 1994.

A Shift Towards Private and Defined Contribution Pension Programs, prepared by Price Waterhouse LLP for the USAID Privatization Seminar series funded under the Privatization and Development contract, 1995.

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BIOGRAPHICAL DATA
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Background Note #970

INTERNATIONAL TRADE AND TRADE REGIMES

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INTERNATIONAL TRADE AND TRADE REGIMES

I. Introduction

Trade is probably as old as human society and so are the rules to govern trade.[1] The regulation of trade among foreign empires dates back to at least 2500 BC., when reference is made to a tariff agreement between the Egyptian and Babylonian kings (Winham, 1992). This agreement is not fundamentally different from the kinds of agreements made between modern governments. Of course, the quantity and quality of the goods and the scope of the regulations are much greater today.

In the period since World War II, the predominate force that has governed trade has undoubtedly been the General Agreement on Tariffs and Trade (GATT). Within this regime, i.e., a set of rules, principles, norms or customary practices that shape expectations about international trade,[2] governmental barriers to trade have been dramatically reduced and international trade has increased tenfold in volume and forty fold in value (Greenaway and Hine, 1991). During the late 1970's and early 1980's, those "rules of the game" have been called into question. Many of the original proponents of international free trade under GATT are expressing reservations. This note looks at the development of the GATT regime, the growing "reservations" about it and the implications of both for the future. It concludes that, in all likelihood, the evolving rules by which trade is practiced are unlikely to seriously threaten the reality of substantial levels of international trade. However, it will likely affect who trades what and how they do it.

II. The Need for an International Trade Regime

The necessity of a dominant entity (e.g., a state or group of states) to set up and enforce international trade rules is advanced by Kindleberger, Gilpin and others

1 The classic history of trade and trade regulation is Condliffe (1950).

2 For more elaboration on the concept of a regime, see Krasner (1983).

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in a theory of "hegemonic stability." Because adherence to rules typically requires enforcement and monitoring, both costly undertakings, the theory of hegemonic stability maintains that the only way to have international economic stability requires the most powerful nation (or group of nations) to assume those costs. These include direct financial costs, but also the costs of trading freely when there are incentives not to. The hegemon must also cajole other nations to trade freely.

In the aftermath of World War II, the international trading system, was in tatters. The only major economies to survive wars in Europe and Asia were the United States and, to a much lesser extent, Great Britain. The high tariffs that remained from the 1920's and 1930's continued to restrict trade among nations. Convinced that such barriers were to blame for the Depression, and to a lesser degree World War II, the United States, as the dominant military and economic power, began to rebuild the global trade system based on liberal trade.[3]

Since the US played a major role in designing it, it is not surprising that much of that system was guided by US experience. The principles upon which GATT was to be based were developed by US administrations between 1922 and 1934. The Forney-McCumber "bargaining tariff" of 1922 signaled an attempt to encourage liberal trade by promoting reciprocally negotiable tariffs. Tariffs under this law were not at all low by today's standards, but they displayed a realization of the importance of liberal trade. They permitted the US to "trade" tariff reductions for tariff reductions abroad.

This attempt at negotiating for lower tariffs, however, was thwarted by domestic protectionist forces, and, when combined with the financial collapse of 1929, provoked the Smoot Hawley tariff of 1930. This legislation increased tariff barriers substantially and across the board, almost doubling them, while providing no room to negotiate reductions as under Forney-McCumber. Meanwhile, Britain and France responded with high tariffs of their own. US trade between 1929 and 1933 fell by 75.2 percent compared with a world decline by 54 percent.

To lead the way out of this spiral of trade restrictions, Franklin Roosevelt asked for and received emergency authority to negotiate reciprocal trade agreements under the Reciprocal Trade Agreements Act of 1934. This allowed the executive to negotiate tariff

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3 The actual role of trade wars more likely served to worsen rather than cause the depression (Bhagwati, 1988). Another important element of the postwar international economic system is the Bretton Woods system of fixed exchange rates and the US as a "lender of last resort." For elaboration on the post-war international monetary system, see Gilpin (1987, Chapter 4). Another important explanation for the US decision to propose an international trade regime was the Soviet Union. The US feared that a failure to revive and unify the still "free world" would endanger their own political principles and economic interests. .

reductions on a bilateral basis. This Act permitted some liberalization, but was interrupted by World War II.

III. GATT structure

Originally the GATT was negotiated in 1947 as one part of a much broader International Trade Organization, which failed to materialize.[4] Interestingly, the most recent negotiations (the Uruguay Round) have enhanced the authority of GATT institutions, making it more of what the architects of the original ITO had envisioned. Even the name is to be changed from the GATT to the World Trade Organization (WTO).

GATT is a trade regime in which nations negotiate to reduce tariffs and reduce domestic discrimination against imported products, with a goal towards reducing overall trade barriers among nations. As we will see, the focus in negotiations has moved from concentrating almost solely on tariff reductions to addressing discriminatory practices. Consequently, the debate has shifted from a clear, agreed upon and easily measurable barrier to much more contentious issues that impinge on the sovereignty of nation-states.

There are three basic principles in the GATT (Gilpin, 1987). The first, contained in Article I, is the principle of *non-discrimination*, or most-favored nation (MFN) status, for all GATT signatories. Basically this means that a nation's barriers to imports should apply to all nations equally, and that some countries should not be given preferential treatment in access to one's domestic market. It also refers to the treatment of imported goods within the home market, i.e., they must be dealt with and traded as domestic products (Winham, 1992).

The second basic principle of GATT is the *liberalization of trade through reductions in trade barriers*. Until the 1970's this basically meant reductions in tariffs. GATT encouraged the use of tariffs as opposed to other forms of trade barriers because they were the most transparent. The importance of transparency is revealed in the third tenet of GATT: *unconditional reciprocity* among the signatories. This refers to how nations go about reducing tariffs with each other: nations making roughly equal concessions to better assure that the gains from increased trade will be mutually beneficial. Such reciprocity was not included in the language of the GATT, but subsequent multilateral trade negotiations (MTN's) have used the principle to facilitate agreements in tariff cutting. The transparency of a trade barrier is important in such situations because it makes the "value" of the barrier

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4 The ITO was to be administered by an international body. The US Senate refused to authorize such a broad delegation of sovereignty to an international organization. There were other problems as well, but US resistance at that point was sufficient to terminate just about any international economic endeavor. Whether similar Congressional opposition to the Uruguay Round agreement will hamper its passage in the US remains to be seen.

obvious to all parties.[5] Thus, countries can negotiate the reciprocal terms to remove the barrier more easily.

The number of participants in these increasingly complex negotiations has grown rapidly. The original number of signatories was twenty-six. However, following decolonization, the number had doubled by in the 1960's. In 1993, 117 nations participated in the negotiations, with others, such as Russia, eager to join. The expansion of members has not only expanded the interests to be accommodated, but the disparity of economic situations (developed, less developed, least developed) has grown larger. This has made agreements more difficult and more time consuming.

There are two important points in the origin of the GATT that have a bearing on the contents of the agreement itself and the evolution of disillusionment with the GATT. The first is that the GATT was as much an international regulation of trade as a free trade document. This point is well summarized by Gilbert Winham (1992):

> ... with the development of trade agreements between nations as a permanent factor in international commerce, the face of regulation has changed. Now regulation is pitted against regulation; that is, the regulation flowing from international agreements that seeks to promote and stabilize economic exchanges between nations is ranged against the regulation of national governments that often seeks to restrict those changes. The issue today is not free trade, whatever that might mean. Regulation is inherent in our highly ordered lives, and the irony is that to reduce regulation of one kind, it takes regulation of another kind (pp. 20-21).

The GATT is a political agreement among nations, and as with all agreements contains compromises that are often based on short time horizons and reflect the interests of dominant players in the trade game. For example, the GATT agreement includes an "escape clause" (in Article XIX) permitting temporary upward adjustments in tariff rates for nations whose domestic industry was severely threatened by import competition. The clause was intended to permit the orderly adjustment of domestic markets.[6] In this sense, the GATT sacrifices some short-term free trade issues for the long term goal of generally freer, fairer trade.

GATT articles also permit deviations from non-discrimination by permitting common markets, customs unions and free trade areas (Article XXIV). *Free trade areas* are

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5 The counter example in this case would be use of a non-tariff barrier, perhaps a quota, or a quality regulation. Since the price value of such instruments is more difficult measure, conflicts will more easily arise over the "price" of removing the barrier.

6 Such adjustments were required to meet three criteria to be considered legitimate under GATT. First, there must be clear indications that the particular industry is threatened. Second, the tariff increases must be offset by the reduction of trade barriers in other areas to ensure the originally negotiated "openness" was maintained. Finally, these tariff adjustments had to be multilateral, e.g., protection of the domestic auto industry would require tariff increases on imported autos from all nations and similar offsets, say on computers, or washing machines.

arrangements in which there are no tariff barriers between the contracting countries, while each nation maintains its own tariff rates external to the free trade area. *Customs unions* are free trade areas which have a uniform external tariff structure. The GATT also permits *common markets*, which are essentially customs unions in which factors of production (labor and capital) move freely among the common market's members. GATT permits "special and differential" treatment of developing countries. This led the way to a Generalized System of Preferences (GSP), originally negotiated not under GATT auspices, but in the United Nations Commission on Trade and Development (UNCTAD). GSP allows trade preferences for developing country exports up to a certain level, when high tariffs are imposed.

Ultimately the GATT can hardly be considered a global free trade agreement to the extent that it only applied to signatories of the agreement. Thus, nations have been able to erect barriers more or less as they wished with countries who were not in members of the GATT. This permitted the United States to subject imports from Eastern Bloc economies (especially the Soviet Union) to the Smoot-Hawley tariff rates of the 1930's!

Finally, GATT includes implicit discrimination in certain types of goods. GATT has generally only applied to manufactured goods, thus excluding primary products, especially agriculture (at the request of the United States in 1947). While it is true that the original members and major nations in the GATT were not dependent on agriculture and the primary sector, at the present time, many of the signatories, and the majority of *people* represented in the GATT depend on agriculture. Thus, the international "free trade" regime has done little to free and stabilize trade that most people and countries now in the GATT are involved in.

The second important point is that GATT, like all contractual agreements, cannot account for all possible future contingencies and thus parts must be reinterpreted or even renegotiated. This permits the agreement to "evolve" through negotiations, but it also can politicize the agreement. As we will see, a major renegotiation of some aspects of the agreement took place in the mid 1970's during the Tokyo Round.

IV. GATT Negotiating Rounds

Despite the substantial deviations from purist principles of non-discrimination, unconditional reciprocity and reductions in tariff barriers, by most accounts the GATT regime has been responsible for an ideological shift toward free trade in the major industrial economies.[7] This has been accomplished in eight major rounds of multilateral tariff

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7 Such ideological shifts are difficult to prove definitively, but that such a shift took place is generally accepted by those who study international trade. In the 1920's and 1930's, those opposed

reductions since 1948 (Table 1). The cuts in these rounds coupled with impressive economic growth reinforce the idea that free trade is good for national prosperity. Since 1948, US tariffs have been reduced by 92%. Current tariff levels for the US, EC and Japan are respectively 4.9%, 6% and 5.4%. Meanwhile, annual economic growth rates through 1973 averaged about 4.7%, while trade expanded by 7.4% annually (Bhagwati, 1988).

A. *Early tariff cutting Rounds*

The first five MTN's, held between 1948 and 1961, principally involved tariff reduction, with the United States making the majority of reductions (Winham, 1992). The major limitation of these cuts is that they represented the "fluff" of generally high tariffs left over from the 1930's.[8] Reducing tariffs in areas with little foreign competition produced large percentage tariff reductions and were politically easy to accept, but their efficacy in creating economic gains from trade were relatively small.[9] These rounds were also not fully multilateral, but conducted in "a series of simultaneous bilateral negotiations" (Baldwin, 1989, p. 191) after which tariff reductions were simply applied to all signatories.[10]

B. *The Kennedy Round*

Following these rounds, the Kennedy Round (1962-1967) resulted in a change of negotiating procedure and achieved broad tariff cuts in major areas.[11] A new major issue concerned the goals of the regime. The European Community (EC), negotiating as a group for the first time, suggested that tariff cuts should harmonize tariff rates internationally, rather than simply reduce tariff rates by a uniform percentage. The US, on the other hand, wanted broader percentage cuts across the board.[12] In essence, a compromise was reached

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to specific protectionist measures were forced to explain why the nation should deviate from protectionism. In the post World War II era, those advocating less free trade are now forced to explain the reasons for deviating from the norm of free trade.

8 For example, the Smoot-Hawley tariffs were akin to a shotgun approach to protection. It covered everything, including industries that faced no competition from foreign imports, and was indicative of the prevalent domestic view that it was best to avoid using foreign goods.

9 For example, a domestic industry facing little prospective foreign competition might have, say, a 50% tariff. Reducing that tariff to zero would do nothing to prices or the competitiveness calculations of that industry.

10 In fact, Baldwin (1989) and others, maintain that there is a strong bilateral character to many aspects of all the MTN's.

11 Across the board cuts," as post-Kennedy Round reductions are often referred to, does not necessarily imply that all tariffs are reduced, or that they are reduced at the same rate. For more details on the Kennedy Round, see Preeg (1970).

12 The basis of this conflict is somewhat predictable. The EC, after achieving a common tariff policy by averaging the tariffs of its members states, recognized that it generally had 50% to 150%

in which disparities were reduced on a "bilateral" basis, similar to the process prior to the Kennedy Round.

This session also had a working group on developments related to non-tariff barriers, but the amount of time and resources spent working on tariff reductions permitted little progress in this area. A notable achievement on this front was the Anti-Dumping Code. GATT rules specify that goods sold below costs constituted unfair trade practices and were subject to countervailing tariffs to bring the prices of these goods to "market" levels. As some industries, notably in the US and the EC, began to be threatened by such practices, the governments of those nations began to press for elaboration of the GATT rules. The Anti-Dumping Codes were an attempt to lay out clearer rules and remedies for "dumping" in order to permit resolution of the issues within the GATT framework. They did not, however, end severe conflict on the issue.

C. *The Tokyo Round*

The Tokyo Round (1973-1979) marked a major shift of emphasis in international trade negotiations. While it resulted in further tariffs reductions, greater attention and time was allocated to "fair trade" issues and the reduction of discriminatory barriers beyond tariffs. Codes, or "rules of the game," regarding some non-tariff barriers (NTB's) on issues such as subsidies, government procurement, and technical barriers to trade were agreed upon.[13] Furthermore, there was a more explicit acceptance that some forms of protectionism were inherent in a "fair trade" system. The codes were an attempt to ensure that nations did not use discriminatory policies to restrict trade unreasonably and that countries have a common set of rules to play by.

> The emphasis in the Tokyo Round was on fair trade, not free trade, and the various governments accepted that the notion of fair trade included certain elements of protectionism ... The main concern of fair trade was the openness of the international economic system, understood in relative rather than absolute terms (Winham, 1986, p.11).

The problem with these agreements was their broad wording. This did little to resolve many of the differences that were responsible for the negotiations in the first place. For example, the United States was, and remains, opposed to subsidies as a means of adjustment, but the EC has used them liberally for adjustment and social policy objectives. The Tokyo Round changes contain language that justifies both sides of the issue. In other

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lower tariffs than the United States, Japan and the UK in major industrial categories (Baldwin, 1989).

13 For more details on the Tokyo Round see Winham (1986).

areas, such as government procurement, the emerging "rules" were more specific and more concessionary, although not wholly resolved.

D. The Uruguay Round

Following the Tokyo Round, there was a great deal of pessimism regarding the future of the multilateral trade regime. The failure to reach substantive agreements on many of the non-tariff barrier issues, the lackluster economic performance of the underwriter of the free-trade regime (the United States), and the refusal to incorporate backlog issues such as agriculture, textiles and quantitative restrictions, all influenced this general pessimism. The trend of decreasing protectionism was feared to be halting, or worse, reversing. In the midst of pessimism brought on by problems of liberalized trade through multilateralism, the Uruguay Round, the latest series of MTN's within the GATT, began in 1986.

The Uruguay Round was the most ambitious round of negotiations yet, and the US instigated it while simultaneously beginning to withdraw from its focus on *international* free trade by cultivating its regional, bilateral and "aggressive unilateral" options. Agriculture was a serious issue for the first time, and pressure to resolve this issue escalated. The United States, joined by a coalition of smaller agricultural exporters, the Cairns group, sought greater export markets in the wealthy EC nations and Japan through a general lowering of trade barriers.[14] The irony here is also heavy, as the US was the major force behind excluding agriculture in the original GATT.

Agriculture was but one of six negotiating issues in the market access category of negotiations. Notable other elements in this category are tariffs, non-tariff barriers, and textiles. Two of the other categories address the reform of GATT rules and processes specifically regarding safeguards, subsidies, countervailing duties and dispute settlement. The final category incorporates new issues: trade in services, trade related investment measures (TRIM's), and intellectual property rights (also known as trade related intellectual property, or TRIP's). These new issues reflect the structural changes in the international economy that have made the advanced industrialized nations more information and service oriented. The desire of these countries (especially the US) to include them represents selfish motives -- they will likely be the gainers if such measures are liberalized -- but is also an attempt to get liberalization on backlog issues by trading access to "traditional" markets for access to markets on "new" (and previously protected) sectors.[15] The new

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14 The Cairns group consists of Argentina, Australia, Brazil, Canada, Chile, Colombia, Fiji, Hungary, Indonesia, Malaysia, New Zealand, the Philippines, Thailand and Uruguay.

15 This "grand" trade is unlikely to occur because the developing countries successfully pressed for a "dual-track" negotiating process, which separates goods and services. The developing countries are particularly concerned that trade in services and restrictions on TRIM's will substantially harm

areas also present new problems because they involve areas that are much less tangible and measurable than trade in manufactures or primary products. There is also resistance by developing countries, who, having begun to embrace free trade in the 1980's, fear that attention is again being shifted away from discussions over their perceived advantages to areas in which developed countries simply seek further dominance.[16]

> The last minute completion of the Uruguay Round has brought some potentially major changes. In addition to the above-mentioned extensions of GATT's authority, other major accomplishments were: rollback of agricultural subsidies, reduction or elimination of tariffs on major industrial goods, and a degree of liberalization in the services trade (*Financial Times*, December 16, 1993).

Whether these agreements are honored in the spirit of free trade remains to be seen.

V. The Rise of New Protectionism

The trade pessimism following the Tokyo Round will probably continue even with the successful completion of the Uruguay Round. Thus, the "new protectionism" demands particular attention in this note, because it reflects many of the current issues in international trade. Many commentators suggest that the erosion of trade liberalization reached critical mass in the mid to late 1970's (Baldwin, 1989; Gilpin, 1987; Bhagwati, 1988; Finger and Nogues, 1987; Pomfret, 1991). After that period, Bhagwati (1988) claims that the "dramatic conjunction of factors -- drawing on ideology , interests and institutions --that had certainly driven the engine of trade liberalization (p. 54)," was reversed and protectionist pressure increased. This pressure led to a variety of non-tariff protectionist policies. These developments have shifted the focus of the debate from how to reduce tariffs (which all agreed were barriers to free trade) to what constitutes an illegitimate barrier to trade. The lack of agreement on this question makes negotiations to reduce "new

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their bargaining positions with foreign investors, especially multinational corporations. An excellent overview of TRIM'sä is in Greenaway (1991). Balasubramanyam (1991) makes the case for freer trade in services in the same volume. The Uruguay Roun actually made progress in both areas, while developing countries were given mroe time to implement the reduction of service trade barriers.

16 The pyramid negotiating process implies that the largest economies dominate the issues and pace of negotiations, leaving developing countries little more than vetoes. In a significant development, developing countries have begun to exert a greater voice in the negotiations, by exercising vetoes and forming coalitions with smaller developed countries to press for certain issues. In addition to the Cairns group, the de la Paix coalition has been instrumental in negotiations over the functioning of the GATT. Winham (1992) notes that coalitions reflect an evolution of the GATT as a Parliamentary governing body. This has benefits in effectively reducing the number of interests to be reconciled. It also makes coalition interests more inflexible: beneficial for those with limited power but making it harder for the dominate economies to agree and then force decisions on smaller economies. Under deadline pressure, however, many details of the most recent agreement were resolved in US-EC negotitations and "forced" on other countries.

protectionist" barriers much more difficult. While simplifying, we can divide them into two general categories: those inside the GATT framework and those overtly outside of it.

A. "Within GATT" Protection: Industrial Policy and Countervailing duties

An area that increasingly prompts trade conflicts is the use of national industrial policies. A precise definition of industrial policy does not really exist. Interpretations range from picking "industrial winners" and subsidizing their development and expansion to using subsidies, tax policy and national product regulations to promote domestic structural transformation to government assistance in research and development at various stages of the product cycle. European countries, Japan and the Asian NIC's are often accused by the United States of picking winners or otherwise subsidizing their exports at various stages, as well as allowing their firms to practice differential pricing policies (higher at home than in their export markets). These nations counter that US industries enjoy an implicit industrial policy: access to defense contracts and government funded research and development programs.

Objections are also raised over adjustment subsidies in European countries. These often take the form of retraining of workers, tax breaks, local content legislation or specific technical standards which cannot easily be met by products for the international market. The purpose is to manage changing comparative advantage in order to dampen social disruption. Such barriers are extremely opaque. Though often involving policy areas that GATT leaves up to national determination , they can be consciously implemented to discriminate against imports.[17]

Changes in GATT rules establish a common basis for legitimate trade practice. Such rules are intended to ensure that domestic industries are not subject to unfair competition-- subsidized by specific export subsidies, or through dumping, i.e., selling goods below the market rate of the exporting country.[18] Both are considered contrary to free market principles, and the post- Tokyo GATT permits countervailing duties on such

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17 An excellent example is health and safety standards. On face, these seem reasonable prerogatives for nations to decide themselves and which will have minimal effects on trade, provided that they are appliedä to both domestic and foreign goods. However, when the EC banned the use of a growth hormone in cattle for health reasons, it substantially limited US exports because US producers often use the hormone to "beef up" cattle production. The US charged that this was thinly veiled protectionism instigated by EC beef producers who, even without the cost advantages of using the hormone, could not compete with US cattle ranchers. They claimed there was no health risk and that the EC was blocking US producers from using its comparative advantage.

18 The GATT does permit the use of subsidies to domestic industries in lieu of increasing tariffs on those goods. The effect on the industry is essentially the same, but, like with VER's they do not typically include concessions in other areas, except insofar as the government subsidies to one area make them less available to "infant industries" or other sectors.

actions to bring the price of the foreign good in line with "market" prices.[19] Since the GATT has no real enforcement power however, interpretation and action on these rules is left largely to the importing government's legislative and judicial process. This presents an easy opportunity for nations to "capture ... the mechanisms for maintaining fair trade ... as protectionist instruments" (Bhagwati, 1988, p. 48) and in the view of many trade economists, they have been. "Fair trade" responses are often strategically initiated by import competing industry to slow market penetration by exporters, drown exporters in legal fees or prompt negotiations for import quotas (see next section). The cost of bringing such charges is negligible and the national interpretation of the rules skews (or is perceived as skewing) decisions in favor of the domestic interest.

Since the definitions of unfair prices or what constitutes an export subsidy are in some dispute within the GATT itself, the significance of illegitimate impositions of countervailing or anti-dumping duties are hard to quantify. Most trade economists tend to look at the number of complaints filed under the countervailing duty provisions and conclude that their rapid acceleration in the late 1970's and in the 1980's presents compelling evidence of at least a move away from the basic tenet of free trade.[20]

B. "Extra-GATT" Protectionism: Voluntary Export Restraints, and Unilateralism

The use of arrangements for settling trade conflicts overtly outside of GATT stipulations has also accelerated greatly among the principle industrialized economies to the point where "there use has been gradually legitimized internationally (Takacs, 1991, p. 177)." These arrangements typically take the form of Voluntary Export Restraints (VER's) or Orderly Marketing Arrangements (OMA's), which are bilaterally negotiated and impose quantitative limits on a countries exports of a particular product, or class of a particular product, such as the Japanese VER on car exports to the US in 1981.[21] Developing countries, especially NIC's, are disproportionately the victims of such restraints. The extent of official VER's reported to the GATT has grown rapidly since the 1970's and may

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19 For a more detailed examination of interpretation of anti-dumping, subsidy and countervailing duty provisions after the Tokyo Round, see Grieco (1990).

20 The prevalence of each of these two approaches is not evenly distributed across the major economies.ä The US virtually alone in its use of countervailing duty actions, while the EC, US, Canada and Australia all tend to use anti-dumping claims. Japan has used neither to any appreciable degree. It and the NIC's are more often than not the victims of these claims. For more information see Finger and Nogues (1987).

21 OMA's and VER's essentially do the same thing. VER's are negotiated between governments, while OMA's are negotiated between industries or between the importing government and exporting industry (Winham, 1986). Here, VER refers to both. This is consistent with the trade policy literature, where it is often difficult to find a definition of OMA's.

not represent the true total.[22] Although globally most severe in the textile industries, VER's have also been negotiated by the US on such imports as cars, TV's, steel, and electronics from countries including Japan, Korea, and Brazil. The estimated extent of VER's in world trade is in the order of 7.5% for intra-OECD trade and 11.1% for OECD imports from developing countries. In particular areas (the US and EC) trade subject to VER's roughly doubled between 1981 and 1986 (Laird and Yeats, 1988).

It is difficult to say whether VER's *per se* constitute a threat to international trade liberalization. If they are considered merely a targeted (and discriminatory) form of preventing major disruptions in the adjustment process, they are within the GATT's "spirit" of orderly adjustment. The fear is that many VER's will go the way of an early VER was negotiated in 1955 between the United States and Japan on cotton textiles. It evolved into the current Multifiber Arrangement (MFA), which sets quantitative limits on textile exporters and products, and represents an evolving and growing *managed* trade regime, with more products and more exporters incorporated into the agreement. "From being a short-term measure to help temporary adjustment, arrangements to protect the industrial countries textile and clothing producers ... have acquired an air of permanence (Pomfret, 1991, p. 113)." Another fear is that VER's have become a popular way to call for "safeguards," yet get them without going through the GATT requirements of showing tangible harm and providing reciprocal tariff cuts.[23] Combined with the capture of GATT rules by domestic interests, protectionists can "talk GATT," while they close their borders.

Another major event signaling an erosion of GATT principles concerns recent US policies, variously labeled as "leveling the playing field" or "aggressive unilateralism." Many in the US argue that they have, now and historically, had a more open market than their competitors. Under Section 301 of the Foreign Trade Act, they seek to use the threat of tariff escalation to gain access abroad. This permits the US to pursue essentially mercantilist policies bilaterally, while countering protectionist pressure and embracing freer trade on *its* terms.[24]

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22 Price (1979, cited in Winham, 1986) suggests that there may be informal VER's in which powerful states simply "notify" smaller states that there are problems with the level of that country's imports, and the country limits its exports to that particular country. This may also occur between powerful trading nations. Recently, the Japanese auto manufacturers have "agreed" to limit production and export into the EC in response to conflicts over whether cars from their plants in the Britain are a part of their official VER (*Economist*, 1993a).

23 See fn. 8.

24 *Mercantilism* refers to the attempt to gain access to export markets exclusively for oneself, while keeping ones own market closed. Some current industrial policy is considered neo-mercantilist, and the term is often associated (though often erroneously) with the Japanese export success. Historically, it was used to maximize profits or gold specie for the state treasury, usually enforced by a powerful navy. It was against such policies that Adam Smith was reacting in *The Wealth of Nations*.

A major criticism of the policy is its criteria of a closed market. Unlike the GATT, which is more rules and procedure oriented, the gist of the US bilateral strategy in Section 301, is outcome and quantity based. For instance, the low foreign penetration in the Japanese semiconductor market led the US to conclude that the market must be closed. In response, the US demanded quantitative import initiatives in Japan. Bhagwati (1988) claims that such "voluntary import initiatives" are analogous to VER's. These outcome oriented approaches have spend more energy on trade diversion, i.e., merely shifting who the particular beneficiary of trade is, than on global trade expansion.

VI. The Rise of Preferential Trade Agreements

The final series of developments which cause many to fear the end of international free trade under GATT rules, is the growth of regional trade arrangements, exhibited in the expansion and economic integration of the European Economic Community, the US free trade agreements with Canada and Israel and Mexico.[25] There is continuing controversy as to whether such regional agreements are good or bad for the overall expansion of trade, independent of whether it threatens to undermine GATT principles, especially non-discrimination (Schott, 1989). For the present, we will look at the development of regional trade regimes, which can largely be viewed within the context of GATT, because they generally involve GATT members, and are, in theory compatible with liberalizing trade internationally.

First of all, the GATT allows regional free trade regimes. These are contained in Article XXIV, which also sets certain conditions for "GATT compatible" forms of "positive discrimination (Pomfret, 1991, Chapter 15)." The primary political reasons for the original acquiescence to free trade areas and customs unions was British desires for preferential treatment in the Commonwealth and US support of the formation of the EC.[26] Of course, it is the expansion and integration of the EC to more resemble an *economic union* that raises the most fears on the Western side of the Atlantic.[27]

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25 The focus on these two areas is obvious. They comprise a huge proportion of world trade and wealth, thus decisions in either area would have important repercussions for all countries. The issue of trade within and with the EC is particularly important because so much trade, approximately half of world trade, takes place between its member countries or the rest of the world (Pomfret, 1991).

26 Following World War I, French fear of Germany propelled them to "reparation" Germany into permanent economic weakness. The terrible outcome of that solution to European security (the rise of Hilter) prompted the US to support integration to constrain Germany's military threat (because of economic and material interdependence) while simultaneously permitting economic recovery in Western Europe.

27 An economic union is a common market in which there is coordinated or centralized economic policymaking, a common currency and other macroeconomic cooperation (Pomfret, 1991).

The analysis of the economic effects of PTA's was pioneered in Viner's (1950) still insightful book on the subject of customs unions. PTA's are typically thought of as "second best" alternatives to *global* free trade. The reasons for opting for second best will be discussed in the next section. A preface to those remarks is to recall that the international trade regime under the GATT is not strictly a free trade regime, but an attempt to regulate protection and encourage freer and "fair" trade. In that sense, if there is a continuum, the GATT is closer to free trade, but still probably a "second best" solution.

PTA's are by definition discriminatory. However, they can be globally *trade creating* or *trade diverting*. The difference between trade creation and diversion ranges from the obvious to the subtle. The devil is in the proverbial details. If, for example, integration produces a large increase in growth, imports would likely rise, just as growth in the 1980's, despite increasing protection, increased imports. If a PTA increased its total tariff barrier to outsiders, formerly uncompetitive industries within the PTA would divert trade globally. More subtly, trade diversion would occur if the reduced barriers to trade, freer capital movement and a larger market within a PTA, allowed PTA goods (formerly competitive or uncompetitive with imports) to become more competitive and if the subsequent absolute imports from greater growth did not exceed that "created competitiveness."

While the only generalization about the global effects of preferential arrangements is that there are none, they may be significant for the stability of the global trading system. The GATT and global free trade advocates stress the political importance of pursuing trade creation and avoiding trade diversion. Trade creation is an expanding pie scenario which encourages participants to cooperate. Trade diversion is more of a zero-sum game, in which nations are competing over a fix pie. It is more likely to result in the "beggar-thy-neighbor" attitude that many economists, political scientists and historians believe produced the trade wars of the 1930's and worsened the Great Depression.

A. Integration in Europe

In many respects the EC maintains protection across the range of goods at levels similar to the US and Japan. Its agricultural restrictions are much higher than in the US and they are also higher in several areas of manufactures. The wave of new protectionism has also increased barriers to trade in the last fifteen years, both outside and within the union, although Hine (1991) argues that such protection has leveled off or declined since the early 1980's.

Much of the issue revolves around which interests will dominate policy making in the unified market.

> There are some groups -- particularly in the more protectionist member countries like France and Italy -- who argue that the Community should move further in this direction [of high external tariffs] ... In present circumstances, there is little chance that such a view would prevail in the Council of Ministers. The leaders of Germany, the Netherlands, Denmark and the UK are well aware that Europe's prosperity depends on close involvement in world trade and the stimulus of global competition. These countries form a blocking minority in the EC council of Ministers against protectionist policies (Hine, 1991, p.92).

What is important to remember is that each particular commercial, social or financial policy which is integrated completely, or even partially, to the European "central" government may have trade creating or trade distorting effects. Even if integration isn't complete, any configuration of national and supranational powers can altered, turning an on-balance trade creating regime into a trade diverting one or vice versa. This no doubt explains the apprehension and the continuing uncertainty about the outcome. It also provides ammunition to all sides of the protectionist issue.

One of the general fears in the international community is that illiberal with respect to non-members, refusing them admittance, or granting it only under very stringent conditions. As the GATT itself concluded in its latest study of European economic integration. the EC has "improved access, transparency and legal security [for importers] in many sectors."[28] In addition to a European Free Trade Area which includes Austria, Iceland, Finland, Norway, Sweden and Switzerland, the EC has permitted preferential trade relations with Eastern Europe, with the promise of admittance into the EC's common market (*Economist*, 1993b,c). There are a number of other countries seeking admission. Such openness to outsiders, while not under the traditional multilateral assumptions of the GATT regime, can be viewed in a positive light, because it is moving in the direction of free trade covering larger and larger areas. On the other hand, the rest of the world fears that if the common trade policy closes the trading door behind these members, the result of "openness" to surrounding countries will simply be a larger fortress. Thus, the central commercial policy making arms of Europe -- the Council of Ministers and the European Commission -- become more and more important.

Hine warns that the uncertain future of Europe will likely go in the direction that America does. If this is true, one may have cause to worry about the international free trade regime, for the Americans have not only begun to impose protectionist measures, but have undertaken their own second-best solution, the North American Free Trade Agreement.

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28 Cited in *The Economist*, (1993h).

B. Canada-US FTA and NAFTA

In January of 1988, the US and Canada formally registered the Canada US Free Trade Agreement. (It was actually the second FTA signed by the US: a US-Israel FTA was created in 1985.) The US-Canada accord attempts rather explicitly to be as consistent with the GATT as possible, incorporating GATT language in some its provisions as well as making trade issues subject to revision, given changes in international trade rules through MTN's. On the whole, it is predicted that the regime will be trade creating, as it often reduces barriers to what were predominately US-Canada exchanges anyway. In addition, the agreement incorporates freer trade in new areas -- investment measures, government procurement and services -- that are on the table in the Uruguay Round. In that sense, it may contain a demonstration effect of the benefits of freer trade in these areas (Brown and Stern, 1989; Grubel, 1989).

Subsequent to the US Canada Agreement the US and Canada have largely completed negotiations to include Mexico in the Agreement, creating a North American Free Trade Area (NAFTA). The push to codify the agreement while leaving particular thorny issues-- large workplace, labor and environmental law discrepancies between Mexico and the northern nations-- for later adjudication, has received some, but probably not "life-threatening," resistance (Economist, 1993e,g).The US has also considered FTA type agreements with Japan, South Korea, Taiwan, ASEAN countries (Thailand, Indonesia, Philippines and Malaysia) and Australia.[29]

C. Other Preferential Arrangements

The GATT provisions allowing free trade areas has extended to many other areas besides the two Atlantic powers. In all, 69 FTA's and preferential trade agreements have been reported to the GATT, most of which have been dissolved. Only four were certified as meeting the GATT Article XXIV requirements (detailed notification to GATT signatories, comprehensive coverage of traded goods, and no increased barriers for third countries), while none were rejected as obviously violating the GATT.[30] Preferential arrangements have come and gone in Latin America, more recently resurfacing in Central America (*Economist*, 1993i; Edwards and Sevastano, 1989). ASEAN, has preferential

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29 For a more in-depth analysis of the prospects of these potential candidates for US FTA's, see Schott (1989). One of the effects of bilateral negotiations of this type is they bring a laundry list of potential candidates. Others potential candidates have included Poland and Chile.

30 The capability to be neither GATT consistent not GATT illegitimate is perhaps unique to international law. Basically, the violations were not obvious enough to justify censure, but were significant enough to prevent acceptance.

tariffs for its members, as do several African regional trade blocs such as Economic Cooperation of West African States (ECOWAS). On the whole, these regional blocs were of little concern to the industrialized economies or to the GATT system.[31] First, their markets were so small that they affected very little trade and their unified economies were so small that the distortions that they caused were only marginal. Furthermore, the GATT, both *de facto* and *de jure*, permitted developing countries to make their own trade policies under the special and differential treatment provisions.

The 1970's were notable for the emerging voice of developing countries in the international trade regime. Many of the developing countries had long been unsatisfied with the trade and financial arrangements of the post-war economic order (Whalley, 1989; Braga and Vasconcellos, 1991). At first, few developing nations were signatories of GATT. Many undertook development policies which eschewed the international trade system for the most part, attempting an semi-autarchic import substitution industrialization (ISI) strategy, promoted by Raul Prebisch and the UN's Economic Commission for Latin America (ECLA).[32] Following the recognition of the rights of developing countries to pursue "independent" trade policies in the Kennedy Round, developed nations conceded that they could not be held to the Tokyo Round codes, and inserted a "special and differential" formula to accommodate them.[33]

Although falling far short of developing country demands for a New International Economic Order (NIEO), developing countries were granted preferential concessions under a variety of bilateral and plurilateral agreements which ultimately authorized in the Generalized System of Preferences (GSP) that had been negotiated within the United Nation Commission on Trade and Development (UNCTAD).[34] The GSP system provides

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31 This is not always true. The US has considered negotiations toward an FTA with the ASEAN because they are large potential markets and their recent economic performance has been impressive.

32 Autarchy is a policy which seeks to restrict all trade and contact with the outside world. Such policiesä are virtually impossible, but the term is often used to refer to states like pre-1980's China and India among others, who attempted to limit imports of many manufactured products in order to develop these sectors. It generally corresponds with ISI.

33 The arguments for differential treatment are highly contentious. In theory, free trade allows poor countries to take advantage of their poverty (demanding lower wages) thus attracting investment leading towards more harmonized wage levels. The reality is much more complicated, due to terms of trade problems, limited factor endowments, smaller markets, limited access to large amounts of capital, consumer regulations in developed countries among other issues. The inability of the GATT to deal vary well withä the problems of developing countries reveals some of its limitations as a "global" free trade regime.

34 A list of these agreements notified to the GATT is listed in Schott (1989). The EC had taken the initiative provided in the Kennedy Round to implement a system of preferences in many former colonies, codified in the Lomé Convention in 1975. Unlike many GSP's, the Lomé Convention permits duty and quota free imports for many goods, and lower barriers to the EC's agricultural markets (Yannopoulos, 1988).

quotas at the developed nations discretion for goods that can be imported at preferential tariff rates. The goods covered are predominately light manufactures, not in products for which LDC's have the greatest comparative advantages, specifically agriculture and textiles (Braga and Vasconcellos, 1991). Major LDC criticisms of these agreements are: 1) They provide too much discretion to the developed nations, who are not obligated to maintain them and can decide when a country "graduates" from preferential status. 2) They are manipulated for both domestic and international political reasons especially by the United States (Whalley, 1989). 3) They serve to deflect attention from liberalizing trade in the areas that developing countries had the greatest comparative advantages, specifically agriculture, textiles and apparel. Despite these criticisms, developing countries continue to accept GSP's because the benefits are very large for them. Other critics of the schemes echo similar concerns, adding that the arrangements contribute to perpetuating bad development policy by LDC governments and that the wording of the exceptions permits free-riding by countries who should have "graduated" from the preferential schemes.[35]

VII. Explanations for challenges to GATT

Although few deny that the shift away from international liberalization towards increased protectionism has occurred, explanations vary greatly. Undoubtedly there are a number of factors that have encouraged new protectionism and the increasing importance of bilateral or non-multilateral agreements. Attention to the various causes and their relative importance is vital because different configurations of factors may imply different, and perhaps contradictory, solutions. This section discusses various explanations put forth for this resurgence.

A. Declining US Global Dominance

Many political economists subscribe to the idea that the international economic system's stability is a public good. As such, there is a tendency for individuals (states) in the international system to "pass the buck" on maintaining the system, preferring to shirk responsibility in lieu of capturing more benefits. Many maintain that the dominance of the United States following World War II permitted it to rebuild the international economic system. Although that system reflects many aspects of American economic thought (free markets, most-favored nation status, tariff reductions, and reciprocity[36]), the US was

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35 For specific commentary on LDC reciprocity and preferential status, see Milner (1991).

36 Most of these principles derive from US practice in the interwar years. The MFN concept was utilizedä in the 1920's. Reciprocity and tariff reductions were based on the success of the 1934 Reciprocal Tariff Agreements Act, which negotiated tariff reductions in the aftermath of trade wars of the 1920's and 1930's.

mostly willing to grant Japan and Europe leeway in some areas in exchange for general adherence and US leadership of the "free world." In essence, the US supplied the public good. This is not to say that it did not benefit immensely from it. Indeed, the success of GATT, or at least of the Western world has made the US very much richer, and a great deal more powerful than any country probably ever has been.

Whether one looks at the US action as self-interested or altruistic, its relative dominance has declined significantly. In areas pioneered by the United States, like high technology and financial services, the US faces competition from Europe and Japan. In traditional areas of manufacture, like automobiles, textiles, and electrical equipment, the US faces stiff competition from Japan and Europe, and NIC's. The combination of pressures produces a "double squeeze" on the industrial economies that has resulted in the national demand for slowing the decline of older sectors and speeding the development of new ones.

Some maintain that the large advantage that the US had over its competitors produced a slackening of competitiveness (Kindleberger, 1981; Olson, 1982; Gilpin, 1987). While this has probably been true in some sectors, it is often overstated. The US still retains large advantages in absolute productivity over most of the world. But the important point for those who use a "declining hegemon" analysis is that the United States is less willing *and* able to supply the public good. Some have suggested that the US has switched from using its hegemony to support the international trade rules to becoming a "predatory hegemon."[37] Such an explanation is consistent with its "aggressive unilateralism" policy mentioned earlier.

In both Europe and the United States declines in certain sectors, especially traditional ones like steel, leather goods and man-made textiles, were rapid and deep. The political implications of rapid and extensive structural changes in explaining increased conflicts in trade relations is well summarized by political economist Robert Gilpin (1987), who reflects how the system may be the victim of its own success:

> The political consequences of this diffusion of comparative advantages and the rise of new industrial powers are powerfully affected by the speed at which changes take place and how long is required for the rising challenger to take a significant share of world markets. The shorter the period, the greater will be the adjustment problem imposed on other states and the greater the resistance of domestic interests. Rapid shifts in comparative advantage give rise to intense economic conflicts between rising and declining economies. (p. 112)

B. Muddling Through

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37 See for example Conybeare (1985, cited in Gilpin, 1987). .

While the declining giant theory may be correct, it does not explain the form of response. Why not use traditional GATT mechanisms and temporarily raise tariffs in certain areas multilaterally rather than NTB's? There are several explanations, all of which may be compatible with free trade despite their deviation from GATT rules.[38] First, NTB's avoid mobilizing opposition that a tariff may provoke. This argument is true only to the extent that the policymaker prefers protection. (If the policymaker and some of his constituents prefer free trade, he would prefer to go public with the request, try hard, fail, and still get reelected by attributing failure to the system, not his efforts.) Second, they are preferred by industry for their more certain short term effects. Although there is a risk of new third country suppliers, asking for tariff hikes is perhaps more uncertain because the level of the tariff and thus its subsequent effect is unknown. Third, they generate rents for both producers. The restricted entity gets to charge higher prices for limiting entry, and domestic industry gets them too. This would clearly be preferred by the exporting country (or industry in the case of an OMA) and the domestic industry, as a tariff would be captured only by the government of the importing country. The preference for this in the US may also be explained by government opposition to direct structural adjustment assistance. VER's permit the equivalent of a subsidy to go directly to the affected industry.

Finally, some have pointed to the use of VER's to blunt attacks on the progress toward free trade made under the GATT. Bhagwati (1988), for example, while not convinced that it means there are not serious threats to free trade, sees VER's as having political efficacy for free traders. While VER's will definitely distort trade patterns, they are a much less drastic response than the GATT, consistent with the principles of non-discrimination and reciprocity, would demand. In order to deter backsliding on tariffs, the principle of nondiscrimination makes raising tariffs a significant undertaking, because they must be raised on all imports, thus causing injury to many countries. Consistent with reciprocity, the offsetting tariffs essentially would have to be re-negotiated with all affected countries. If the pressure for protection is intense because of sudden surges of imports from particular countries (which has often been the case in areas like electronics, cars and steel), VER's permit attention to be addressed but deflected, while permitting the exporting country to evade the VER and capture some of the income from it and letting new exporters enter the market.[39] Somewhat related to this interpretation of the positive aspects of the

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38 These are adapted largely from Takacs (1991) and Baldwin (1991).

39 Bhagwati observes that often the pressure for protection responds to sudden waves of imports from new, low-cost or high quality competitors. The pressure can be dissipated, while adjustment takes place, in several ways. First, VER's are easy to get around. Either by innovative exporting, such as breaking down the item into component which are not covered by the specific VER, or in the case of multinationals, shipping from another location, or by illegally exporting through third countries, the products can still be traded. Second, other countries will be encouraged to get into

current "new protectionism" is that it must bow to free trade and the GATT, e.g., abuse of the countervailing and dumping duties. Of course, this can become utterly meaningless if abusive definitions become the norm and then change the GATT rules.

Other political arguments for the rise of new forms of protectionism incorporate the "fair trade" aspects of the GATT. Like Bhagwati's optimistic interpretation of the rise of VER's, this could be viewed as an attempt to save the multilateral free trade institution in the face of opposition. Hence, US and EC countries impose countervailing or dumping duties on imports based on allegations of subsidized exports or a general lack of reciprocity, but within GATT rules. The US often points to its massive trade deficit overall and with particular countries in addition to the lack of imports in certain sectors of foreign markets as evidence of an "unlevel playing field." They use such evidence further as an example of how open borders may have detrimental effects if other's borders are closed. Such allegations are highly contentious and problematic however, because they may reflect a lack of adjustment or sluggish productivity growth in the US rather than unfair practices abroad.[40] Further, the governmental level (national vs. international) at which "dumping" prices or harmful export subsidies are determined and their overall impact (see next section) is often as highly politicized. Critics of such policies point to the disingenuous motivations of many proponents, specious economic arguments and the "more open than thou" attitude such policies presume but do not prove, pointing instead to a safer presumption of confining the adjustment process to international agreement or one's own economy (Bhagwati, 1990).

C. *Explaining Preferential Trade Areas: Faster, Easier and Freer Trade*

Impatience *and* disenchantment with the GATT process forms the basis of regional trade deals. First, GATT critics charge that the process is too slow. The Tokyo Round took seven years to conclude.[41] The Uruguay Round took seven to get started and remains

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the act, thus imports may continue to rise.ä In such cases, industry must still adjust, and free trade policy-makers can point to their efforts and drag their feet, even if the protectionist pressure does not subside. Baldwin (1989) argues furthermore, in a more rational choice approach, that particular protectionist pressures will subside as the domestic industry andä its political base withers and others, who are incidentally less threatened by a VER than by the effects of tariff offsets, will gain in political stature.

40 Economists agree that protectionism has little or nothing to do with the trade deficit. A current account imbalance is caused by low savings and a high deficit, making the US a net importer of capital. See Kreuger, 1990.

41 Jeffrey Schott (1989) argues that the Tokyo Round actually took less time: "In the Tokyo and Uruguay Rounds, the Ford and Reagan administrations, respectively, were only able to launch the negotiations and set out initial negotiating positions... In the Tokyo Round the "real" negotiations lasted only 18 months." (pp. 21-22) He also adds that such complaints can become self-fulfilling prophecies, when nations divert attention from the MTN process in favor of other

unresolved after seven years of official negotiations. This contrasts with five GATT rounds between 1948 and 1962 two between 1962 and 1979, rapid progress with European integration in the last ten to fifteen years, eighteen months to hammer out the US-Canada Agreement and about five years for the NAFTA. The second complaint is that there are too many interests (96 signatories) to reconcile too many complex issues (15 substantive areas) in MTN's, which operate essentially by consensus. Reducing issues to the lowest common denominator amongst such a heterogeneous group stifles more substantive gains that can be made among "like-minded" countries. Third, critics alleges that exceptions to the reciprocity and MFN rules allow countries to "free ride" on liberalization in other countries while legally keeping their borders closed. Finally, they maintain that the GATT enforcement mechanisms do not work, so there is little point in continuing to make commitments in a forum in which they will not be mutually respected.[42]

In order to overcome many of these criticisms that make the fist-best solution of global free trade unattainable, proponents claim that "less than multilateral," i.e., bilateral or plurilateral, agreements are preferable as second-best solutions. FTA's and the like offer nations that can agree the ability to promote freer trade faster, while preventing them from having to pay the unreciprocated costs of free trade to those who don't play by the rules. Such arrangements could permit freer trade either across the board (which would be acceptable in the GATT) or in particular sectors (which require a GATT waiver[43]). Additionally, they may permit the extension of free trade into areas not covered by the GATT, such as services, financial markets or agriculture (Grubel, 1989).

Another explanation often cited for regionalism by the US is that bilateral agreements are a bargaining chip with which the US can cajole or demonstrate a resolution of the Uruguay Round. Alternatively, some maintain that regional liberalization of sectors currently on the table in the Uruguay Round permits a demonstration or model of the benefits of liberalization in such sectors. The US-Canada agreement's inclusion of services was a conscious attempt to demonstrate the benefits of such liberalization. Finally, US policymakers who perceive that the US has been taken advantage of also see regional agreements as a means to signal their unwillingness to tolerate intransigence by other nations at the multilateral level, by creating alternatives to being a "sucker." A risk in this strategy is the implications of having their bluff called or of having that justification "captured" by more resolutely protectionist interests.

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plans. There are only so many trade negotiators and so much time. Furthermore, if the issues are complex it only underscores these true ability to have a dual-track option.

42 These are adapted from Schott (1989).

43 An example of a sectoral liberalization agreement is the US Canada Auto Pact (Morici 1989).

Another second-best proposals, somewhere in between a FTA like NAFTA and GATT multilateralism is are conditional MFN arrangements. The former seeks to make the "good" of free trade excludable. Those who play by the rules are permitted MFN while others are kept out and prevented from free riding.[44] As with the alleged trade creation benefits of customs unions, such answers depend on the details of how MFN is determined and how much trade creation a conditional MFN would produce. To some degree, such policies being considered in the Uruguay Round with respect to trade in services and TRIM's, as part of the dual-track negotiations on that topic.[45]

While most of the arguments about preferential trade areas point out that they expanding free trade and do not erect higher barriers to trade. The arguments against this approach are twofold. First, freer trade in some areas may create distortions from global comparative advantage and division of labor. Consider 3 countries: X and Y in the PTA, Z outside. Z is the cheapest producer of X's only import, but Y, which also exports to X may have a "created" comparative advantage by virtue of a PTA which it would not otherwise have had. Thus, Z loses despite being most efficient. The second is that these PTA will function like trade blocs in the event of an economic crisis, thus repeating the experience of the Great Depression.

D. Free Trade Reconsidered: The Rise of "Imperfect Trade" Economists

While the role of political interests and institutions plays a large role in defining policy, the role of ideas is becoming more and more recognized for the part it plays. Perhaps ideas are rationalizations for interests, but, we must admit the role of ideas in shaping the GATT and other aspects of the post-war order.[46] New developments in economics and trade theory are responsible for creating or at least amplifying attention to the possible benefits of deviating from pure free trade.

One of the major intellectual developments that justify deviations from free trade is theories of imperfect or oligopolistic competition and dynamic competition in certain industrial sectors developed by "imperfect trade economists" like Paul Krugman, James Brander and Barbara Spencer (Krugman, 1986).[47] Imperfect trade economists argue that

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44 One of the perplexing things about presumption that the GATT is non-exclusionary is that it is not. It excludes non-members. Not only are the former Communist countries examples, but Taiwan, despite its wish to join, has remained outside of GATT due to the feared reaction of the PRC.

45 See fn. 13.

46 These ideas come both from historical (Adam Smith, David Ricardo) and contemporary sources (Keynes). New ideas played a in the both the alternative development paths pursued by developing countries through the 1970's and their return to the free trade camp (Krueger, 1974)

47 The book cited here is a compilation of papers presented at a forum of academics and policymakers. One of the contributors, Laura D'Andrea Tyson, was a recent appointment to the President Council

many new industrial sectors are globally oligopolistic, due to the economies of scale, the benefits of learning by doing and the nature of modern production technology . With few producers, the assumptions of free market theories are less tenable, and thus the arguments for free trade and government non-interference are less appropriate. The upshot of much of this theory is that there may be sectors in which government subsidies or intervention may produce global gains even in an otherwise free trading economic system (Brander, 1986). Perhaps more problematic is that early intervention in an oligopolistic market may be necessary to capture any benefits, as it becomes more costly to attempt to enter the market too late.

Students of imperfect markets also note that there may be national advantages to having particular industries because their innovations are likely to have spillover effects. In some ways, this is similar to some of the arguments made for the imperative of industrialization for "real" development. Unlike ISI advocates of the past, these authors emphasize the highly problematic nature of identifying those industries and the optimal intervention as well as the potential making things worse through intervention:

> ... I will not deny that strategic export promotion could in principle be beneficial, but I will suggest instead that it is equally possible that it would be economically harmful and that the policymaker has no systematic basis for identifying instances where the former is true rather than the latter. In other words, the efficacy of any targeting policy ultimately rests on its criteria for selection and the information that would be required to implement a successful policy of strategic export promotion along the lines suggested by the Brander and Spencer analysis is well beyond what economists or industry analysts could reasonably hope to provide. (Grossman, 1986, p. 48-49)

When one considers the possibility of other nations retaliating in the face of strategic trade policies (a condition often missing from the economists' models) carrying out a strategic trade policy is truly perilous. Allegations by US or other officials that other countries are engaged in such policies are rife. However, to believe that Korea or Japan engages in such surgical promotion must appeal to *luopan* and *feng shui* advisors imported from Hong Kong rather than economics.[48]

What Grossman does not add here, but which he and many of those studying imperfect markets are aware of, is such a possibility provides another bullet for protectionists. Trade policy has been dominated by the economic theory of the benefits of a free market. Imperfect competition models do not deny the values of generally free markets, but they lay an important, and potentially revolutionary seed that objectively, or as

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of Economic Advisors. This underscores the reality of the intellectual bases of business and government policy.

48 For more details about this form of Chinese mysticism in business, see Hornik (1993).

objectively as economics can be, legitimates some protectionist sentiment. Paul Krugman (1986), one of those working on imperfect markets, tells us how free trade may be demystified:

> Fifteen years ago economists could and did assert that so little was known about the implications of imperfect competition for international trade policy that nothing useful could be said on the matter. There is still considerable uncertainty, but not so much that economists are without useful insights (p. 12)

VIII. Conclusion

The past fifteen years provide grounds for questioning the commitment of the major industrial economies to multilateral free trade. First, domestic demands in developed countries have produced *protectionist "innovations"* that either manipulate agreed to rules, such as the GATT's safeguard provisions, or openly flaunt them, as in the case of VER's. Second, early *exceptions to the non-discrimination principle*, often made for geo-political as much as political economic reasons, have produced contentious trade politics through much of the post-World War II era. Though these preferential trade agreements are widespread deviations from GATT guidelines, it is not clear that their effect on trade liberalization is more negative than positive. Third, the demands for structural transformation in the United States, the backbone of the modern trade system, has provoked what may be an attempt to "level the playing field" by unilateral force. These policies can be attributed, in part, to *a decline in American hegemony* and a consequent unwillingness to provide the collective good of trade system stability. Finally, *new ideas* have undermined the dogmatic assumption that free markets are always even theoretically the first-best policy. Despite these problems, world trade continues to grow and barriers remain at low levels.

The Uruguay agreement appears to be more than mere "muddling through." As in all negotiations, a number of irresolvable issues were simply eliminated from the text. However, a number of substantive reforms would restrict the ability of the EC and US from imposing NTB's. The importance of rule reform was essential in remedying the use of VER's and other extra-GATT safeguard measures. Still, this will not eliminate the domestic sources of protection, nor will it prevent the government from more informally "suggesting" that nations restrain their exports or increase their imports.

However, it would be erroneous to assume that the failure of progress in the GATT rounds or the continuation of protectionist pressures would lead to a return to the protectionism of the 20's and 30's. Nations and production processes are much more interdependent than they were during any point in history. This means that there are a greater number of exporters, who have direct interests in keeping markets open.

Additionally, the organization of consumers, generally the ultimate beneficiaries of freer trade in the form of lower prices, is much higher now than in the 20's and 30's, and may provide further resistance to substantial reversals in generally free trade.

Table 1. GATT Negotiating Rounds.

Round Name and Location	Date	Number of Participants	Major Trade Issues
Geneva, Switzerland	1947	23	tariffs
Annecy, France	1948	13	tariffs
Torquay, England	1951	38	tariffs
Geneva	1956	26	tariffs
Dillon Round (Geneva)	1960-61	26	tariffs
Kennedy Round (Geneva)	1964-67	62	tariffs and some NTB's
Tokyo Round (Geneva)	1973-79	99	NTB's and tariffs, enforcement and dispute resolution
Uruguay Round (Geneva)	1986-93	117	NTB's, tariffs and new areas (services, TRIP's and TRIMS), enforcement and dispute resolution

Source: *Financial Times*, 1993.

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Trade Laws and Institutions: Good Practices and the World Trade Organization

by

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Implementing all the rules and principles of the WTO will do much to reduce the extent to which the trade policy regime of a country distorts incentives. However, much also remains discretionary, especially for developing countries. Full consistency with WTO requirements is therefore neither necessary nor sufficient to ensure that the trade policy formation process will not be captured by rent-seeking lobbies. A great need remains for careful institutional design, and a deliberate and conscious decision whether to exercise the various options allowed for under the WTO, both the 'good' and the 'bad'.

* This paper is part of an ongoing effort in the Technical Department to monitor and disseminate information regarding multilateral trade policy developments and good practices in this domain to the ECA/MNA Regions. Thanks are due to Will Martin, Petros C. Mavroidis and Alan Winters for comments on an earlier version. The views expressed are personal and should not be attributed to the World Bank.

Summary

Trade laws, policies and institutions play an important role in determining the competitive conditions prevailing on domestic markets, the sustainability of trade liberalization, and export performance. It is increasingly recognized by policymakers seeking to enhance competition on domestic markets and promote export-oriented production that a narrow view of trade policy--basically comprising the set of tariffs or quotas that are applied at the frontier--is no longer appropriate. Trade policy can be defined to encompass all policies that imply discrimination against foreign products/producers, or between foreign sources of supply. It pertains to goods (tangible products), services (intangible products), and knowledge (intellectual property). Consequently, trade policy more broadly defined extends also to government procurement practices, the development and enforcement of product standards, or the regulations affecting inward and outward foreign direct investment (FDI). FDI is often the preferred route for foreign firms to contest a market, and is often the most effective way for the host nation to obtain new technologies, enhance the security of access to export markets, or increase the efficiency of the service sector.

A distinction should be made between trade policy and trade laws and institutions. Policy comprises an action taken by a government, presumably to meet a specific objective. Usually, a mix of fiscal and income redistribution considerations underlie the use of trade policy. The trade laws and institutions constitute the framework through which policy is developed and implemented. Careful design of institutions and procedures is very important in order to reduce the scope for capture of the policy formation process is not captured by special interests. Equal care should be taken with respect to implementation of trade policy. The effective level of trade barriers is determined not only by the tariffs and quotas that are formally imposed by means of legislation, decrees and regulations, but also by the administrative procedures used to implement policy. For example, the procedures used to classify, value and process imports in conjunction with discretionary granting of exemptions may be such as to imply that 'effective' tariffs are quite different from statutory rates.

A country may participate in international agreements that affect both institutional design and trade policies. The General Agreement on Tariffs and Trade (GATT) imposes a variety of disciplines on trade policies of member countries, the most important being its nondiscrimination rules. With the creation of the World Trade Organization (WTO) as part of the outcome of the Uruguay round of multilateral trade negotiations, multilateral disciplines on a large variety of trade-related policies has been extended to all GATT members. The first part of this paper provides a summary of the relevant disciplines of an institutional nature of the trade agreements administered by the WTO: the new GATT (or 'GATT-1994'), the General Agreement on Trade in Services (GATS) and the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPs). An understanding of the WTO's rules and disciplines is important for decision makers in any country, but is of particular relevance for countries in Europe and Central Asia, and the Middle East and North Africa. Many of the countries in these regions are currently not GATT members, but a substantial number of them have submitted a request for GATT/WTO membership. Accession working parties have already been established by the GATT for 15 countries in the two regions: Albania, Algeria, Armenia, Belarus, Bulgaria, Croatia, Estonia, Jordan, Latvia, Lithuania, Moldova, Russia, Saudi Arabia, Slovenia, and Ukraine. These

countries account for most of the current 'accession queue' (which totaled 21 applicants as of April 1994). Many other countries in the region are already GATT members, and will therefore be directly affected by the substantive obligations implied by the various provisions of the WTO (e.g., on customs valuation, product standards, or intellectual property protection).

The second part of this paper assesses the adequacy of the various WTO rules and obligations from the perspective of economic efficiency and private sector development. The WTO is an attempt in international cooperation between sovereign states. It's existence reflects the fact that it allows States to overcome political constraints that inhibit unilateral adoption of policies that increase national economic welfare: more liberal trade policies. While the WTO is a far-reaching agreement that goes significantly beyond pre-existing GATT disciplines, full implementation is not sufficient for governments concerned with maximizing economic growth and constraining the incentives for interest groups to invest productive resources in rent-seeking lobbying activities. The objective of the WTO is to limit the potential for governments to impose negative externalities upon other countries when implementing trade policies. The focus of attention is therefore on the effect of policies on *other* countries; not on the effect of a government's policies on its own economy. While the agreed set of rules are presumably in each signatory's interest (otherwise they would not join), it does not follow that the WTO's rules and disciplines are optimal from the perspective of a government that implements trade policy. The question to be posed then is to what extent the WTO helps a government in adopting policies that are efficiency enhancing.

The WTO

Although the WTO will certainly help, the extent to which it provides support in this connection depends greatly on the decisions that are taken by the Government. Membership of the WTO may help increase both the credibility of trade policy reform, in part by allowing governments to resist demands from politically influential interest groups for altering policies in the future. Both the general principles and much of the specifics of the WTO's rules are efficiency-enhancing. While adherence to WTO rules and principles can clearly be of great value to a country in terms of increasing the credibility of reform-minded governments, there are blemishes, some of them important. Many of the WTO's disciplines are optional, either in the sense that members have discretion regarding the extent to which they apply (i.e., their coverage), or have a choice whether to invoke them. A useful distinction can be made between the possibilities that exist to opt out of disciplines that are 'good' in that abiding by them is likely to be efficiency and welfare enhancing to a country, and the possibilities that exist for opting to use measures that are permitted, but are likely to be detrimental to efficiency and welfare. Examples of the first category of 'options' are the magnitude and restrictiveness of tariff bindings, participation in the procurement agreement, and the specific commitments made under the GATS. Examples of the second set of 'options' are use of antidumping, balance-of-payments safeguards, and participation in regional integration. It is also useful to distinguish between a country's own policies affecting access to its markets and the policies maintained by trading partners. The lower barriers in export markets and the greater is the security (stability) of that market access, the better it is for export-oriented producers. The extent to which the WTO's 'options' are invoked by its member countries largely determines the incentive structure facing firms and consumers. Limiting the extent to which the 'bad' options are exercised and maximizing the extent to which

the 'good' options are exploited is, however, a matter for which each national government bears the primary responsibility.

Implementing all the rules and principles of the WTO will do much to reduce the extent to which the trade policy regime of a country distorts incentives. Although much is required, much also remains discretionary, especially for developing countries. This is really the key issue as far as the impact of the WTO on trade policy stances and market access conditions are concerned. Tariffs facing developing country exporters in OECD markets were already low before the Uruguay round started. What mattered was the restrictive quota regime applying to textiles and clothing, and enhancing the security of market access. Indeed, the MFA can be considered to be a subset of this issue, reflecting the non-functioning of GATT's safeguard provision during the 1970s and 1980s. As noted previously, security of market access is not only a matter of external concern, i.e., access to export markets. Equally, if not more, important is the degree of uncertainty confronting importers in a country that must have access to inputs at world market prices if they are to be able to compete on global markets. For many developing countries the issue of contingent protection has not been a priority, given the often high levels of import tariffs and extensive use of quantitative restrictions and associated licensing requirements. But, both aspects of the trade regime are to some extent 'optional', in that developing country governments have substantial discretion what and how much to bind, and are consequently relatively free to impose or raise trade restrictions.

Full consistency with WTO requirements is therefore neither necessary nor sufficient to ensure that the trade policy formation process will not be captured by rent-seeking lobbies. A great need remains for careful institutional design, and a deliberate and conscious decision whether to exercise the various options allowed for under the WTO, both the 'good' and the 'bad'. The focus of the WTO is on the multilateral trading system, not on minimizing the domestic welfare cost of trade policies that are pursued by a government. This leaves substantial scope for maintaining a trade policy stance that is much more distorting (inefficient) than is necessary to achieve a given objective. There are no requirements regarding the dispersion of protection across industries (whether in nominal or effective terms); no rules relating to the granting of tariff preferences and exemptions to specific domestic groups or agencies; no disciplines on many kinds of subsidies (and even prohibited subsidies may be maintained, subject of course, to countervail or retaliation by affected trading partners); no endorsement of--or general rules for--the adoption of duty drawback or temporary admission mechanisms for imported inputs; and no rules relating to the use of countertrade. Many of these aspects of the trade regime that is maintained by a government are, of course, of great importance. This study does not discuss the issue of the design of trade reform programs at any length, as these have been summarized in a number of World Bank studies. The focus is rather on a discussion of the holes and loopholes in the WTO and the options available to 'close' these holes.

Towards Good Practices

This paper assumes that the fundamental objective of the design of trade policy *institutions* is simple: tame the rent-seeker (Koford and Colander, 1984). Achieving this is difficult, and will depend in part on the specifics of individual countries. However, some general principles are by now well known. Assuming for purposes of discussion that trade taxes are not

the primary revenue generating instrument available to the government, good practices should build upon a recognition that trade policy is an inefficient redistributive instrument. A first requirement then is that the net cost to the economy of a policy is determined (both estimated *ex ante* and monitored *ex post*), and the incidence of the implicit tax is identified. The best way this can be done is by an agency that has a statutory mandate to determine the impact of a trade policy on the economy, both in terms of efficiency (resource cost) and equity (income redistribution). One option in this connection is to give this mandate to the competition law enforcement agency; another is to create an independent agency to fulfill this role. The policy formation process should give a voice to all potentially interested parties, whether they stand to gain or to lose, with final decisions should be taken/approved by an entity that has an economy-wide focus (for example, the Prime Minister's office or the Ministry of Finance).

To reduce pressure for intervention in trade, participation in international agreements that bind a government to a policy stance can be helpful. Agreements such as the WTO both creates pressure for liberalizing access to markets over time in a way that may be both politically more feasible than unilateral action (by providing domestic export-oriented interests with benefits that offset to a greater or lesser extent the losses incurred by protected industries) and locks in the result. As noted previously, this requires that the WTO be implemented to the fullest extent possible by binding tariffs at applied rates and scheduling all service sectors in the GATS, joining the main remaining 'voluntary' discipline, i.e., the Government Procurement Agreement, and pursuing mutual recognition agreements relating to conformity assessment and certification (GATT Standards Agreement), and professional qualifications (GATS), and so forth.

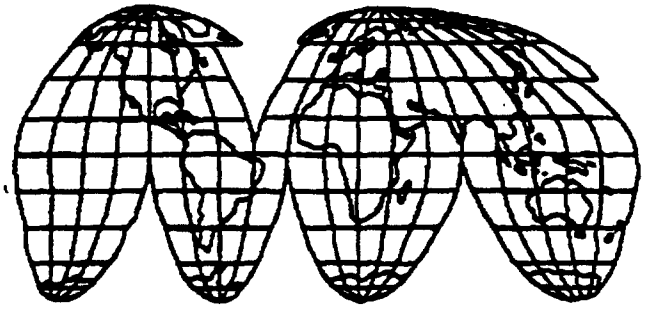
Another requirement is to maintain control over the mechanism through which industries may petition and obtain temporary protection against import competition. In most circumstances there will be a political need for such a mechanism, if only to 'sell' trade liberalization. It is important that only one safeguard mechanism exist under which temporary protection can be granted with a view to facilitating its restructuring. In practice, the safeguard mechanism foreseen under Article XIX of the GATT should be more than adequate to allow domestic import-competing industries to obtain some temporary relief from foreign competition. If it is politically impossible to abolish instruments such as antidumping (the first best solution), competition policy or appropriately defined national welfare ('public interest') criteria should be used in its application, and procedures defined that are neutral (unbiased) with respect to determining if dumping has occurred.

Allowing policies to be challenged before the domestic courts for violation of international (i.e., WTO) commitments is a mechanism that can be used to help enforce international treaty obligations. While this is quite far-reaching, as it implies that a Member decides that the WTO creates rights (and obligations) for individuals, taking this step would greatly increase the strength of WTO disciplines, inducing greater confidence in the commitment of a government to a liberal trade policy stance. The best illustration of this has been the role of the European Court of Justice in enforcing the provisions of the Treaty of Rome regarding the establishment of the common market.

The best trade policy is free trade. While few countries have achieved this, an increasing number are pursuing it, both unilaterally and in the setting of regional agreement. The WTO can

help achieve this goal by 'ratcheting' moves to lower tariff rates by binding reductions in barriers through the GATT and the GATS. There is potentially also much to be gained from pursuit of regional integration agreements if these are WTO-consistent (full free trade) *and* go substantially beyond the WTO as regards their coverage (i.e., include factor mobility and eliminate contingent protection). Recent vintages of the Association Agreements that have been negotiated between the EU and partner countries go some way towards meeting these conditions, although agriculture and contingent protection are important blemishes. Such agreements may help a government more than the WTO in terms of locking-in trade policy reforms and increasing their credibility as this is a requirement, not a choice. An Association Agreement with the EU can be beneficial in terms of 'upgrading' the regulatory environment to be more conducive to private sector development. A large component of the Association Agreements agreed between the Central and Eastern European countries (CEECs) concerns the regulatory regime pertaining to capital flows (especially foreign direct investment), contestability of service markets, and the application of competition law. The fact remains that preferential liberalization among a subset of nations is inferior to multilateral liberalization. Free trade agreements with the EU must therefore be accompanied with a trade policy stance vis-a-vis the rest of the world that is broadly similar to that applied to the EU to ensure that costly trade diversion does not eliminate many of the potential welfare gains associated with opening up the domestic market to competition from European firms.

The Uruguay Round Agreement on Agriculture: An Evaluation



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Bringing Agriculture into the GATT

The Uruguay Round Agreement on Agriculture: An Evaluation

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The Uruguay Round Agreement on Agriculture: An Evaluation

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PREFACE

The International Agricultural Trade Research Consortium, an informal association of university and government economists interested in agricultural trade, has taken a keen interest in the Uruguay Round and the negotiations on agriculture from the inception of talks in 1986. This paper is the ninth in a series of Commissioned Papers that have attempted to monitor and interpret the progress of the negotiations and in a modest way to provide a platform for ideas. This last paper completes the story of the negotiations and adds the element of evaluation. The set of papers as a whole provide a chronicle of the changing concerns over the seven and a half year period.

The present Commissioned Paper is the work of a team of authors, under the Chairmanship of Tim Josling. Each co-author contributed a section for the paper and participated in reading and improving the other sections. The drafting responsibilities, reflecting, geographical expertize, were as follows: Chapter 4 (the United States) Sumner; Chapter 5 (the EU) Tangermann; Chapter 6 (Canada) Miner; Chapter 7 (Australia and New Zealand), MacLaren; Chapter 8 (Japan) Honma and (Korea) Lee; Chapter 9 (Latin America) Valdes. Josling, Tangermann and Miner drafted Chapters 1-3 and 10. Hyunok Lee translated the Korean section. Claudia Smith processed the manuscript. Though not necessarily agreeing with every sentence in the text, each of the authors wishes to be associated with the entire report.

The paper has benefitted from careful review by several people with official responsibilities for the content of agricultural trade policy in Ottawa and Washington, D.C. We thank them, but grant them the anonymity that they request. Other reviewers we can mention are Kym Anderson, Dale Hathaway, Scott Pearson and Sandy Warley, each of whom gave us insightful comments and helpful editorial suggestions.

We were anxious to provide a readable yet reasonably detailed interpretation of the agricultural component of the Uruguay Round to inform IATRC members and others. We hope we have not sacrificed accuracy for speed or brevity, but would refer readers to the official texts and Schedules on any specific matter of detail or language.

A note about terminology might help to prevent confusion. We have chosen to refer to the twelve countries of the European Community (EC) by their new name (since November 1993) of the European Union (EU) even when the reference is to a time when the EU did not exist. Though the EC does technically still exist, as a "pillar" of the EU, usage has shifted rather quickly to the new name. We have however chosen to refer to the GATT, both as an institution and as a set of articles, even though this is to be only one part of the new World Trade Organization (WTO). Technically speaking, the GATT (1947) Agreement, which current contracting parties (i.e., members) have accepted, has been converted into GATT (1994), through the Uruguay Round outcome. Countries can still be signatories to GATT (1947) but not GATT (1994). However, most countries will accede to the WTO, which includes GATT (1994) along with the General Agreement on Trade in Services (GATS) and the Agreement on Intellectual Property Rights (TRIPS). Thus one can still talk of GATT as being the set of trade rules for goods (including agriculture), if no longer as a separate institution.

List of IATRC Commissioned Papers on the Uruguay Round

1. Assessing the Benefits of Trade Liberalization
2. Designing Acceptable Agricultural Policies
3. Negotiating a Framework for Action
4. Tarification and Rebalancing
5. Potential Use of an Aggregate Measure of Support
6. Reinstrumentation of Agricultural Policies
7. The Comprehensive Proposals for Negotiations in Agriculture
8. Reviving the GATT Negotiations on Agriculture
9. The Uruguay Round Agreement on Agriculture: An Evaluation

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Executive Summary

From the start, agriculture played a central role in the Uruguay Round of GATT trade negotiations. The Punta del Este Declaration called for a solution to the problems facing agricultural trade through modified trade rules and an agreement to lower protection levels. It was recognised that such an improvement implied negotations on the national farm policies as well as just trade policies. The time that it took to reach agreement reflected the political sensitivity and technical complexity of this task.

The Agreement embodied in the Final Act of the Uruguay Round breaks new ground for agriculture, and takes a big step towards placing this sector of world trade under rules more consistent with those in operation in other areas. However, the degree of liberalization of markets is modest, and much remains to be done in future rounds of negotiations.

The most far-reaching element in the Agreement is a change in the rules regarding market access. With very few exceptions, all participating countries have agreed to convert all existing non-tariff barriers (along with unbound tariffs) into bound duties and not to introduce new non-tariff measures. Negotiators agreed to reduce these new bound tariffs, as well as tariffs already bound earlier, according to Schedules included as a part of the Agreement.

"Tariffication" will impose changes in import policies for a number of countries. Canada will replace import quotas for dairy and poultry products with tariffs, initially at a high level. The European Union will replace its variable levy with tariffs, though a maximum duty-paid price for cereals has been negotiated which puts a limit on the tariff charged. Latin American countries have generally engaged in tariffication in recent years in advance of the Uruguay Round Agreement: for these, and other countries their tariffs will now be bound. The US will forgo the use of Section 22 import quotas and the negotiation of voluntary export restraint agreements with beef suppliers, but the impact on these markets is likely to be small. Japan and Korea have been allowed to delay tariffication in the case of rice for the next few years.

The Agreement provides in cases of tariffication for "minimum access opportunities", to guard against the impact of high initial tariff rates. This will open up reduced-tariff quotas for a number of products including beef, cereals and fruits and vegetables. The quotas will be expanded to about 5 percent of consumption over the 6 year period. Japan and Korea have agreed to a greater expansion of market access for rice in compensation for the delay in introducing tariffs.

The ability of countries to control export subsidies in agricultural markets was one of the main issues under discussion in the negotiation. Under the Agreement, countries accept commitments on reducing expenditure on export subsidies as well on the quantity of subsidised exports. This will limit export subsidies by the EU and other countries, for such products as wheat, dairy products and beef, and should lead to firmer world market prices in these commodities. These quantities are also expressed in the Schedules which form part of the Agreement. Countries have also agreed not to apply export subsidies

to commodities not subsidised in the base period.

The Agreement also sets rules and commitments for domestic support policies. It defines a set of policies which are deemed to be less trade-distorting than others, and allocates them to a "green box" which is broadly immune to challenge. Other policies not sheltered in this way are subject to reduction through a limit on the total support given by domestic subsidies and administered prices. It was decided that neither the U.S. deficiency payments (under current legislation) nor the new hectarage compensation payments under the reformed Common Agricultural Policy of the EU need to be reduced. It was also agreed that subsidies that conform to the new rules are sheltered from international challenge under the GATT.

Developing Countries generally face less stringent commitments, having 10 years rather than six to make the changes, and having to meet only two-thirds of the reduction targets. In addition, development policies are included broadly in the "green box".

Along with the provisions on domestic and trade policies in the Agreement, participants also concluded an Agreement on Sanitary and Phytosanitary Measures (the SPS Agreement). The goal was to make it easier to distinguish between genuine health and safety issues and disguised protection. The right of countries to set their own safety and health standards is reaffirmed, but with the proviso that such standards should be based on scientific justification and that use be made of international standards where possible.

The extent to which the Agreement will lead to greater market access, curb export subsidies and modify domestic policies in the next few years can only be determined from a detailed inspection of the Schedule of commitments made by the individual countries. Paradoxically, the immediate impact on national policies is likely in most cases to be small. Many countries have been engaged in a process of reducing government support to agriculture, and making such support more closely targetted to needs, in advance of the outcome of the Round. Policy reforms in the EU, Canada, Sweden, Australia and New Zealand, along with much of Latin America, have been strongly influenced by the negotiations in the Uruguay Round. The Agreement thus takes on the task of supporting and locking-in such reforms, and encouraging them in other countries.

In some aspects the Agreement falls short of expectations (or at least initial demands). It does not constitute a major move toward free trade in agricultural products: the cost of changing the rules has been to give up some degree of liberalization. The tariffs which countries will impose in place of non-tariff barriers are in many cases so high that trade will be restricted to the agreed access quantities. Export subsidy programs will continue though at a reduced level. The major pressure to reinstrument farm policies will continue to be from domestic budget constraints. It will take further rounds of negotiations to reduce protection in agricultural markets to a level comparable to that for most manufactured products. However, with the rule changes and the new types of country commitments agreed, a much more promising basis has been created for future negotiations.

Chapter 3. Issues in Implementing the Agreement on Agriculture

The Agreement on Agriculture takes a big step in the direction of "bringing agriculture fully into the GATT". However, in some aspects the Agreement falls short of expectations (or at least initial demands), and some of its elements may also turn out to cause difficulties when it comes to implementing Agreement provisions. The extent to which this is the case differs among the major areas covered by the Agreement.

The particular way in which the conversion of non-tariff barriers into tariffs has been achieved in the Agreement has sometimes been called "dirty" tariffication, because the initial tariffs from which reductions start are often very high, sometimes several hundred percent. In part this reflects the high rates of protection in agriculture. But governments have often searched for price data for calculating base period tariff equivalents that result in high tariffs compared to the actual level of protection in the base period.[8]

Moreover, the simple (unweighted) averaging that countries could use when allocating tariff reductions to individual products has allowed much scope for continued protection of the "sensitive" products. Even the requirement of a minimum reduction by 15 percent has not really helped very much. It was possible for a country, say, to reduce tariffs on three items with an initial tariff of more than a hundred per cent by only 15 percent each and still meet the overall 36 percent unweighted average by reducing by 100 percent the low initial tariff of another product. The dispersion of rates of protection across agricultural products could become more pronounced after the Agreement, causing trade to become more, rather than less distorted.

The Special Safeguard Provisions may also reduce the benefits of tariffication. If trade expands, as one would hope under an agreement supposed to result in liberalization, the quantity trigger safeguard provision is likely to be invoked by many importers. The price trigger provision could also be relatively often applied if countries were allowed to use trigger prices that are high compared to current international market prices. For markets subject to tariffication, there is the risk that the use of safeguard provisions will become the rule, rather than the exception, though it should also be pointed out that trade subject to the high above-quota tariffs is likely to be small. It also remains to be seen how the implementation of these provisions will affect the equity of trading activities. The quantity trigger provision has a tendency to treat imports in the latter part of a year worse than those coming in early, and the price trigger

[8] For a fuller discussion of the process of tariffication see Josling and Tangermann, 1994.

provision is presumably to be applied on a shipment-specific basis, which can lead to a previously unknown degree of price differentiation in agricultural trade.

The minimum access provisions, to be implemented through tariff-rate quotas, entail many of the problems that quantity-oriented trade policies usually have. Where they are effective, in the sense that imports actually come in under the reduced tariff, rents will result. Hence, there is a need to find appropriate ways of allocating tariff rate quotas to traders. Governments of importing countries will want to allocate licenses to their domestic companies, and exporters are unlikely to receive any price advantage. Issues may arise out of the fact that minimum access commitments have sometimes been undertaken for relatively large aggregates of products, such that importing countries have wide scope for choosing the "appropriate" allocation to individual products.

Finally, the Special Treatment provisions in the form of the "rice clause", apparently necessary to bring Japan and Korea aboard the Agreement, are a delay in the implementation, if not a breach in, the principle of tariffication. Two other countries have also made use of the rice clause: the Philippines (for rice) and Israel (pigmeat, cheese, and milk powder). It remains to be seen whether there will be attempts to extend the delay allowed under these provisions. In any case, a number of issues may arise, some of which may bear similarity to issues that have come up in the protection of "old" Article XI:2(c), such as that of "effective production restricting measures".

Given the traditional preponderance of export subsidies in agriculture, the reduction of both outlays and quantities required by the agreement looks like a straightforward approach. The wording of Agreement rules in this area and the existence of quantitative commitments in country Schedules are so much clearer than the earlier vagueness of the "equitable share" that it is difficult to find anything wrong with this element of the Agreement. However, the quantity constraint on subsidized export, useful as it may be from a pure trade perspective, can push governments of exporting countries into more and strengthened supply controls. This danger of growing government inference with domestic markets is troublesome and is not in line with the Uruguay Round's avowed aim of fostering a more market-oriented agriculture.

As in the case of minimum access commitments, export subsidy undertakings come in the form of relatively large commodity aggregates. Governments, therefore, still have the possibility of creating problems for each other in the area of export subsidization, by shifting the product

composition of their subsidized exports such that different competitors are treated differently.[9] Moreover, within the constraints on expenditure and quantities, there is no restriction on country targeting of export subsidies.

Domestic subsidies are the least impacted by the quantitative provisions of the Agreement. The "domestic" support provisions of the Agreement act as constraints on the total level of support, whether provided through border measures or through domestic subsidies. Subsidies for individual commodities are not separately constrained, nor are particular policy instruments. Given the numerical parameters of reduction commitments in the areas of market access and export competition, it could well happen that all the reduction required in AMS is effectively achieved through liberalization of border measures. Where that is the case, domestic subsidies in the narrow sense need not actually be brought down and could even be raised, even though overall protection is reduced.

The extent to which the definition of the "green box" will become a problem must be awaited. The general criterion for domestic measures exempted from reduction ("no, or at most minimal, trade distortion effects of effects on production") is laudable. Not all of the policies included in the illustrative list of exempt policies in the Agreement would always fully meet this criterion.[10] On the other hand, all of the policies on the list are considerably less distorting than most traditional domestic subsidies in agriculture. In that sense this list at least establishes an appropriate direction for future agricultural policies. Moreover, it is probable that policies will still have to meet the "decoupled" test even if they appear on the illustrative list. Special provisions, however, have been written into the domestic support provisions of the Agreement which (at least for the transition) exempt US deficiency payments and EU compensation payments from reduction requirements. These policies would not have qualified under the "green-box" criteria. However, they have less protection then green-box policies from challenges under the GATT, under the Peace Clause.

These provisions, arising from the 1992 Blair House Accord, also illustrate another more

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[9] Shifting can, however, occur only among tariff lines identified as having subsidies. Countries cannot shift subsidies to other tariff lines even if they might appear to come under the same broad commodity category.

[10] One example of this problem is the treatment of crop insurance. It is difficult to hold that crop insurance does not increase production. It encourages farming on marginal lands where yields are uncertain. On the other hand one can limit government contributions to the cost of such insurance, so that no subsidy is paid. However, it is important to recongize that policies claimed to fall in the "green box" must not only meet the respective description in the illustrative list, but also the general criterion of no, or at most minimal distortion. Hence, a crop insurance scheme that has distorting effects is not "green."

general shortcoming of the Agreement. Whereas individual countries with specific policy difficulties were required to obtain waivers from GATT obligations, the text of the new Agreement on Agriculture has been drafted such that "waivers" are effectively built into the general agreement. The "rice clause" for Japan and Korea is another such case.[11] More important, though, may be the political consequence of the fact that under the new Agreement, some important participants have managed to be more equal than others.

[11] An important distinction, though, is that in the latter case the countries wishing to use this special treatment had to declare that in their Schedules.

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CHAPTER 10

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Trade Policy in Developing Countries

So far we have analyzed the instruments of trade policy and its objectives without specifying the context—that is, without saying much about the country undertaking these policies. Each country has its own distinctive history and issues, but in discussing economic policy, one broad distinction is between two groups of countries. On one side are the developed or advanced countries: North America, Western Europe, Japan, and a few others. These countries, whatever their economic problems, are by the standards of the rest of the world highly successful economies. With only about 15 percent of the world's population, the advanced countries account for about 60 percent of the world's production and international trade. Given how well these economies perform, it is reasonable to suppose that their economic systems are fairly efficient, so neither the demands on trade policy nor the expectations placed on it are usually very large.

Most of the world's population, however, lives in **developing countries** that lag far behind these advanced nations.[1] Developing countries span the range from rapidly growing nations such as South Korea (which may soon be "graduated" into the category of advanced countries) to nations like Ethiopia that live on the edge of subsistence. Despite the huge differences among developing countries, however, their shared relative backwardness creates some common themes in their trade policies. First, many developing nations have tried to use trade policy to favor manufacturing as opposed to traditional sectors such as agriculture and mining in the hope that this would help them catch up with wealthier countries. Second, many poorer countries have tried to use

[1] Developing country is a term used by international organizations that has now become standard, even though some "developing" countries have had declining living standards for a decade or more. A more descriptive but less polite term is less-developed countries (LDCs).

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trade policy to cure the problem of uneven development or dualism *within* the country. Finally, developing countries sometimes argue that their relative poverty is not their own fault but is instead due to an unfair international economic system, and they have at times tried to use international negotiation to bring about changes in that system.

In this chapter we examine the special issues of trade policy raised by each of these considerations. In the next chapter we turn to the different concerns of the advanced countries.

TRADE POLICY TO PROMOTE MANUFACTURING

Perhaps the most distinctive difference between trade policy in advanced countries and in poor countries is that in developing countries policy is more consistently preoccupied with the encouragement of manufacturing as opposed to other sectors of the economy. This preoccupation is, to some extent, a result of the symbolic importance of manufacturing as a sign of national development. Most advanced nations are mainly exporters of manufactured goods, while poor nations are usually exporters of "primary" products such as agricultural produce and minerals. Thus, countries seeking to demonstrate their strength and independence often want to have conspicuous domestic industries such as steel or petrochemicals. Beyond the symbolism of manufacturing development, however, governments in many nations have been strongly influenced by theoretical arguments for trade policy to promote manufacturing. The most important of these arguments is the *infant industry argument* for temporary protection of the manufacturing sector against import competition, which we mentioned in Chapter 6.

Why Manufacturing is Favored: The Infant Industry Argument

According to the infant industry argument, developing countries have a *potential* comparative advantage in manufacturing, but new manufacturing industries in developing countries cannot initially compete with well-established manufacturing in developed countries. In order to allow manufacturing to get a toehold, governments should temporarily support new industries, until they have grown strong enough to meet international competition. Thus it makes sense, according to this argument, to use tariffs or import quotas as temporary measures to get industrialization started. It is a historical fact that the world's three largest market economies all began their industrialization behind trade barriers: the United States and Germany had high tariff rates on manufacturing in the nineteenth century, while Japan had extensive import controls until the 1970s.

Problems with the Infant Industry Argument The infant industry argument seems highly plausible, and in fact it has been persuasive to many governments. Yet economists have pointed out many pitfalls in the argument, suggesting that it must be used cautiously.

First, it is not always a good idea to try to move today into the industries that will have a comparative advantage in the future. Suppose that a country that is currently labor-abundant is in the process of accumulating capital: when it accumulates enough

capital, it will have a comparative advantage in capital-intensive industries. That does not mean that it should try to develop these industries immediately. In the 1980s, for example, Korea became an exporter of automobiles; it would probably not have been a good idea for Korea to have tried to develop its auto industry in the 1960s, when capital and skilled labor were still very scarce.

Second, protecting manufacturing does no good unless the protection itself helps make industry competitive. Pakistan and India have protected their manufacturing sectors for decades and have recently begun to develop significant exports of manufactured goods. The goods they are exporting, however, are light manufactures like textiles, not the heavy manufactures that they protected; a good case can be made that they would have developed their manufactured exports even if they had never protected manufacturing. Some economists have warned of the case of the "pseudo infant industry," where industry is initially protected, then becomes competitive for reasons that have nothing to do with the protection. In this case infant industry protection ends up looking like a success but may actually have been a net cost to the economy.

More generally, the fact that it is costly and time-consuming to build up an industry is not an argument for government intervention unless there is some domestic market failure. If an industry is supposed to be able to earn high enough returns to capital, labor, and other factors of production to be worth developing, then why don't private investors develop the industry without government help? Sometimes it is argued that private investors take into account only the current returns in an industry and fail to take account of the future prospects, but this is not consistent with market behavior. In advanced countries at least, investors often back projects whose returns are uncertain and lie far in the future. (Consider, for example, the U.S. biotechnology industry, which attracted hundreds of millions of dollars of capital years before it made even a single commercial sale.)

Market Failure Justifications for Infant Industry Protection To justify the infant industry argument, it is necessary to go beyond the plausible but questionable view that industries always need to be sheltered when they are new. Whether infant industry protection is justified depends on an analysis of the kind we discussed in Chapter 9. That is, the argument for protecting an industry in its early growth must be related to some particular set of market failures that prevent private markets from developing the industry as rapidly as they should. Sophisticated proponents of the infant industry argument have identified two market failures as reasons why infant industry protection may be a good idea: **imperfect capital markets** and the problem of **appropriability**.

The *imperfect capital markets justification* for infant industry protection is as follows: If a developing country does not have a set of financial institutions (such as efficient stock markets and banks) that would allow savings from traditional sectors (such as agriculture) to be used to finance investment in new sectors (such as manufacturing), then growth of new industries will be restricted by the ability of firms in these industries to earn current profits. Thus low initial profits will be an obstacle to investment even if the long-term returns on this investment are high. The first-best policy is to create a better capital market; but protection of new industries, which would raise profits and thus allow more rapid growth, can be justified as a second-best policy option.

The *appropriability argument* for infant industry protection can take many forms, but all have in common the idea that firms in a new industry generate social benefits for which they are not compensated. For example, the firms that first enter an industry may have to incur "start-up" costs of adapting technology to local circumstances or of opening new markets. If other firms are able to follow their lead without incurring these start-up costs, the pioneers will be prevented from reaping any returns from these outlays. Thus, pioneering firms may, in addition to producing physical output, create intangible benefits (such as knowledge or new markets) in which they are unable to establish property rights. In some cases the social benefits from creation of a new industry will exceed its costs, yet because of the problem of appropriability, no private entrepreneurs will be willing to enter. The first-best answer is to compensate firms for their intangible contributions. When this is not possible, however, there is a second-best case for encouraging entry into a new industry by using tariffs or other trade policies.

Both the imperfect capital markets argument and the appropriability case for infant industry protection are clearly special cases of the *market failures* justification for interfering with free trade (Chapter 9). The difference is that in this case the arguments apply specifically to new industries rather than to any industry. The general problems with the market failure approach remain, however. In practice it is difficult to evaluate which industries really warrant special treatment, and there are risks that a policy intended to promote development will end up being captured by special interests. There are many stories of infant industries that have never grown up and remain dependent upon protection.

How Manufacturing Is Favored: Import-Substituting Industrialization

Although there are doubts about the infant industry argument, many developing countries have seen this argument as a compelling reason to provide special support for the development of manufacturing industries. In principle such support could be provided in a variety of ways. For example, countries could provide subsidies to manufacturing production in general, or they could focus their efforts on subsidies for the export of some manufactured goods in which they believe they can develop a comparative advantage. In most developing countries, however, the basic strategy for industrialization has been to develop industries oriented toward the domestic market by using trade restrictions such as tariffs and quotas to encourage the replacement of imported manufactures by domestic products. The strategy of encouraging domestic industry by limiting imports of manufactured goods is known as the strategy of **import-substituting industrialization.**

One might ask why a choice needs to be made. Why not encourage both import substitution and exports? The answer goes back to the general equilibrium analysis of tariffs in Chapter 5: a tariff that reduces imports also necessarily reduces exports. By protecting import-substituting industries, countries draw resources away from actual or potential export sectors. So a country's choice to seek to substitute for imports is also a choice to discourage export growth.

The reasons why import substitution rather than export growth has usually been chosen as an industrialization strategy are a mixture of economics and politics. First,

until the 1970s many developing countries were skeptical about the possibility of exporting manufactured goods (although this skepticism also calls into question the infant industry agrument for manufacturing protection). They believed that industrialization was necessarily based on a substitution of domestic industry for imports rather than on a growth of manufactured exports. Second, in many cases import-substituting industrialization policies dovetailed naturally with existing political biases. We have already noted the case of Latin American nations that were compelled to develop substitutes for imports during the 1930s because of the Great Depression and during the first half of the 1940s because of the wartime disruption of trade (Chapter 9). In these countries import substitution directly benefited powerful, established interest groups, while export promotion had no natural constituency.

The 1950s and 1960s saw the high tide of import-substituting industrialization. Developing countries typically began by protecting final stages of industry, such as food processing and automobile assembly. In the larger developing countries, domestic products almost completely replaced imported consumer goods (although the manufacturing was often carried out by foreign multinational firms). Once the possibilities for replacing consumer-goods imports had been exhausted, these countries turned to protection of intermediate goods, such as automobile bodies, steel, and petrochemicals.

In most developing economies, the import-substitution drive stopped short of its logical limit: sophisticated manufactured goods such as computers, precision machine tools, and so on continued to be imported. Nonetheless, the larger countries pursuing import-substituting industrialization reduced their imports to remarkably low levels. Usually, the smaller a country's economic size (as measured, for example, by the value of its total output) the larger will be the share of imports and exports in national income. Yet as Table 10-1 shows, Brazil, with a domestic market less than 10 percent as large as that of the United States, exported the same fraction of its output as the United States. India is the most extreme case: in 1983, exports were only 6 percent of output, a share less than that of the United States and far less than that of large industrial countries such as Japan and Germany.

As a strategy for encouraging growth of manufacturing, import-substituting industrialization has clearly worked. Latin American economies now generate almost as large a share of their output from manufacturing as advanced nations. (India generates

TABLE 10-1 Exports as a percentage of national income, 1983

India	6
Brazil	8
United States	8
Japan	14
West Germany	30
South Korea	37
Hong Kong	95
Singapore	176

Source: World Bank. *World Development Report*. Washington, D.C.: World Bank, 1985.

less, but only because its poorer population continues to spend a high proportion of its income on food.) For these countries, however, the encouragement of manufacturing was not a goal in itself; it was a means to the end goal of economic development. Has import-substituting industrialization promoted economic development? Here serious doubts have appeared. Although many economists approved of import-substitution measures in the 1950s and early 1960s, since the 1960s import-substituting industrialization has come under increasingly harsh criticism. Indeed, much of the focus of economic analysts and of policymakers has shifted from trying to encourage import substitution to trying to correct the damage done by bad import-substitution policies.

Results of Favoring Manufacturing: Problems of Import-Substituting Industrialization

The attack on import-substituting industrialization starts from the fact that many countries that have pursued import substitution have not shown any signs of catching up with the advanced countries. In some cases, the development of a domestic manufacturing base seems to have led to a stagnation of per capita income instead of an economic takeoff. This is true of India, which, after 20 years of ambitious economic plans between the early 1950s and the early 1970s, found itself with per capita income only a few percent higher than before. It is also true of Argentina, once considered a wealthy country, whose economy has grown at a snail's pace for decades. Other countries, such as Mexico, have achieved economic growth but have not narrowed the gap between themselves and advanced countries. Only a few developing countries really seem to have moved dramatically upward on the income scale—and these countries either have never pursued import substitution or have moved sharply away from it.

Why didn't import-substituting industrialization work the way it was supposed to? The most important reason seems to be that the infant industry argument was not as universally valid as many people assumed. A period of protection will not create a competitive manufacturing sector if there are fundamental reasons why a country lacks a comparative advantage in manufacturing. Experience has shown that the reasons for failure to develop often run deeper than a simple lack of experience with manufacturing. Poor countries lack skilled labor, they lack entrepreneurs, they lack managerial competence, and they have problems of social organization that make it difficult to maintain reliable supplies of everything from spare parts to electricity. These problems may not be beyond the reach of economic policy, but they cannot be solved by *trade* policy: an import quota can allow an inefficient manufacturing sector to survive, but it cannot directly make that sector more efficient. The infant industry argument is that, given the temporary shelter of tariffs or quotas, the manufacturing industries of less-developed nations will learn to be efficient. In practice, this is not always, or even usually, true.

With import substitution failing to deliver the promised benefits, attention has turned to the costs of the policies used to promote industry. On this issue, a growing body of evidence shows that the protectionist policies of many less-developed countries have badly distorted incentives. Part of the problem has been that many countries have used excessively complex methods to promote their infant industries. That is, they have used elaborate and often overlapping import quotas, exchange controls, and

domestic content rules instead of simple tariffs. It is often difficult to determine how much protection an administrative regulation is actually providing, and studies show that the degree of protection is often both higher and more variable across industries than the government intended. As Table 10-2 shows, some industries in Latin America and South Asia have been protected by regulations that are the equivalent of tariff rates of 200 percent or more. These high rates of effective protection have allowed industries to exist even when their cost of production is three or four times the price of the imports they replace. Even the most enthusiastic advocates of market failure arguments for protection find rates of effective protection that high difficult to defend.

A further cost that has received considerable attention is the tendency of import restrictions to promote production at inefficiently small scale. Even the largest developing countries have domestic markets that are only a small fraction of the size of that of the United States or the European Community. Often, the whole domestic market is not large enough to allow an efficient-scale production facility. Yet when this small market is protected, say, by an import quota, if only a single firm were to enter the market it could earn monopoly profits. The competition for these profits typically leads several firms to enter a market that does not really even have room enough for one, and production is carried out at highly inefficient scale. The answer for small countries to the problem of scale is, as noted in Chapter 6, to specialize in the production and export of a limited range of products and to import other goods. Import-substituting industrialization eliminates this option by focusing industrial production on the domestic market.

Those who criticize import-substituting industrialization also argue that it has aggravated other problems, such as income inequality and unemployment (problems discussed later in this chapter under the heading of the dual economy).

Despite the criticism of import-substituting industrialization by economists, few countries that followed policies of import substitution have dismantled their trade barriers. The reason for this reluctance to change policy is only partly that they continue to believe in import substitution as a development strategy. An equally important factor is that at this point a lot of capital has been invested in industries that could not survive without protection, and many workers in protected industries would be hurt if that protection were removed. Thus there is now a vested interest in the continuation of import-substitution policies.

TABLE 10-2 Effective protection of manufacturing in some developing countries (percent)

Mexico (1960)	26
Philippines (1965)	61
Brazil (1966)	113
Chile (1961)	182
Pakistan (1963)	271

Source: Bela Balassa. *The Structure of Protection in Developing Countries*. Baltimore: The Johns Hopkins Press, 1971.

TRADE LIBERALIZATION AND ECONOMIC GROWTH: THE CASE OF CHINA

For much of the 1980s, the world's most populous nation seemed to be well on the road to becoming the biggest NIC of them all. After moderates drove radical Maoists from power in 1976, they instituted a series of economic reforms that allowed much greater play for market forces generally, and that opened up the Chinese economy to international trade in particular.

The result of the opening of China to trade was a dramatic increase in both imports and exports. In 1976 exports were only 5.6 percent of China's national income, and imports only 5.3 percent. By 1987 exports were up to 15.8 percent, while imports had risen to 17.3 percent. Most of the new Chinese exports were manufactures rather than raw materials: very low Chinese wages allowed China to become a competitive exporter of labor-intensive manufactured goods, and inexpensive Chinese products began appearing in increasing numbers on world markets. Meanwhile, many of the imports were capital goods, used to aid a rapid expansion of manufacturing capacity. China's industrial production grew at a remarkable 12 percent annual rate between 1977 and 1988.

This manufacturing expansion did not come at the expense of agriculture. On the contrary, agricultural production also expanded rapidly, at more than a 6 percent annual rate. Compared with the previous decade, during which political turmoil had crippled the economy, this amounted to a virtual economic miracle—and a classic demonstration of the potential of export-oriented industrialization. By 1989 many international analysts were predicting that China would emerge as a more important factor in world trade than any of the established NICs, perhaps more important than all of them combined.

Unfortunately, at the time of writing that future appears to have been indefinitely postponed. In 1989 the forces of change unleashed by economic reform spilled over into demands for political change. The Chinese government responded by sending in the army, and in the political crackdown that followed there was a reversal of many of the economic reforms of the previous decade.

Another Way to Favor Manufacturing: Industrialization Through Exports

Although the attempt to promote industrialization through import substitution has now fallen into disfavor among economists, not all industrialization among less-developed countries has been a failure. Since the mid-1960s, a small group of initially poor countries has combined rapid growth of output and living standards with industrialization oriented primarily toward export rather than domestic markets. These countries are often referred to as **newly industrializing countries**, or **NICs**. The most spectacular performers among the NICs have been the four Asian countries of South Korea, Hong

Kong, Taiwan, and Singapore, sometimes referred to facetiously as the "Gang of Four" (after the allegedly villainous clique ousted by the current Chinese government).

Aside from their rapid growth, the most remarkable thing about the Gang of Four is their openness to international trade. Table 10-1 shows some comparative figures for the shares of exports in national income. The contrast between the NICs and the import-substituting industrializers is clear.[2]

For the most part, the NICs have not followed policies of strict free trade (except for Hong Kong, which is the least regulated economy in the world). Compared with the import-substituting nations, however, all of the highly successful countries seem to have rates of protection that are both lower and less variable across sectors.

The big question about the NICs is whether their success can be emulated by other developing countries. Does Korea do so well because of its relatively low rate of protection or because of other factors? If, say, Mexico were to abandon its strategy of import substitution, would its growth rate sharply accelerate? Obviously countries differ, and it might be that the successful NICs do well because of social factors such as a national commitment to education or work ethic. On the other hand, 25 years ago, few people would have said that Korea had a society well suited to economic growth. It was only after trade policy changed that Korea began to look like a winner. Was this success just a coincidence?

Whatever the final verdict on the causes of success in the NICs, the remarkable achievements of export-oriented development have shattered the old belief that industrialization must be aimed at the domestic market.

PROBLEMS OF THE DUAL ECONOMY

While the trade policy of less-developed countries is partly a response to their relative backwardness as compared with advanced nations, it is also a response to uneven development *within* the country. Often a relatively modern, capital-intensive, high-wage industrial sector exists in the same country as a very poor traditional agricultural sector. The division of a single economy into two sectors that appear to be at very different levels of development is referred to as **economic dualism**, and an economy that looks like this is referred to as a **dual economy**.

Why does dualism have anything to do with trade policy? One answer is that dualism is probably a sign of markets working poorly: in an efficient economy, for example, workers would not earn hugely different wages in different sectors. Whenever markets are working badly, there may be a market failure case for deviating from free trade. The presence of economic dualism is often used to justify tariffs that protect the apparently more efficient manufacturing sector.

A second reason for linking dualism to trade policy is that trade policy may itself have a great deal to do with dualism. As import-substituting industrialization has come

[2] It may seem puzzling that Singapore's export share exceeds 100 percent. However, no paradox is involved. National income, as explained in Chapter 12, measures the value *added* by the economy, not the total value of the goods it produces. Singapore often buys partly finished manufactures from abroad, processes them further, then exports them. For example, fabric woven in the United States may be sewn by Singapore workers into garments, which are then exported. The value added—the difference between what the imported fabric cost and the price of the finished clothing—can easily be less than the cost of the fabric. When this is the typical pattern, imports and exports will end up larger than national income.

under attack, some economists have argued that import-substitution policies have actually helped to create the dual economy or at least to aggravate some of its symptoms.

The Symptoms of Dualism

There is no precise definition of a dual economy, but in general, a dual economy is one in which there is a "modern" sector (typically producing manufactured goods that are protected from import competition) that contrasts sharply with the rest of the economy in a number of ways:

1. The value of output per worker is much higher in the modern sector than in the rest of the economy. In most developing countries, the goods produced by a worker in the manufacturing sector carry a price several times that of the goods produced by an agricultural worker. Sometimes this difference runs as high as fifteen to one.

2. Accompanying the high value of output per worker is a higher wage rate. Industrial workers may earn ten times what agricultural laborers make (although their wages still seem low in comparison with North America, Western Europe, or Japan).

3. Although wages are high in the manufacturing sector, however, returns on capital are not necessarily higher. In fact, it often seems to be the case that capital earns *lower* returns in the industrial sector.

4. The high value of output per worker in the modern sector is at least partly due to a higher capital intensity of production. Manufacturing in less-developed countries typically has much higher capital intensity than agriculture (this is *not* true of advanced countries, where agriculture is quite capital-intensive). In the developing world, agricultural workers often work with primitive tools, while industrial facilities are not much different from those in advanced nations.

5. Finally, many less-developed countries have a persistent unemployment problem. Especially in urban areas, there are large numbers of people either without jobs or with only occasional, extremely low-wage employment. These urban unemployed coexist with the relatively well-paid urban industrial workers.

Case Study

ECONOMIC DUALISM IN INDIA

The economy of India presents a classic case of economic dualism. In a country of over 700 million people, only 6 million are employed in the manufacturing sector. These manufacturing workers, however, produce 15 percent of the gross national product and receive wages more than six times as high as agricultural wages. Manufacturing is far more capital-intensive than agriculture; indeed, for the past 30 years investment on capital equipment for the tiny manufacturing labor force has consistently been larger than total investment in agriculture.

This sharp distinction between manufacturing and agriculture has actually grown over time. Since 1960, for example, the real wages of manufacturing

workers have risen by about 80 percent, while those of farm workers have risen only about 5 percent.

Why is the gap between sectors so large? It seems likely that government policies play a key role. In India, government subsidies and protectionist policies have encouraged investment in manufacturing, and investment in the most capital-intensive sectors in particular. At the same time, labor laws designed to protect workers' interests have probably helped the bargaining position of unions, enabling organized workers to win large wage increases even though there are millions of workers who would be willing to take their jobs at lower wages.

Will India's manufacturing sector grow and absorb the traditional economy? Unfortunately, there is little reason to think so. From 1960 to 1980, manufacturing employment grew at an annual rate of only 3 percent, not much faster than India's population.

Dual Labor Markets and Trade Policy

The symptoms of dualism are present in many countries and are clear signs of an economy that is not working well, especially in its labor markets. The trade policy implications of these symptoms have been a subject of great dispute among students of economic development.

In the 1950s, many economists argued that wage differences between manufacturing and agriculture provided another justification, beyond the infant industry argument, for encouraging manufacturing at agriculture's expense. This argument, known as the **wage differentials argument**, can be stated in market failure terms. Suppose that, for some reason, an equivalent worker would receive a higher wage in manufacturing than he would in agriculture. Whenever a manufacturing firm decides to hire an additional worker, then, it generates a marginal social benefit for which it receives no reward, because a worker gains an increase in his wage when he moves from agriculture to manufacturing. This is in contrast to what would happen without a wage difference, where the marginal worker would be indifferent between manufacturing and agricultural employment and there would be no marginal social benefit of hiring a worker other than the profits earned by the hiring firm.

The effects of a wage differential on the economy's allocation of labor can be illustrated using the *specific factors model* presented in Chapter 3. Assume that an economy produces only two goods, manufactures and food. Manufactures are produced using labor and capital; food is produced using labor and land. Then the allocation of resources can be represented with a diagram like Figure 10-1. The vertical axis represents wage rates and marginal products; the horizontal axis represents employment. Employment in manufactures is measured from the left origin O_M, while employment in food is measured from the right origin O_F. MPL_M is the marginal product of labor in manufactures, MPL_F the marginal product in food; P_M is the price of manufactures, P_F the price of food. Thus the two curves in the figure represent the *value* of the marginal product of an additional worker in each sector.

When there is a wage differential, workers in manufactures must be paid a higher wage than workers in food; in the figure the manufactures wage is assumed to be w_M.

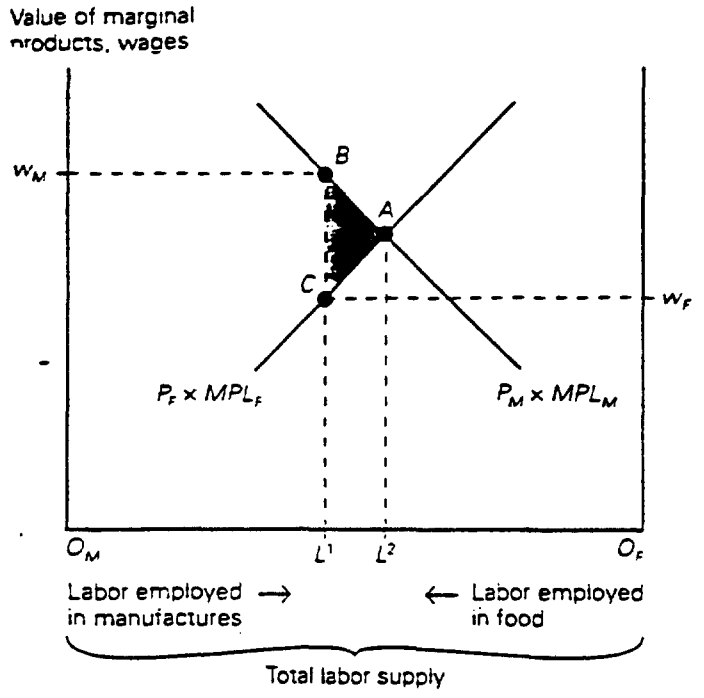

FIGURE 10-1 The effects of a wage differential.

If manufactures must pay a higher wage than food, the economy will employ too few workers in manufactures and too many in food.

the food wage w_F. Employers in each sector will hire workers up to the point where the value of a worker's marginal product equals his wage; thus employment in manufactures is O_ML^1 (point B), employment in food is L^1O_F (point C).

Suppose that the economy were now able to shift one worker from food to manufactures. Manufactures output would rise; food output would fall. The value of the additional manufactures output, however, would be the wage rate in manufactures, w_M, while the value of the reduction in food output would be the lower wage rate in food, w_F. The total value of the economy's output, then, would rise by $w_M - w_F$. The fact that the value of output can be increased by shifting labor from food to manufactures shows that the economy is allocating too little labor to manufactures. An efficient economy would set the marginal product of labor equal in both sectors, which would be achieved if O_ML^2 workers were employed in manufactures, L^2O_F in food (point A). (The increase in output achieved by moving to this efficient allocation of labor would be equal to the colored area ABC in the figure.)

If there is a wage differential, then, markets will misallocate labor; firms in the industrial sector will hire too few workers. A government policy that induces them to hire more can raise national welfare.

As usual, trade policy is not the first-best policy to expand manufacturing employment. Ideally, government policy should target employment directly, either by eliminating the wage differential or by subsidizing firms to hire more workers. A subsidy to manufacturing production is not as good, because it encourages capital as

well as labor to move into manufacturing[3]—and capital does not receive an especially high return in manufacturing. A tariff or import quota is still worse, because it also distorts demand. Nonetheless, as a second-best alternative (or more strictly third-best), a tariff on manufactures could be justified by the wage differentials argument.

In the 1950s and 1960s this seemed to be a fairly convincing argument. In a famous paper published in 1970, however, the economists John Harris and Michael Todaro offered a devastating reinterpretation of the labor markets of less-developed countries.[4] They pointed out a link between rural-urban migration and unemployment that undermines the case for favoring manufacturing employment, even though manufacturing does offer higher wages.

Harris and Todaro began from the observation that countries with highly dualistic economies also seem to have a great deal of urban unemployment. Although one might suppose that this unemployment strengthens the case for creating more urban jobs in manufacturing, Harris and Todaro pointed out that despite this unemployment, migration from rural to urban areas continues. They concluded that rural workers were willing to come to the cities and take the risk of being unemployed in return for the chance of getting high-paying industrial jobs. The chance of getting a job depends, of course, on how many jobs are available.

According to the Harris-Todaro model, an increase in the number of manufacturing jobs will lead to a rural-urban migration so large that urban unemployment actually rises. When an additional worker is hired by the manufacturing sector, two or three more workers may leave agriculture to swell the ranks of the urban unemployed. Although the lucky worker gains, his wage gain will be largely (maybe even completely) offset by the wage losses of the newly unemployed. The supposed social benefit of additional manufacturing employment is therefore lost.

Like the infant industry argument, the wage differentials argument for protection is now in disfavor with economists. This is partly because of arguments like that of Harris and Todaro and partly because of the general backlash against import-substitution policies. In fact, trade policies adopted as a response to economic dualism are now often accused of actually making that dualism worse.

Trade Policy As a Cause of Economic Dualism

Trade policy has been accused both of widening the wage differential between manufacturing and agriculture and of fostering excessive capital intensity.

The reasons for huge wage differentials between agriculture and industry are not well understood. Some economists believe that these differentials are a natural market response. Firms, so the argument goes, offer high wages to ensure low turnover and high work effort in countries not used to the discipline of industrial work. Other economists argue, however, that the wage differentials also reflect the monopoly power

[3] This cannot be seen in the specific-factors model, because that model assumes that capital cannot be used in the agricultural sector. In the factor-proportions model, however, the superiority of a wage subsidy to a production subsidy can be demonstrated. See Harry G. Johnson, "Optimal Trade Intervention in the Presence of Domestic Distortions," in Robert E. Baldwin et al., *Trade, Growth, and the Balance of Payments* (Chicago: Rand McNally, 1965), pp. 3–34.

[4] John R. Harris and Michael P. Todaro, "Migration, Unemployment, and Development: A Two-Sector Analysis," *American Economic Review* 60 (1970), pp. 126–142.

of unions whose industries are sheltered by import quotas from foreign competition. With freer trade, they argue, industrial wages would be lower and agricultural wages higher. If so, dualism—and unemployment—may be worsened by import restrictions, especially those undertaken in the name of import substitution.

The excessive capital intensity of manufacturing is partly due to relatively high wages, which give firms an incentive to substitute capital for labor. To the extent that trade restrictions are responsible for these high wages, they are to blame. Also, in some countries a controlled banking system in effect provides subsidized credit to industrial firms, making capital-labor substitution cheap. The most direct channel, however, has been through selective import control. In many cases, imports of capital goods enter without tariff or other restriction, and sometimes with de facto import subsidies. This policy further encourages the use of capital-intensive techniques.

NEGOTIATIONS BETWEEN DEVELOPING AND ADVANCED COUNTRIES: THE NORTH-SOUTH DEBATE

So far we have focused on how individual developing countries have tried to use their own trade policies to help themselves grow. Since World War II, however, developing countries have also tried to get the advanced countries to change their policies. The result has been a set of running arguments that are often called the **North-South debate** because (with the exception of Australia and New Zealand) all the advanced countries are in the temperate zones of the Northern Hemisphere, while most developing countries lie in the tropics.

Three questions have been at the heart of the North-South debate:

1. Have poor nations been exploited? Is the affluence of the advanced nations achieved to some degree at the expense of developing countries?
2. What is the role of foreign capital in development? Is investment by advanced nations in developing countries good or bad for them?
3. Should the prices of developing-country exports be higher? Should cartels be organized to raise the prices of raw materials?

Are Poor Nations Exploited?

Poor nations, and their advocates in the advanced countries, have often claimed that the wealth of the rich nations is based on exploitation. This position was easier to argue when much of the less-developed world was under direct political domination from Europe. (Actually, at the height of imperialism, few colonies paid enough tribute to repay the cost of administering them. But there were some examples of brutal exploitation, especially in Africa.) In the modern world, the case for exploitation must rest on something about the transactions between North and South that works to the South's disadvantage.

It is clear that trade between advanced countries and developing countries is marked by "unequal exchange." Developing nations use much more labor to produce the goods they export to advanced nations than these nations use to produce the goods they supply in return. The Ricardian model presented in Chapter 2 showed, however,

that this is not a useful way to look at international exchange. Given the low productivity of developing countries in both manufacturing and agriculture, unequal exchange is inevitable: it is not an indication that the poor countries are losing from their trade.

A more sophisticated view of exploitation comes from the same line of thought as the infant industry argument. Suppose that developing countries could potentially develop efficient manufacturing industries but that they cannot get started in the face of competition from established industries in the advanced nations. Then it might be that the division of the world into rich manufacturing nations and poor agricultural countries is a historical accident—the rich countries just got there first, and their industrial development precluded development by the rest of the world. This view is sometimes called the doctrine of **uneven development.** Unlike the concept of unequal exchange, which the model in Chapter 2 showed to be misconceived, but like the infant industry argument, uneven development is an idea that makes sense. The question is whether it is true.

The answer is that uneven development is hard to justify given the experience of the last few decades. On one side, the doctrine depends on the correctness of the infant industry argument. Yet the history of import-substitution policies shows that even with decades of protection from foreign competition, many developing countries have not been able to develop efficient manufacturing sectors. On the other side, some developing countries have done very well at selling manufactures in world markets without infant industry protection. Both the failure of protected industries to achieve efficiency and the success of unprotected industries indicate that competition from established industries in advanced countries is not the main factor inhibiting growth in developing countries.

Many people—not all of them from developing countries—would like to believe that the poverty of most of the world is caused by the wealth of the lucky advanced nations. The sheer awfulness of world poverty makes us want to find villains. In fact, however, it is hard to find evidence that the wealth of the advanced countries has been achieved at the expense of developing nations.

The Role of Foreign Capital and Multinational Firms in Development

The doctrine of uneven development concerns the effects of foreign *trade* on development. Many LDCs have been equally concerned about the effects of foreign *investment*, especially when it comes as direct investment by multinational firms. Does an important role by foreign multinationals hurt the economy of a less-developed country?

At one level the opposition to foreign multinationals is based on concern over national sovereignty. In the past, some countries have felt that foreign firms dominate their economies and have too much influence over their politics. The caricature of the "banana republic" that is virtually owned by the United Fruit Company has sometimes had a basis in reality. Even in a country as large as Mexico, foreign companies dominated the economy and had powerful political influence in the early years of this century; it was partly a nationalistic reaction to this foreign control that set off the Mexican revolution of 1910–1920. As is the case for international investment generally, foreign ownership declined during the period between the wars and has never regained the

relative importance it had in the years before World War I. Despite some scare talk, national sovereignty has not been much threatened in the postwar period. A rise in multinational operations during the 1950s and 1960s did, however, raise some legitimate economic concerns.

Essentially, recent concern over multinationals has focused on technology: the kind that multinationals use (the issue of **appropriate technology**) and the way in which it is made available to others (the issue of **technology transfer**).

Appropriate Technology Those who raise the appropriate technology issue argue that multinational firms bring with them a technology that is suited to the capital-abundant, labor-scarce economies in which they are based but not to the poor economies to which they come. The slogan "small is beautiful," coined by the development theorist F. W. Schumacher, has popularized the view that LDCs need small-scale, labor-intensive methods rather than the large-scale, capital-intensive methods that allegedly characterize the operations of multinationals.

Defenders of multinationals reply that multinationals are no more inclined to use inappropriate technology than domestically owned firms, and that when they do it is because they are given inappropriate incentives. When multinationals produce manufactures in dualistic economies, for example, they face relatively high wages and government policies that encourage them to import expensive machinery. Given these incentives the multinationals adopt capital-intensive techniques similar to the ones they use at home. Given different incentives, they would behave differently.

There is some evidence to support this view. Consider Mexico, which has traditionally pursued a policy of import-substituting industrialization and which has the characteristic problems of dualism: a capital-intensive manufacturing sector that offers too few jobs to employ the growing population of urban unemployed. Since 1966, U.S. firms have been allowed to establish plants in northern Mexico that export to the United States and receive special exemption from both U.S. and Mexican restrictions on trade: raw materials can be imported from the United States without tariff or import restrictions, and the United States has agreed to charge tariffs only on the value-added, not the total value of goods exported from Mexico. Because powerful unions are absent, wages in these export-oriented manufacturing plants—known as *maquiladoras*—are lower than wages in the older import-substituting industries. Also, no special incentives have been offered to these new plants to import expensive capital goods. The results are dramatic: the *maquiladoras* of northern Mexico are only about one-tenth as capital-intensive as the traditional manufacturing sector. Despite having only modest investment, the offshore manufacturing now employs some 25 percent of Mexican industrial workers. The Mexican experience suggests that when multinationals are given an incentive to use appropriate technology, they are as likely to use it as domestic firms.

Technology Transfer The technology transfer issue is a cousin to the infant industry issue of appropriability. Recall that infant industries are supposed to yield extra benefits in the form of experience and knowledge that diffuse to other sectors of the economy. Critics of multinationals argue that when an infant industry consists of foreign firms, the technology is developed elsewhere and is not *transferred* to the rest of the domestic economy. These critics would prefer to see domestically owned firms that either license technology from abroad or develop it themselves. They believe that even though these

firms might initially have higher costs than a multinational, the indirect benefits would be larger.

While there is no hard evidence on how technology transfer by multinationals compares with that by domestic firms, it might be informative to ask whether the NICs, which seem to have been successful at adopting advanced technology, have relied on multinationals. The answer is that they vary enormously. On one side, Korea and Hong Kong have relied primarily on local entrepreneurs to develop their industry. On the other side, Taiwan and Singapore rely heavily on multinationals—so much so in the case of Singapore that some observers have characterized it as a "contract labor" economy that hires itself out to foreign firms. All four economies have done spectacularly well at improving their living standards.

Raising the Export Prices of Developing Countries: Commodity Export Cartels

Despite their efforts at industrialization, most developing countries remain exporters of agricultural products and minerals—often called "commodities"—and importers of manufactures. Thus, the terms of trade of developing countries as a group are related to the prices of commodities relative to those of manufactured goods. Governments of poor nations have therefore always been interested in ways to raise commodity prices. The most promising route to increased commodity prices has often seemed to be the formation of **commodity export cartels**, in which a group of countries exporting the same commodity agree to restrict supply and drive up the price.

We saw in Chapter 9 that a country that is a large exporter of some good can raise its welfare at other countries' expense by imposing an export tax. If there are several exporting nations, however, each individual country will be restrained from imposing a large export tax, because some of the benefit of the higher prices that result will accrue to other exporters rather than the taxing country. The basic idea of an export cartel is that several exporters acting together will take into account the benefits that each gains from the export taxes of the others, and that they will therefore succeed in raising prices (and their welfare) more than if they acted independently.

For example, suppose that Brazil and Colombia were the world's only coffee exporters. If Brazil were to impose a tax on its coffee exports in order to raise world prices, some consumers would shift to Colombian coffee; this shift would limit how high an export tax Brazil could profitably impose. Colombia would feel similarly constrained. If Brazil and Colombia agreed to raise coffee prices together, however, they would both feel free to raise prices higher, to their mutual gain (and the rest of the world's loss).

Gains from forming a cartel are greatest when the cartel controls much of world production, when there is little ability on the part of consumers to switch away from the product, and when alternative sources of supply are difficult to develop. Over the years there have been many attempts to form export cartels, in commodities ranging from coffee to oil to tin. For the most part, however, these cartels either broke apart or were less successful in raising prices than their founders hoped. The reasons have partly to do with the limits on cartel power: most cartels have controlled too little of world production and have faced both substitution by consumers and competition from alternative sources. Equally important, cartels have trouble imposing discipline on their

own members. Each country has an incentive to cheat, undercutting the rest of the cartel so as to sell more. If too many members cheat, the "honest" members will find that it is not worth trying to support the price.

Case Study

OPEC

Most commodity export cartels have been unimpressive in their results, but there has been one spectacular exception. The Organization of Petroleum Exporting Countries (OPEC), founded in 1961, was able during the 1970s to engineer a huge rise in the price of oil. For a time, it seemed as though OPEC could serve as a model for other commodity exporters. In fact, however, OPEC's success has remained unique, and OPEC itself fell on hard times in the mid-1980s.

What was special about OPEC? Part of the answer is that political disturbances helped disrupt the supply of oil and drive up the price: the Arab-Israeli war of 1973 led to an Arab embargo, while the fall of the Shah in Iran (1979) and the Iran-Iraq war (begun in 1980) reduced deliveries from the Persian Gulf. Also, OPEC accounted for more than half of world oil production outside the U.S.S.R. in the early 1970s, and both the supply and demand for oil are inelastic in the short run.

Cheating by cartel members was less of a problem for OPEC than other cartels, at least at first, because of the dominant role of Saudi Arabia. In effect, the Saudis had a large enough market share that they were willing to support the price by reducing output even when other members of OPEC produced more than they were supposed to.

These special circumstances explain why oil could be more effectively cartelized than other commodities. And even OPEC eventually ran into problems: by 1986, long-run shifts in demand and increasing supply from non-OPEC sources had forced price reductions to levels that, in real terms, were the lowest since 1973.

Despite the failure of attempts to raise prices through export cartels, developing countries continue to argue that something should be done to improve their terms of trade, which fell during the mid-1980s to the lowest levels since the Great Depression. At times they have proposed that advanced countries fund price-support programs, in which international organizations would buy up commodities whenever their prices fell to some minimum level; such programs would be extremely expensive, however, and there is no sentiment in the industrial countries for providing the necessary resouces.

SUMMARY

1. Trade policy in less-developed countries can be analyzed using the same analytical tools used to discuss advanced countries. The particular issues characteristic of *developing countries* are, however, different. In particular, trade policy in developing countries is concerned with three objectives: promoting industrialization, coping with

the uneven development of the domestic economy, and attempting to undo what is perceived as unfair or exploitative economic relations with advanced countries.

2. Government policy to promote industrialization has often been justified by the infant industry argument, which says that new industries need a temporary period of protection from competition from established competitors in other countries. The infant industry argument is valid only if it can be cast as a market failure argument for intervention. Two usual justifications are the existence of *imperfect capital markets* and the problem of *appropriability* of knowledge generated by pioneering firms.

3. Using the infant industry argument as justification, many LDCs have pursued policies of *import-substituting industrialization* in which domestic industries are created under the protection of tariffs or import quotas. Although these policies have succeeded in promoting manufacturing, by and large they have not delivered the expected gains in economic growth and living standards. Many economists are now harshly critical of the results of import substitution, arguing that it has fostered high-cost, inefficient production.

4. A small group of developing countries has managed to industrialize not through import substitution but through development of manufactured exports. These *newly industrializing countries* (NICs) have achieved rapid growth in output and living standards. A major question is whether other countries, by moving away from import-substitution policies, can achieve similar success.

5. Most developing countries are characterized by economic *dualism:* a high-wage, capital-intensive industrial sector coexists with a low-wage traditional sector. Dual economies also often have a serious problem of urban unemployment.

6. The difference in wages between the modern and traditional sectors has sometimes been used as a case for tariff protection of the industrial sector. This is the *wage differentials* case for protection. This view no longer receives much credence among economists, however. More recent analyses suggest that protection will lead to more rural-urban migration, which worsens the urban unemployment problem and may worsen the symptoms of dualism.

7. Governments of developing countries and their supporters have argued that the current international economic system is unfair and that the poverty of the developing world is related to advanced countries' wealth. The most coherent view of this kind is the doctrine of *uneven development*, which is related to the infant industry argument. According to this doctrine, advanced countries were just lucky in getting established in the industrial sector first, forestalling industrial development by later competitors. A review of the evidence, however, finds little support for the view that advanced nations grew wealthy at the expense of others.

8. On a less global level, multinational enterprises have been accused of failing to provide benefits to their host countries, either because they use *inappropriate technology* or because they fail to make a *technology transfer* that improves the technological level of the rest of the economy. Defenders of multinationals argue that multinationals use inappropriate technology because they are faced with distorted incentives. On the technology transfer issue, some countries have done well with extensive foreign investment and others have done well without it, so that it is hard to reach any definite answer.

9. Finally, most developing countries export commodities, and they have always tried to find ways to raise commodity prices. In the 1970s the success of OPEC led to hopes that *commodity export cartels* could improve the terms of trade of many developing countries. It seems, however, that OPEC benefited from uniquely favorable conditions (and OPEC itself has come on hard times).

KEY TERMS

developing countries
imperfect capital markets
appropriability
import-substituting industrialization
newly industrializing countries (NICs)
economic dualism
dual economy
wage differentials argument
North-South debate
uneven development
appropriate technology
technology transfer
commodity export cartels

PROBLEMS

1. "Japan's experience makes the infant industry case for protection better than any theory. In the early 1950s Japan was a poor nation that survived by exporting textiles and toys. The Japanese government protected what at first were inefficient, high-cost steel and automobile industries, and those industries came to dominate world markets." Discuss critically.
2. A country currently imports automobiles at $8000 each. Its government believes that domestic producers could manufacture autos for only $6000 given time but that there would be an initial shakedown period during which autos would cost $10,000 to produce domestically.
   a) Suppose that each firm that tries to produce autos must go through the shakedown period of high costs on its own. Under what circumstances would the existence of the initial high costs justify infant industry protection?
   b) Now suppose, on the contrary, that once one firm has borne the costs of learning to produce autos at $6000 each, other firms can imitate it and do the same. Explain how this can prevent development of a domestic industry, and how infant industry protection can help.
3. Why might import substituting industrialization be more successful in large developing countries such as Brazil than in smaller nations such as Ghana?
4. The very small economy of Cantabrigia has a total labor force of 20 workers. These workers can produce two goods, manufactures and food. In production of manufactures, the *marginal* product of labor depends on employment as follows:

Number of workers	Marginal product of last worker
1	20
2	18
3	16
4	14
5	12
6	11

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4 What Should Trade Policy Target?

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Recent developments in international trade theory have shown that there may be domestic gains from trade policy targeted to particular industries facing foreign competition. Governments and firms are seen as being engaged in a strategic game to gain profits in world markets. The theory indicates that policies such as export subsidies can affect the underlying structure of the game so as to allow domestic firms to achieve extra profits from exports that exceed the amount of the subsidy. If this is the case, the policy will have resulted in a net gain to the domestic economy.[1] In theory some of the additional profits could be redistributed by taxation so that the general taxpayer does not lose from the cost of the subsidy and still allow the owners and workers in the targeted industry to be better off.

In policy circles there has been a perception that some foreign governments such as the French and Japanese have chosen to target certain sectors of the economy.[2] This has led to a current debate about whether the United States should also join the targeting game. There are many difficult issues that arise from this debate, including philosophical questions about the appropriate role of government. Supposing this issue were decided in the affirmative, there is also a considerable difference of views as to which types of industries should be targeted. For example, should the government attempt to revitalize declining industries, support existing profitable high-technology industries, or somehow pick the winners of the future? This paper is not concerned directly with the first major issue. Rather it has the more limited objective of addressing some aspects of the second question as to the types of industries to be targeted. In particular, the aim is to describe the implications of the recent trade theory for the broad characteristics of industries most likely to lead to a national benefit from targeting.[3]

riers to entry that help to ensure that domestic firms at least have a potential for earning substantial profits from export sales (characteristic 1). Commitment to heavy expenditures on capital and R&D can play a central role in the strategic game between firms (characteristics 2 and 7, part i). This strategic game in capital and R&D which naturally occurs in the early stages of a product's life cycle has a major influence on the eventual profitability of the product in the mature production stage of the industry (see characteristic 7). Among other things this game also affects the eventual concentration of the domestic industry relative to the foreign industry, which is a factor in the effectiveness of any continuing government promotion of the industry (see characteristic 3). Finally, we associated decreasing average costs of production and dynamic learning economies with heavy capital and knowledge requirements for production. As indicated in characteristic 5, part ii, these scale economies tend to magnify any advantage from a government subsidy program.

This emphasis of the economic theory on large capital and knowledge requirements strongly point toward the encouragement of the development of new products and processes as part of any targeting program that might hope to lead to a national benefit rather than just favor some special interest group. The enhancement of the ability of domestic firms to pick up quickly on new advances being made elsewhere could also be important.

However, even if it had been decided that a targeting policy of this kind were desirable, many more theoretical as well as practical issues remain. For example, it should be clear from this paper that an advantage from targeting can depend not only on the right choice of industry to target but on the nature of the targeting instruments themselves. Although we know that a direct production subsidy is likely to have different effects than a wage subsidy or certainly than a capital or R&D subsidy, very little study has yet been done on this question.

In particular, given that the creation and maintenance of high profits is a key requirement of the theory, more information is needed on the likely effects of various methods of targeting on both foreign and domestic entry into a targeted industry. For this purpose the question as to whether a targeting policy should be narrowly focused toward a single firm or product, or broadly focused toward an industry as a whole, is also important. The answer to this can partly depend on the nature of the targeting instruments. For example, an

industrywide export subsidy may create entry of domestic firms, reducing the domestic advantages from the subsidy, but a broadly based R&D subsidy applied to the same industry may lead to the creation of new products for which the innovating domestic firm has at least a temporary world monopoly. Even if it is decided that an active U.S. industrial targeting policy is not appropriate, research on the likely effect of various targeting policies within different industries could help us understand foreign targeting practices and the best methods to counteract them.

As a final concluding remark I would like to emphasize that I believe it is important that policy discussion on industrial targeting proceed so far as possible from facts concerning particular industries and the likely effects of targeting policies, rather than from preconceived notions arising, for example, from the traditional competitive trade model, which may not be very relevant in many real industrial situations. Also it would appear that the tax code in the United States already has many provisions that have the effect of promoting some industries relative to others. For example, rules for depreciation of commercial real estate tend to promote real estate development. One would hope that a better understanding of which types of intervention are more likely to improve rather than worsen overall domestic welfare could at least modify the distribution of government expenditure and tax relief in the right direction relative to the present somewhat haphazard system.

Notes

1. See Spencer and Brander (1983, 1984) for the basic theoretical argument.

2. See, for example, USITC publications No. 1437, October 1983, and No. 1517, April 1984.

3. This paper should not be viewed as an overall survey of the literature on industrial targeting. Other criteria as to which industries should be targeted have been suggested. Krugman (1983) provides an excellent discussion and critique of some of these.

4. Kreps and Scheinkman (1983) show that if firms play a two-stage game in which capacity is chosen prior to output and if capital requirements are inflexible, then under some mild assumptions on demand, the unique outcome is a Cournot equilibrium. Under this structure a higher domestic capacity should reduce the equilibrium levels of capacity and output of the foreign firms.

5. This result does depend on some specific assumptions concerning the

in the two markets, the structure of competition could well be different at home than abroad. For example, there may be a higher proportion of domestic to foreign firms serving the domestic market than foreign markets, which reduces the chances that a subsidy on domestic sales will be socially beneficial. Some types of policies, such as subsidies to capital and R&D or encouragement of research joint ventures, naturally apply to both foreign and domestic markets. Since these types of policies could well be particularly helpful in the long-run strategic game between firms, consideration of their effects on both the domestic and foreign markets would be required.

An Example

One example of targeting of an industry that broadly fits the criteria of this paper is provided by the development of the European Airbus consortium. Indeed, government support of the European Airbus consortium may be one case in which a government subsidy program has proved effective. The consortium is approximately 70 percent government owned and enjoys substantial subsidies from the French and German governments, which on some calculations amount to about 20 percent of the airplane price. Airbus has managed to capture a substantial portion of the commercial wide-body jet aircraft market at the expense of sales of U.S. competitors, such as Boeing and McDonnell-Douglas. It seems clear that government subsidization has allowed the airbus to obtain a larger share of the world market than it otherwise would. Indeed it is rather unlikely that an unsupported private European firm would have entered the market at all.

Whether government subsidization will translate into economic success in the sense that the additional profits earned from the airbus are more than sufficient to pay for the subsidy is not yet clear. However, the aircraft industry does satisfy a number of the criteria that theory indicates are likely to be important for a successful targeting program. The industry has substantial barriers to entry because of large capital and R&D requirements increasing the chances of good returns on investment. From the European perspective there is substantial foreign competition (from the United States) so that European sales are at the expense of the sales and profits of foreign firms. Indeed, since the European Airbus consortium is the only European contender in the wide-body aircraft market, subsidization is particu-

larly effective since additional sales cannot reduce sales of other domestic firms.

Apparently the Japanese are also interested in targeting their aircraft industry, although the Japanese are not yet a major force in this industry. Whether the Japanese can also be successful remains to be seen. As indicated in the previous section, the theory of industrial targeting indicates that as more governments subsidize the same industry, the possible gains from subsidization are reduced. Countries could benefit from mutual agreements not to subsidize.

Conclusion

Fundamentally the possibility of a domestic gain from a government subsidy program targeted to a particular industry depends on the way in which government intervention affects the strategic interplay between foreign and domestic firms. This argument therefore depends first on the existence of imperfect competition in the targeted industry and on the nature of that competition. There is general agreement that many industries are not perfectly competitive, but it would be much harder to get agreement that any particular industry fit the somewhat abstract requirements indicated by the theory. Nevertheless, theory in industrial organization and trade does give some guidance as to the broad characteristics one would need to look for in developing a targeting program of a type that might have some chance of conferring a net domestic benefit.

For example, one should look toward those industries in which the domestic country is likely to have a natural advantage relative to the foreign competition even if there were no government intervention. Lower existing domestic marginal costs tend to increase the impact of each dollar spent on a subsidy program in raising domestic export profits (characteristic 5, part i). Also factor prices in the industry should not tend to increase much in response to targeting. This is more likely to be the case if the industry does not have a strong union or, if the industry is unionized, that worker incomes be at least partly based on profit sharing (characteristic 4, parts i and ii). Furthermore no key input should be in fixed supply (4, part iii).

More important, a number of the conditions for profitable targeting of export-oriented industries point toward industries that have large capital or knowledge requirements. Such requirements provide bar-

directed toward a broad or a very narrow group of products and whether the foreign subsidy program is fully committed in the sense that it cannot be changed by domestic actions.

If a foreign government targets a narrowly defined product such as the 250K semiconductor chip, then similar domestic targeting of the same product is not likely to be beneficial. The domestic government would be better off being first to promote some other likely growth product, although even this is a highly risky policy. If one basically believes in private enterprise, a domestic response to foreign subsidization in the form of subsidization of a broad group of industries such as the semiconductor industry as a whole would have the advantage of allowing private domestic firms to continue to choose the specific products to be developed, presumably taking into account the likely foreign developments. Unless a product promoted by a foreign government had exceptional potential, the domestically chosen products are likely to be significantly different from those of their foreign rivals, making the foreign subsidization of the industry less relevant.

Some types of foreign subsidies can more easily be reduced by negotiation and other domestic actions. A foreign subsidy program that has already resulted in increased R&D and capital expenditure in specific products will have long lived effects on the distribution of any rents earned on those products, even if domestic government pressure reduces future subsidy levels. On the other hand, subsidies such as those that reduce the cost of export financing have less of a long-lived effect on the profitability of exporting industries and may also be more amenable to bargaining tactics. A domestic policy of matching such a subsidy set by a rival producing nation could in the short run allow domestic firms to achieve a major sale and, by nullifying the advantage from the foreign government action, could be an important bargaining tool to reduce subsidy levels. This appears to be the situation with the type of help to export financing which is provided by the U.S. Export-Import Bank.

Targeting of Export-Oriented Industries versus Purely Domestic Industries

The question has been raised as to why subsidize exports when the tax money could equally be spent on subsidizing domestic sales. For example, Baron (1984, p. 79) argues that both policies could help the industry achieve economies of scale, lowering prices, but a subsidy to

domestic sales would have the advantage of being kept at home rather than becoming a gift to foreign consumers.

First, the reasons for subsidizing exports or export-oriented industries imply very different policies from those associated with helping the domestic consumer. If it is the domestic consumer the government has in mind, targeting policies could well include efforts to increase entry of new firms into the industry, reducing the degree of industry concentration, which tends to lower prices and profits. This policy is just the opposite of those implied by the theory of export targeting. The logic of targeting of exports is based on raising the profits of domestic firms at the expense of the sales and profits of foreign rivals. Consumers will not necessarily benefit much, since an increase in domestic profits depends on prices not falling too far.

Also, if there is but one monopoly or oligopolistic industry within an otherwise perfectly competitive economy, one can say that the output of the monopoly is too low relative to the optimal product mix from the viewpoint of consumers. This is not the case in an economy with a large number of monopoly and other types of distortions. The theory of the second-best indicates that unless all distortions are undone by domestic policies, an attempt to remove a few distortions by subsidizing domestic sales of some oligopolistic industries may not result in a net improvement in consumer welfare. Some industries may expand too much, relative to other monopolistic industries that are not subsidized or do not respond in the same way to the subsidy program.

For both the preceding reasons, the direct inclusion of consumer preferences in a targeting program is likely to distort and complicate the application of such a program, making it less likely that increased domestic benefits would be achieved. However, if domestic consumer preferences are not taken into account, then the same kind of argument that has been presented in support of subsidies to exporting firms would also apply to domestic sales. Because of imports, domestic firms may well face competition from foreign firms at home as well as abroad. To the extent that a subsidy will increase sales of domestic firms at the expense of imports, the country can gain from the transfer of profits from foreign firms.

This does not mean, however, that whenever it is advantageous to subsidize exports, it will also be advantageous to subsidize domestic sales. If, as we have been assuming, the domestic and foreign markets are separate in the sense that different prices can be charged

Characteristic 7 If a domestic industry is involved in rivalry with foreign firms, it will be a better candidate for targeting by R&D and investment subsidies if

i. R&D and capital costs form a significant proportion of industry costs, indicating they are important factors in firm rivalry;

ii. a likely winning product is in the early stage of development or production and R&D, and capital subsidies will raise entry barriers to foreign firms.

Targeting and Import Protection

Tariffs and quotas can also be used to target domestic industries. If there are significant scale economies or dynamic learning economies from moving down the experience curve, the closing or partial closing of the domestic market to foreign competition can in theory lead to a lower marginal cost of production which then promotes success in exports (see Krugman 1984). Indeed, it has been argued that the existence of a closed domestic market in Japan allowed Japanese firms to gain sufficient experience in modern technology so as to become a force in international competition. Also, if the domestic market is large, protection, by taking away potential sales by foreign firms, may inhibit foreign entry in industries with high entry cost. This would leave the market clear for a domestic firm to enjoy maximum scale economies (see Dixit and Kyle 1984).

However, this method of promoting exports is rather indirect and can easily lead to the reverse result. For example, in economies such as Australia and Canada, high tariff walls in certain industrial fields have led to the development of too many small plants which do not have sufficient scale economies to compete successfully on the world market.

Even if tariffs and quotas allow achievement of some scale economies by domestic firms, commonly they will still have the effect of raising prices in the domestic market, to the detriment of consumers. In comparing protection with subsidy measures of industrial promotion, one must always keep in mind that protection normally reduces world trade, whereas subsidies are generally trade enhancing. Broadly speaking, subsidy measures have a better chance of improving world welfare (including consumer benefits) than do protection measures.

This is not to say one should accept foreign subsidization of rival firm production as a gift. Foreign subsidies may help domestic consumers, but if they reduce the profits earned by domestic producers, in many cases the economy will lose as a whole. Tariffs in the form of antidumping duties can therefore be an appropriate measure to offset the effects of foreign targeting practices on the domestic economy.

Targeting by Other Governments

An important question is the way targeting by other governments might affect the criteria for domestic targeting. It has been argued that the U.S. government should match foreign subsidies so that U.S. industry is not put at a disadvantage by foreign governments. This is the so-called "level playing field" argument.

It should be clear from the criteria for targeting that have been presented that such a policy is not likely to be generally advantageous. In the first place the very fact that an industry or product group has been targeted by a foreign government reduces the expected rent to be earned by other firms in the industry (see characteristic 1). Even if the domestic return from subsidization is still positive, if foreign targeting has been successful in reducing foreign marginal cost, the domestic return from a subsidy will be lower than otherwise (see characteristic 5). In other words, although matching foreign subsidies may make a "level playing field," the playing field is now at a lower level than before. Prices and profits in each country are likely lower after subsidization by both governments than if there had been no government intervention (see Brander and Spencer 1984).

Also the industries that are most suitable for targeting by foreign governments may not always satisfy the criteria for a national gain from domestic targeting. For example, if the industry is highly concentrated in the foreign country but not in the United States, this asymmetry will tend to favor a foreign subsidy but will make the optimal U.S. subsidy low or perhaps even negative, implying that an export tax would be appropriate.

On the other hand, a domestic government should not necessarily be dissuaded from supporting certain industries that meet the required characteristics, just because a foreign government has decided to target the same industry. An important consideration is the nature of any foreign subsidy program. For example, it is important whether the foreign subsidy program and the proposed domestic program are

ii. there are substantial scale or learning economies from increased production.

More fundamentally, innovation in products or processes can lead to the creation of an initial absolute advantage in the production of a product. It has been argued that because of spillover effects of R&D or transfer of technology to other firms, an innovating firm will be unable to appropriate fully the return from R&D. Patent protection can help to overcome this problem, but it has proved less than fully effective, particularly in the international arena. In those industries where there are major problems from appropriation of returns from R&D, private incentives can lead to too little R&D from the viewpoint of the best resource allocation within a society.[7] Transfer of technology to other firms confers benefits to society that are not taken into account by the innovating firms.

This traditional argument for government subsidization of R&D arising from the existence of substantial spillover effects of R&D depends on taking a world view of welfare, rather than the more national view in which the gains and losses of other nations are not taken into account. From a domestic viewpoint it is important whether the externalities are conferred on domestic or foreign firms. If there is oligopolistic rivalry between foreign and domestic firms, any spillover of domestic R&D to the foreign firms is likely to reduce the rents earned by domestic firms in international markets. This effect could lower the domestic benefit from R&D subsidies. Domestic policies can be designed to reduce the extent of spillovers of domestic R&D to foreign firms. For example, the law could be amended to reduce the ease of licensing of U.S. innovations to foreign firms.

Even if a firm is not first in innovating a product, it may still do well if it is in a position to copy and improve on major innovations being made elsewhere. If there is international rivalry, this means that a domestic industry will be better off if it is in a position to take maximum advantage of spillovers of R&D from foreign firms. For example, it has been suggested (e.g., Weinstein et al. 1984) that the Japanese semiconductor industry has benefited substantially from U.S. R&D in basic technologies. By concentrating on process technology, the Japanese were able to replicate or adapt U.S. designs at low cost. This enabled them to capture in a relatively short time a large share of the market in consumer products using semiconductors. Government support of activities that speed the transfer of foreign

technology to domestic firms can be domestically beneficial. These considerations lead to characteristic 6:

Characteristic 6 A domestic industry will be a better candidate for targeting by R&D subsidies if

i. there is a minimum of spillover of new domestic technology to rival foreign firms;

ii. the government intervention aids the transfer of foreign technology to domestic firms.

On the other hand, if there are no spillovers of R&D so that domestic firms can appropriate the full return from R&D, an increase in domestic R&D due to government subsidies can set the stage for an increase in profits from export sales, which more than exceeds the cost of the R&D subsidy. Just as in the case of capital subsidies, this policy is effective to the extent that it leads foreign firms to reduce their R&D levels (see Spencer and Brander 1983). Domestic firms alone may not be in a position to achieve such a response. If a domestic firm announces that it is substantially increasing its expenditure on R&D, this may not be entirely convincing or credible to foreign firms who may decide to continue with their R&D plans, making the domestic increase in R&D unprofitable. On the other hand, increased domestic expenditure on R&D would be expected as a natural response to a domestic subsidy to R&D and could well indicate to foreign firms that their research in this area is less likely to pay off. Hence supporting R&D-intensive industries could be one way of obtaining a greater share of future winning industries.

There also may be a connection between government support of R&D and capital investment in the early stages of a product's development and the future structure of the industry in terms of the eventual number of firms in the industry and the timing of their entry. In the early stages of a product's life cycle, an initial innovating firm may have a temporary monopoly of the product. After a time imitators enter, reducing the profits of the innovating firm and bringing the industry into what is often called its "mature phase." Government subsidies to investment by the original firm can allow it to enjoy greater economies of scale, making entry by other firms less profitable. There may be a domestic gain if such policies reduce the number of foreign entrants or delay the entry of foreign firms. These ideas are summarized in characteristic 7:

less in response to a subsidy, increasing the bonus payments of workers from profit sharing. In the extreme, if the union set wages at the competitive level so that all transfers of rent to workers comes from profit sharing, then the union would have no effect on the total domestic rent earned from government intervention.

Also certain means of subsidization are more likely to result in an increase in the union wage than others. My conjecture here is that a subsidy tool that reduces the negative impact of a wage increase on employment more than other tools is likely to lead the union to be more aggressive in raising wages. For example, direct and permanent wage subsidies would likely have the least restraining effect on the union. Wages would have to increase by more than the subsidy per worker in order to reduce employment. In the case of a capital or R&D subsidy an increase in the wage bill equal to the total amount of the subsidy would tend to lead to a substitution of capital for labor and intensify the search for labor-saving innovations. This prospect may lead a union to be more moderate in its wage demands.

If inputs are not easily substitutable in production, a production subsidy or subsidy per unit of output would affect the union wage in the same manner as a wage subsidy. This effect would be reduced if the subsidy were restricted to export sales, as is the case with the current interest rate subsidy to purchaser financing which is provided by the Export-Import Bank. Most exporting firms also produce for the domestic market, and the union wage bargain covers both domestic and export sales. The prospect of a reduction in domestic sales and employment from a wage increase should mitigate the tendency for wages to rise.

A further factor price effect to be considered is the possibility that there is a fixed amount of some critical input used in a group of exporting industries. Dixit and Grossman (1984) show that in this case an export subsidy to one of the exporting industries would increase production of that industry, but mainly at the expense of the profits and sales of other exporting industries. Dixit and Grossman suggest that such an input might be scientists or engineers of a particular kind. It is clear that this could be a problem, particularly in the short run. In the long run, inputs are not generally fixed in supply. Given the demand, more engineers and scientists would be trained in the United States, and additional skilled workers would emigrate to the United States from other countries.

These considerations lead to characteristic 4 of industries most likely to be suitable for targeting:

Characteristic 4 Factor prices should not increase much in response to domestic targeting. This is more likely if

i. the industry does not have a strong union;

ii. worker incomes are at least partly based on profit sharing;

iii. no key input is in fixed supply.

Cost Advantages

Another question is whether subsidy money is better directed toward those industries where a country already has an initial advantage, such as cheaper raw materials or better-trained workers, or whether the money would be better spent in some way compensating for higher costs of production relative to the foreign competition.

If the nature of the industry is such that an export subsidy is beneficial, it can be shown that the lower the initial domestic cost relative to foreign marginal cost, the greater is the domestic gain from a given amount of subsidy. There is a greater return in increased profit from each subsidy dollar if the domestic industry already has a natural advantage relative to the foreign competition.

In addition the very nature of imperfect competition leads it to be associated with scale economies, which provide a barrier to entry and thus maintain the industry profitability. In this case government intervention, particularly in the form of subsidies to capital, can lead to a lowering of marginal cost sufficient to create a domestic advantage where otherwise it might not have existed. Of course it does not follow that such a policy is necessarily in the country's best interest. Rather, this consideration indicates that if an industry has a natural cost advantage in production such as cheaper raw materials or location advantages, and if in addition it is subject to learning economies or other scale economies, then it is a better candidate for targeting than otherwise. This idea is expressed as characteristic 5:

Characteristic 5 Targeting is more effective if

i. the domestic industry has a fundamental cost advantage relative to the foreign competition;

output tends to reduce foreign output more, the greater the number of foreign firms or the less concentrated the foreign industry. With a greater number of foreign firms each firm may tend to cut back less, but the total reduction in output tends to be higher for a given expansion in domestic output induced by a subsidy.

Also declining marginal costs, both short and long run, magnify the tendency for foreign output to fall in response to domestic expansion. In the short run a cutback in output then raises marginal costs, reducing the profitability of output at the margin so that output is reduced more than if marginal cost were constant. In the long term foreign firms would move to plants designed for a lower level of output, raising their average costs because they are able to take less advantage from economies of scale.

Turning to the question of concentration in the domestic industry, for any one domestic firm the response of rival domestic firms to an industry subsidy is just as important for profits as the response of rival foreign firms. As expressed by Eaton and Grossman (1983), there is a kind of pecuniary negative spillover between domestic firms, in the sense that each firm in choosing its output considers only the effect of that output choice on its own price and profits and does not take into account the way its actions may affect other firms in the domestic industry. An increase in sales by any one domestic firm tends to reduce the price and profits received by other domestic producers. One normally applauds this effect, which leads to more competitive pricing as being in the best interest of domestic consumers, but if sales are mainly to foreigners, the country's best interest lies in keeping monopoly profits high. This negative effect of the expansion of other domestic firms on the price and profit earned by any one domestic firm tends to be smaller the more concentrated is the domestic industry, since there are then fewer firms to which the externality applies. Of course, as indicated earlier, even if there are a large number of domestic firms, the existence of an equally large number of foreign firms can offset this effect, so that an export subsidy can still be advantageous.

Assuming that firms have Cournot behavior and each firm produces the same product at the same cost of production, the effect of industry concentration on whether a domestic export subsidy would reduce foreign sales sufficiently to raise welfare is summarized in characteristic 3:

Characteristic 3 The domestic industry involved in exporting should be more concentrated or equally as concentrated as the rival foreign industry.

This advantage from domestic concentration points toward an argument for relaxation of antitrust laws for firms that are heavily engaged in export sales. This could facilitate the internalization of the negative spillovers from independent pricing of export sales by domestic firms. The cost of all this, of course, is that the same cartel-like pricing behavior could carry over to the domestic market.

Factor Price Effects

The rent extracted from export sales includes rents received by workers as well as total profit. Workers receive rent if they earn more than the opportunity cost of their labor. As explained by Krugman (1984), if an export subsidy results in an increase in employment so as to increase the total rent earned by workers in industry, this is a benefit to the economy just as much as an increase in industry profit. On this basis the existence, for example, of high worker rents due to unionization might be used as an indication that the industry could be a candidate for targeting by the government.

However, the existence of a union brings an additional player into the strategic game between firms and governments, and government subsidy policies rather than just increasing employment would under normal conditions result in an increase in the union wage.[6] This increase in the wage with the same or higher employment level would increase the total rent earned by workers. However, this is not just a transfer of profit from shareholders to workers, leaving the total surplus earned by the industry unchanged. An increase in the wage by increasing marginal costs affects the result of the strategic game, reducing the level of exports as well as the total rent earned by the industry. To the extent that a subsidy is reflected in a higher wage level, this undoes the strategic effect of the subsidy, making each subsidy dollar less effective.

Of course the impact of a union on the effectiveness of targeting depends on both the nature of the union bargain and the nature of the subsidy or protection tool. If the union contract depends partly on profit sharing, then the union will have an incentive to raise wages

from domestic expansion, allowing the possibility that domestic profits will increase.

This requirement clearly rules out intervention in the case of a true monopoly where a domestic firm does not face competition or potential competition in export sales. A true monopolist will be in a position to price and make investment choices so as to maximize its own profits.

Whether an export subsidy will cause foreign firms to cut back output depends on the nature of the oligopolistic rivalry between firms and on the nature of the response, if any, by foreign governments. The effect of oligopolistic rivalry in pricing decisions has been explored in Eaton and Grossman (1983). They show that the opposite industry response, often associated with tacit collusion models, is certainly possible. If one firm raises price by cutting back output, this may cause other firms to follow suit and also cut back output, increasing prices closer to the joint profit-maximizing monopoly level. Conversely, a rise in exports by domestic firms brought about by an export subsidy could lead to an increase in output by other firms and a further fall in prices, reducing the profitability of the domestic industry. Such would be the case under what is called Bertrand competition, in which each firm assumes that if it changes its own price, other firms will maintain their price even in the face of loss of sales. In this case an export tax rather than a subsidy would increase domestic profits from exports.

On the other hand, the Eaton and Grossman (1983) analysis applies most easily to short-run pricing decisions after capital is in place. In the earlier stages of product development, there may well be a prior game between rival firms as to the level and timing of capital investments. In highly capital-intensive industries, capacity decisions will condition the nature of future price rivalry, exerting an important influence on overall profitability and market share at the future production stage. For example, if an industry has a large and inflexible capital requirement, once the foreign firms are at capacity, an expansion of domestic output cannot induce an immediate expansion in foreign output as is implied by Bertrand price behavior. Theoretical work by Kreps and Scheinkman (1983) supports this view.[4]

In such industries it would seem likely that an early and large domestic investment would tend to preempt the foreign competition leading to the lower foreign investment and output in the long run, which is required if targeting is to be domestically beneficial. Government policies that increase domestic capacity are likely to serve as signals to foreign governments and firms that domestic ouput will be higher so that the return on investment to foreign firms will be lower. Such policies are likely to be most effective in reducing foreign capacity if they occur relatively early in the product life cycle before plans for foreign capacity have been finalized.

This discussion should make clear that one of the problems in implementing targeting is that the nature of the reaction of the foreign firms and governments may not be known. Further study of this complicated question would be needed on an industry by industry basis. In effect, this discussion implies the following requirements for successful use of targeted subsidies:

Characteristic 2 The domestic industry must be subject to serious foreign competition or potential competition. Subsidy of the domestic industry should lead foreign rival firms to cut back capacity plans and output. Although they are not necessary, large and inflexible capital requirements are likely to increase the chances of this type of behavior.

Industry Concentration

As indicated in the previous section, an export subsidy will increase domestic welfare only if the enhancement of domestic exports from a subsidy is not "too large" in relation to the reduction in sales or rival foreign firms, so the fall in price associated with the subsidy is kept to a minimum. Assuming that the industry satisfies characteristics 1 and 2, some factors are likely to magnify the tendency for domestic expansion to be at the expense of foreign rivals, making the industry a better prospect for domestic targeting.

Dixit (1984) and Eaton and Grossman (1983) have shown that the price fall associated with an export subsidy is likely to be lower, the more concentrated is the domestic export industry relative to the foreign competition. Hence this consideration tends to favor subsidization of those industries or parts of industries that consist of fewer domestic than foreign firms. The exact form of this result does require some special assumptions on the nature of the industry, but the direction of effects should still remain.[5]

Considering the foreign industry first, a given increase in domestic

Identification of these characteristics is a preliminary step toward translating theory into practical policy proposals, but there remain serious practical problems of implementation. For example, some characteristics indicated by the theory require information that is not readily available, such as the nature and level of costs in both domestic and foreign firms. Furthermore accurate prediction of the behavior of foreign firms and governments, which is important for some of the characteristics, is likely to be extremely difficult to obtain. These problems and others may well make a policy of targeting particular export industries undesirable. Nevertheless, even without domestic implementation of an industrial targeting policy of this sort, it seems useful to see what economic theory has to say on the subject. This should lead to more informed debate as well as perhaps to some better understanding of the effects of foreign industrial policies.

In this paper I take a broad view of what is meant by trade policy targeting. In some discussions the word targeting is restricted to policies that promote some narrow group of products within an industry or even a single firm. Although trade theory does indicate some of the issues that might arise in deciding on how specific to a firm, product, or group of products a targeting policy should be, this question is very much affected by the particular nature of the industry or group of industries being considered and would require both more theoretical analysis and detailed industry studies. I also take a broad view as to the nature of the targeting instruments. Clearly export subsidies and tariffs are two possible instruments. However, other policies such as subsidization of R&D and plant and equipment could well have a greater long-run impact on profits earned from export sales and would need to be considered as part of any policy to promote industrial exports.

Industry Profitability and Barriers to Entry

The argument for export subsidies found in the recent theory is based on extracting additional profits from foreign producers and consumers. For an export subsidy to be domestically welfare improving, it must increase the profits to be earned by the industry on export sales by an amount exceeding the cost of the subsidy to the taxpayers. Apart from dynamic considerations of product innovation and development, and the possibility of extreme economies of scale, a net gain requires that the sale price exceed the opportunity cost of inputs

determined without the subsidy. This cannot be the case unless there is some barrier or cost of entry to the industry, both to make subsidization initially beneficial and to preserve the gain in profits for a reasonable length of time. Common barriers to entry would include high capital or R&D requirements as well as legal barriers such as patent laws.

Traditional trade theory assumed that there were no barriers to entry so that an industry would consist of a large number of small firms earning only the normal profit required to remain in business. In such a purely competitive industry, price is equal to each firm's private marginal cost of production, so an export subsidy of, for example, $1 per unit, would lead to a price that is $1 less than the real marginal cost of production. In this situation an export subsidy can only reduce domestic welfare, at best acting as a gift to foreign consumers.

This requirement for profitability would appear to rule out subsidization as a method to "save" unprofitable or so-called declining industries and still benefit the country as a whole. This is generally the case, although some seemingly unprofitable industries might earn above-normal returns from exports if the hidden returns in the form of wages and salaries above their opportunity cost are counted.

The first requirement for an industry to be appropriate for targeting is summarized as characteristic 1:

Characteristic 1 The industry or potential industry must be expected to earn additional returns (expressed in profits or greater returns to workers) sufficient to exceed the total cost of the subsidy. This requires that at least for a period there be substantial barriers to entry.

Restrictions in Sales of Foreign Firms

For an export subsidy to be appropriate, increases in domestic exports must lead to a reduction in the output levels of rival foreign firms. Indeed, an export subsidy is more likely to improve domestic welfare, the greater is this effect or the more the domestic expansion is at the expense of sales of foreign rivals. Without a loss in sales by foreign firms, the increased domestic exports induced by a subsidy would normally result in a fall in price sufficient to make the additional sales unprofitable. A reduction in foreign output mitigates the price fall

nature of the industry. For example, firms are assumed to have Cournot behavior, implying that in equilibrium each firm will have chosen the level of output that maximizes its own profits given the level of outputs of the other firms. Also it assumes that each firm produces the same product at the same cost of production.

6. See Brander and Spencer (1984) for a model of the strategic interplay between firms and a union in a partially unionized industry. It can be shown that a subsidy on exports of the unionized firm would be substantially absorbed in higher wages, reducing the effectiveness of the subsidy.

7. There is an opposite argument: that excessive duplication of research effort by competing firms will lead to an excessive use of resources for R&D. If this is the case encouragement of research joint ventures by domestic firms could solve this problem by allowing R&D dollars to be spent more effectively (see Grossman and Shapiro 1984).

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Global Growth Through Global Competition: Linking Commercial Policies and Trade/Economic Performance

SRI International

The processes driving economic development are by no means fully understood. But much can be learned by experience. History shows above all that economic policies and institutions are key building blocks. This finding is encouraging because it implies that countries which have failed to prosper can do better by improving policies and making the right institutional choices. The Commercial Policy Framework Model focuses in particular on identifying which policies promote economic development.

A central theme of this initiative is the interaction between government and the private sector. A consensus has been reached on the need for a "market-friendly" approach to development. The key elements of a market-friendly approach include:

- Investing in people;
- Creating the right "enabling environment" for private enterprise;
- Integrating with the world economy; and
- Establishing a sound macroeconomic foundation.

Recent political events have helped encourage acceptance of the market-oriented principles. For example, the dramatic political and economic events in Eastern Europe and the former Soviet Union have generated unprecedented enthusiasm for introducing market-oriented reforms. Countries which previously favored import substitution strategies in Latin America and Africa now are turning increasingly towards export promotion and open-market policies to achieve higher levels of economic growth. Many countries which formerly endorsed socialist models which relied heavily on state subsidies and state-owned enterprises have now transformed their regimes towards a private market orientation. Even countries in East and Southeast Asia which have long been known for their market-oriented export strategies have taken further steps to liberalize their economies.

There is increasing consensus that competitive markets are the best way found yet for stimulating trade. Domestic and external competition provides the incentives that unleash entrepreneurship and technological progress. However, it is also recognized that markets cannot operate in a vacuum; they require the proper legal and regulatory framework that only governments can provide.

Improving the standards of living through economic development has been an important, and sometimes daunting challenge facing many countries. This challenge has been approached with different development strategies over the past thirty years, with mixed results. Overall, the economic growth of developing countries has surpassed the long-term historical growth trend of industrial countries. The economic growth rate of the developing world averaged 4.8 percent over the 1965-1990 period, compared with a 3.5 percent growth rate for industrialized countries.

During this time period, some of the formerly low-income countries have raised their relative economic position to the point where they are entering the ranks of the industrialized world. In particular, the growth of the four "Asian Tigers" has been striking. Taiwan, Hong Kong, Singapore and South Korea saw their per capita incomes increase by a factor of five in the twenty-five years between 1965 and 1990. One of the most interesting features of the success of the Four Tigers is that these nations achieved rapid and sustained economic growth with few resource endowments. Most of the economic success in those countries has been attributed to the policy choices, to the institutions promoting economic development, and to the productivity of the human resource base.

What is both heartening and disturbing about the development results is that the distribution of accelerated, sustained growth has been very uneven across different regions. While nations in East and Southeast Asia have on average attained steady or accelerated growth, the Sub-Saharan and Latin American regions have experienced economic stagnation. Most important, poverty and the associated, wrenching problems of malnutrition, high infant mortality, underemployment, low life expectancies, and wasted human potential, are still far from being eradicated.

Conditions for Rapid and Sustainable Growth

Eight factors play a key role in generating rapid and sustainable economic growth:

- Political stability
- Macroeconomic stability
- Resource endowments
- Labor resources
- Capital resources
- Infrastructure
- Technology
- Entrepreneurship

A country's commercial policy environment directly affects all of these factors except political and macroeconomic stability by the "rules of the game" -- the regulatory and policy climate in which businesses operate. "Market friendly" policies reduce distortions in the economy, allow businesses and firms to respond to market signals, and encourage investment and development. Sound commercial policies help to reduce risks to investors, increase business confidence, and allow countries to develop their true comparative advantages. The next section summarizes the impacts of key commercial policies.

Business Start-up

The registration and approval process is a critical hurdle for businesses and entrepreneurs since it is the initial step before a business can invest in new or expanded operations. Complicated registration requirements and a lengthy approval process delay start-up operations and discourage potential investors, especially those with neither the money nor personnel to proceed through a circuitous screening process. Smaller firms are particularly likely to be dissuaded by the investment in time and money required to proceed through demanding and uncertain registration and screening

process. A simpler, more automatic process that minimizes "red tape," discretion and waiting time allows investors to quickly realize potential investment opportunities.

Registration and approval begins with business policies governing procedures for company formation and extends to other areas such as taxation requirements, permits to purchase land and construct buildings, and licenses to use natural resources or hire labor. How quickly investors receive the necessary approvals for start-up can depend largely on a country's policy environment. Until recently in Kenya, final approval for investment projects took up to a year for clearance because investors were required to visit each of the government ministries overseeing the approval process and to submit separate applications to each ministry. By contrast, Singapore and Hong Kong have centralized all decisionmaking for investment screening and permit approval. In these countries investors can obtain approval for projects in as little as 24 hours.

Pricing Policy: Inputs

Almost all businesses of every size, whether they produce for local or export markets, require a steady flow of inputs to keep the company running. One of the key policy instruments affecting the timely availability of inputs is pricing policy. Guaranteeing an adequate flow of raw materials to industry requires pricing policies that provide adequate incentives for suppliers. Artificially low prices that do not reflect the true value of inputs can be wasteful and costly to society, while overpriced inputs represent an excess cost to be borne by industry.

Import Policies

An important tool for eliminating the disadvantages that industrial producers in developing countries may face in competing in the world market is guaranteed free access to the imported raw materials and intermediate inputs used in industrial activities that generate value added. "Free access" in this case means that such imports are free of import and foreign exchange restrictions as well as free from tariffs and indirect taxes. Rather than opening their borders immediately to free trade, many developing countries establish free trade regimes for exporting while maintaining protected regimes for production in the local market during the transition period. Free trade status is often given first to exporters as a first step toward the first-best solution of economy-wide free trade.

Financial Market Policies

As we saw in previous sections, pricing policies are essential for guaranteeing the efficient allocation of inputs used by enterprises in the production process. Similarly, interest rates, which represent the price of financial resources in the capital market, will determine the efficient allocation of capital resources. Sound interest rate policies will: (i) provide incentives for mobilizing international and domestic capital; (ii) allocate credit to enterprises which can earn the highest economic return; and (iii) signal a stable and predictable financial system which encourages investment, savings and development. The experiences of many developing countries suggest that positive real interest rates most often result from policies that allow interest rates to respond to

changes in the business cycle, to adjust to fluctuations on the foreign exchange market, and to reflect the relative risk of investment opportunities.

Exchange Rate Policy

The exchange rate is also an essential price that will determine the cost of imports, the competitiveness of exports, and ultimately the cost and availability of capital. Methods of determining the exchange rate vary by country and are distinguished by their degree of flexibility. The choice of a particular regime over another is not so important as the necessity of maintaining an appropriately valued and stable real exchange rate. Recent studies by the World Bank have found that on average, countries with misaligned real exchange rates exhibit poorer growth performance than countries with appropriately valued ones. Undervalued currencies make imported capital excessively expensive and can restrict an enterprise's ability to import essential capital inputs. Conversely, an overvalued exchange rate can lead to capital flight by making foreign financial assets relatively more attractive than domestic ones, thus encouraging investors to place their assets abroad rather than investing them in the domestic economy.

Foreign Investment Policies

Investment is widely recognized as a primary catalyst of long-term, broad-based sustainable economic growth, and guaranteeing a steady flow of investment funds depends critically on a supportive policy and regulatory environment. The most important features in attracting prospective investors, both foreign and domestic, are policy stability and clear "rules of the game."

Labor Policies

As a primary factor of production, labor is particularly susceptible to government policies that in turn directly impact a firm's profitability and competitiveness. Meaningful policies to protect workers and avoid exploitative or discriminatory practices are necessary and important. However, government regulations that determine minimum wages, labor mobility, the hiring and firing of employees and the use of expatriate personnel, all of which are intended to protect workers, can in some cases have counterproductive effects on industrial development and long-term job creation.

Taxation

Taxation is a key policy instrument which affects government fiscal balances and business profitability. In every country there is an important balance between raising sufficient government revenues to provide adequate public services and to maintain infrastructure and providing ample incentives to private business to invest and obtain satisfactory returns on capital.

High corporate taxes are viewed by the business community as burdensome as they result in a reduction in net cash flow and the profitability of investments. High corporate taxes can act as a drag on economic growth and also can provide strong inducements for tax evasion. Corporate tax rates examined in this study ranged from a low of 15 percent in Hong Kong, Chile and Mauritius to

a high of 55 percent in Ghana and Uganda. The countries with the lowest levels of corporate taxes, including Hong Kong, Korea, Taiwan, Chile, and Mauritius, enjoyed high levels of private investment and high levels of economic growth. Experience in these and other countries suggests there is a strong link between tax levels and economic growth.

In addition to corporate income taxes there are a number of taxes which affect business profitability. These include, among others, import duties, sales taxes, value added taxes, payroll taxes, social security, and capital gains taxes. There has been a general movement in many countries throughout the world towards lower, broader based taxes. This type of tax regime provides adequate incentives for longer-term economic growth, while also being low enough to reduce incentives for evasion.

Export Policy

In the export area, there are a number of policy pre-conditions which need to be met in order for countries to compete internationally and rapidly increase production. Experience from successful export led-growth countries has shown that exporters need a policy environment that contains the following elements:

- **Maintenance of a competitive exchange rate**: An exchange rate system that maintains a competitive exchange rate is the single most effective export promotion instrument.

- **Access to inputs at internationally competitive prices**: Meeting this condition requires liberalized trade regimes, elimination of monopolies and price controls, and the introduction of policies which encourage domestic competition.

- **Access to international markets**: This requires the absence or elimination of all restrictions on exporters including export taxes, export licensing, and quantitative controls.

- **Access to credit and other financial services at internationally competitive rates**: In general, the economy does not benefit from special below market rates of credit for exporters, but rather from policies that ensure exporters credit at internationally competitive rates adjusted for risks associated with local economic and political conditions. In many countries with tightly controlled financial markets, formal credit is unavailable at any price for non-traditional exporters. This represents a serious policy impediment to exporting.

Commercial Policy Research Methodology and Findings

Research Goals

Given the importance of a business-friendly commercial policy environment for private sector development, it is imperative for policymakers to identify feasible policy alternatives, and to assess their effectiveness. To this end, cross-country experiences can be utilized to examine specific policy approaches and the lessons learned from their successes and failures in enhancing economic performance. Cross-country data is also useful for conducting policy benchmarking, which is an effective technique for assessing the comparative position of a country's commercial policy regime against its competitors in attracting international investment and trade.

Although comparative assessments of economic policies have been conducted in the past, in most cases the comparison is limited to a few countries and confined to a specific policy area, such as the foreign investment policy regime. In order to assess the commercial policy practices of a large number of countries across a broad range of policy areas (such as trade, investment, tax, foreign exchange, etc.), it is necessary to identify an analytical framework within which commercial policies can be examined in a systematic and objective manner.

Research Methodology

<u>Data Collection and Classification</u>. To examine the commercial policy environment and its relationship to economic performance, 36 policy variables and 4 economic performance indicators have been selected as the basis for international comparison. To the extent possible, quantifiable measurements of policy differences were utilized. The economic performance indicators selected are:

- Average annual real GDP growth 1980-90
- Average annual real industrial growth 1980-90
- Average annual growth rate of gross domestic investment 1980-90
- Average annual growth rate of exports 1980-90

To measure the economic policy environment, the 36 policy variables were selected on the basis of the following criteria:

- Their importance in forming the overall commercial policy environment;
- The availability of up-to-date information;
- The objectivity and reliability of data sources; and
- The country coverage available.

Information was collected from the World Bank, International Monetary Fund (IMF), United Nations Conference on Trade and Development (UNCTAD), Office of the U.S. Trade Representative (USTR), U.S. Department of Labor, Center for International Settlement of Investment Dispute (CISID), foreign embassies, major accounting houses, and other sources.

The policy variables analyzed were classified under nine categories:

1. Business start-up
2. Pricing
3. Import policies
4. Export policies
5. Foreign exchange policies
6. Domestic investment policies
7. Foreign investment
8. Labor
9. Taxation

The policy variables were categorized so that they could be assessed as policy groups in forming the overall commercial policy environment. Such classification can also accommodate cross-country comparison in each individual policy category.

Data Analysis. A rating system which assigns summary policy scores to each nation was formulated. These scores describe the degree to which the commercial policy regimes are business-friendly and competition-based. The scores of the policy variables within the same policy category were then summed and harmonized according to a conversion scale to yield Policy Category Scores (PCSs), which fall into a range of 1-4. This is to ensure that the scoring system will be not be biased towards the policy categories in which more data and information are available. The PCSs are then given weights which reflect their relative importance in forming the overall commercial policy environment.

The Total Score (TS) for each country was obtained by summing the weighted scores from all the policy categories. The maximum achievable Total Score for a country is 100. Total Scores can be compared across countries as a summary description of the commercial policy environment. In addition, comparisons and benchmarking can be conducted in each policy category by comparing the Policy Category Scores across all countries or groups of countries. Perhaps more importantly, the correlation between the Total Scores, Policy Category Scores, and economic performance across countries can be observed and analyzed.

It should be noted that a country which has the most competition-based commercial policy environment will not have the perfect score of 100. This is due to the fact that for certain policy variables, higher scores are assigned to countries that have adopted special incentives specifically to encourage investment or trade, such as income tax exemptions for exporters, or income tax holidays for investors. In many countries, such special incentives are often provided to investors and exporters to counteract the restrictive commercial policies in other areas.

BOX 5.1

POLICY VARIABLES INCLUDED IN THE DATA SET

Policy Category	Policy Variable
Import	Mean Trade-Weighted Tariff Tariff Variance All Non-tariff Barriers
Export	Export Taxes Export Restrictions Export Income Tax Exemptions Duty Free Imports
Tax	Minimum Corporate Income Tax Rates Top Corporate Income Tax Rates Minimum Personal Income Tax Rates Top Personal Income Tax Rates Sales Taxes + Value-Added Tax Rates
Domestic Investment	Income Tax Holidays Duty Exemptions Other Incentives: Accelerated Depreciation Investment Allowance R&D Incentives
Foreign Investment	Direct Investment Restrictions Expatriate Employment Restrictions Differential Treatment between Domestic and Foreign Investment Dispute Settlement Mechanisms
Business Start-Up	Business Licensing Business Registration Approvals
Pricing & Interest	Price Controls Price System Interest Controls Credit Allocation
Foreign Exchange	Exchange Rate System Foreign Exchange Level Foreign Exchange Restrictions Profit Repatriation Restrictions Capital Repatriation Restriction
Labor	Hiring/Firing Flexibility Minimum Wage Wage Controls

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Results and Conclusions

Overall, the commercial policy climate as well as functional policy clusters are found to be closely correlated to economic performance. The following policy inferences can be drawn from the data analysis:

- Developing countries with high Total Scores performed better in economic growth, investment growth, and especially in export growth.

- High GDP growth in developing countries is especially correlated with high Policy Category Scores (PCSs) in the import, foreign exchange, and business policy categories.

- The developing countries with rapid investment growth have high PCSs in the domestic investment and foreign direct investment policy areas.

- The developing countries which experienced negative investment growth on average have low PCSs in foreign exchange, business, pricing and interest policies.

- Developing countries which performed well in export growth have higher rates of investment, industrial and GDP growth.

- The countries that enjoyed rapid export growth have very "friendly" commercial policy environments, measured by high Total Scores.

- The countries which experienced stagnant or negative export growth scored poorly especially in foreign exchange, trade, business, and tax policies.

Over the 1980's the top ten developing country scorers achieved much higher cumulative growth than the bottom ten. GDP growth was 75 percent higher, investment stock expanded by 30 percent instead of shrinking by 12 percent, and export growth was six times as high.

Regional Observations

A perusal of the policy scores and performance of countries in regional groupings yields the following observations:

- The East/Southeast Asian group and the OECD group have the highest (and almost identical) Total Scores, but the Asian group enjoyed higher GDP growth between 1980 and 1990. This is probably due to the fact that the OECD countries are mature economies, while the newly industrialized Asian countries have more room for growth, at least until they catch up with the industrialized countries.

- Compared to OECD countries, East/Southeast Asian countries scored higher (that is, were more favorable toward business) in tax and domestic investment policies, but lower in business, foreign exchange, foreign direct investment, and pricing and interest policies. It can be inferred from this observation that although open by worldwide standards, the East/Southeast Asian countries have less open commercial policy environments than the OECD countries. The East/Southeast Asian countries compensate with special tax and investment incentives in order to attract business and investment.

- Sub-Saharan Africa has very weak export and investment growth, and low policy scores, especially in tax, foreign exchange, pricing and interest policies. Although many Sub-Saharan African economies have suffered from wars, civil strife and political instability throughout the 1980s, the poor economic conditions were exacerbated by the extremely unfavorable commercial policy environment which prevailed in many countries.

- Compared to the newly industrializing East/Southeast Asian countries, LAC countries are weak in import and tax policies. The economic performances of the LAC countries are also much weaker than the East/Southeast Asian and OECD groups.

Global Growth Through Global Competition

The result of the data analysis provides strong evidence of the linkage between favorable commercial policy environment and economic growth. By applying the lessons learned through the use of the model presented in this report, it is possible to increase economic output through the introduction of competition-based commercial policies. Developing countries possess many resources, such as labor, natural resources, and climate which are underutilized due to the lack of a favorable policy climate to act as the catalyst. Cross-country experience has demonstrated that many of these resources can be unleashed and organized productively by private enterprise operating in a competitive market environment. However, the only means by which private enterprise is exposed to competitive forces is the adoption of sound commercial policies. The linkage between economic performance and commercial policies provides clear, strong evidence of the need for competition-based policy structures.

Commercial Policy Scores for Selected Countries

	IM	EX	TA	INV	FDI	BUS	P/I	FX	LAB	Tota	gGD	gEX	gIND	gINV	gGNP/Cap
Singapore	16	8	12	6	8	8	12	12	8	90	6.6	8.9	5.8	4.3	5.3
Hong Kong	16	8	16	2	6	8	12	12	8	88	6.9	4.4	N/A	4.4	5.6
U.S.A.	16	6	12	4	8	8	12	16	6	88	2.6	4	2.9	3.3	1.7
U.K.	16	6	8	4	8	8	12	16	4	82	2.9	2.6	1.3	5.3	2.6
Korea	16	8	12	8	8	8	9	8	4	81	9.6	12	12.1	13	8.7
New Zealand	16	8	4	2	8	8	12	16	6	80	1.5	3.6	1.3	2.9	0.7
Taiwan	16	8	12	6	4	8	12	8	6	80	8	13	N/A	5.5	6.5
Japan	12	6	8	6	8	8	12	16	2	78	4.2	3.9	4.9	6	3.6
Paraguay	16	6	16	4	8	4	6	16	2	78	2.7	12	0.2	0.3	-0.8
Costa Rica	12	8	12	6	8	6	9	12	4	77	3.1	4.6	2.9	4.4	0.7
Saudi Arabia	16	8	12	4	8	4	9	8	8	77	-0.2	-4.2	-2.9	N/A	-3.4
Australia	12	6	4	4	8	8	12	16	6	76	3.1	4.6	3	2.2	1.6
El Salvador	12	8	12	4	8	4	6	16	6	76	1	-2.7	1.6	2.3	-0.3
Germany	16	8	0	4	8	8	12	16	4	76	2.3	4.1	0.9	2.6	2.2
Ireland	16	8	0	4	8	8	12	16	4	76	3.5	7.1	N/A	0	3.3
Jamaica	12	8	12	4	8	6	6	16	4	76	1.6	0.8	2.6	3.6	0
Norway	16	8	4	0	8	8	12	16	4	76	2.7	7.4	5.2	-0.2	2.3
Canada	8	8	8	4	6	8	12	16	4	74	3.1	5.7	3	4.5	2
Netherlands	16	8	0	2	8	8	12	16	4	74	2.1	4.4	N/A	2.4	1.6
Malaysia	12	6	8	8	6	4	9	12	8	73	5.7	11	7.7	4.4	2.9
Chile	12	8	4	2	8	8	12	12	6	72	2.2	5.2	3.6	5.1	1.6
Zambia	12	6	8	8	4	4	12	16	2	72	0.8	-3.2	0.9	0.2	N/A
Malawi	8	6	12	8	8	6	6	12	4	70	2.9	5.8	3.5	-0.9	-0.1
Tanzania	8	6	12	8	8	4	6	12	6	70	3.1	-1.2	2.2	5.6	0
Bolivia	16	8	12	0	4	2	9	16	2	69	0.3	4.5	-0.8	-8	-2
Argentina	8	8	8	2	8	6	9	16	2	67	-0.4	2.1	-1.4	-6.9	-1.5
Colombia	4	8	8	2	6	8	9	16	6	67	3.7	12	4.8	-0.2	1.2
Mexico	12	6	12	2	4	6	9	12	4	67	1.2	3.5	1.3	1.8	1.2
Namibia	4	8	4	8	8	6	9	12	8	67	1	N/A	-1.1	-6.2	-1
Thailand	8	6	12	8	6	4	6	12	4	66	2.9	14	9.6	9.8	5.9
Botswana	4	6	8	6	6	8	9	12	6	65	10.1	N/A	10.1	N/A	6.1
Lesotho	4	6	8	6	8	6	9	12	6	65	5.4	N/A	8.5	9	-0.5
Morocco	8	8	0	6	8	8	9	12	6	65	4.2	5.9	3	2.5	1.6
Cyprus	8	6	12	6	6	6	6	12	2	64	5.8	6.6	N/A	N/A	4.7
South Africa	4	6	4	6	6	8	12	12	6	64	1.1	0.7	-0.1	-4.4	0.1
Uruguay	8	6	8	4	8	4	9	12	4	63	0.6	3.1	0	-5.9	-0.4
Barbados	16	8	4	8	8	8	6	0	4	62	N/A	N/A	N/A	N/A	N/A
Zimbabwe	16	6	4	6	4	4	6	8	6	60	2.8	-0.8	1.9	1.8	-0.9
Indonesia	4	6	12	2	6	4	9	12	4	59	5.6	4.5	5.9	6.9	3.9
Tunisia	4	8	8	4	8	4	9	12	2	59	3.7	5.6	2.9	-1.1	1.1
Philippines	4	6	12	2	4	2	9	12	6	57	1.1	3.3	-0.5	-1.8	-1.2
Swaziland	4	6	4	8	6	4	9	12	4	57	N/A	N/A	N/A	N/A	1.6
Turkey	4	8	0	6	8	6	9	12	4	57	5	7.2	6	2.8	2.9
Ghana	8	8	8	8	6	4	6	8	0	56	3.2	5.2	3.7	9	-0.3
Hungary	12	6	4	4	8	6	6	8	2	56	0.6	2.2	-1.6	-1.6	0.7
Venezuela	0	6	16	4	4	6	6	12	2	56	1.5	0.1	2.1	-3.9	-1.3
PNG	16	6	8	4	4	4	3	8	2	55	2	6.8	2.4	-0.9	-0.6
DR	4	6	12	0	8	4	6	8	6	54	1.7	-1.5	1.6	4.5	-0.2

Commercial Policy Scores for Selected Countries

Country	IM	EX	TA	INV	FDI	BUS	P/I	FX	LAB	Tota	gGDP	gEX	gIND	gINV	gGNP/Cap
Guatemala	12	6	12	6	4	0	6	4	4	54	1.1	-0.7	-0.2	-0.7	-1.8
Mozambique	4	6	4	8	6	0	9	12	4	53	0.4	N/A	-0.4	3.1	-3.6
Senegal	12	8	4	8	8	6	3	0	4	53	3.1	5.6	3.8	3.7	0.1
Uganda	12	4	8	4	8	4	3	8	2	53	2.5	2.3	4.6	11.9	-2.4
Sri Lanka	8	6	4	8	8	4	6	4	4	52	4	6.3	4.7	1.2	2.5
Kenya	0	8	4	6	8	4	9	8	4	51	4.2	2.9	4	0.6	0.3
Cote D'Ivoire	12	6	4	4	8	0	3	8	0	45	-0.5	4.5	-1.6	-1.7	-4.6
Pakistan	0	8	4	6	8	4	3	8	4	45	6.1	9.9	7.5	5.6	3.2
India	0	8	4	4	6	0	6	12	4	44	5.4	7.4	6.3	5.1	3.2
Angola	8	2	8	4	4	0	3	8	4	41	N/A	N/A	N/A	N/A	N/A
Egypt	8	4	4	6	4	0	3	8	4	41	4.8	2.8	4.2	-0.1	1.9
Cameroon	12	8	4	4	4	4	3	0	0	39	1.4	-1.3	2.2	-5.4	-1
China (PRC)	8	4	12	4	4	2	3	0	0	37	9.4	12	11	12.4	7.8
Brazil	0	6	8	4	2	2	3	8	2	35	2.5	4.3	1.7	-0.1	0.5
Bangladesh	0	6	4	4	6	0	3	8	0	31	4.3	7.2	4.9	-1	1.9
Zaire	4	6	0	4	4	0	3	8	2	31	1.8	-11	2.3	-4.5	-2.2

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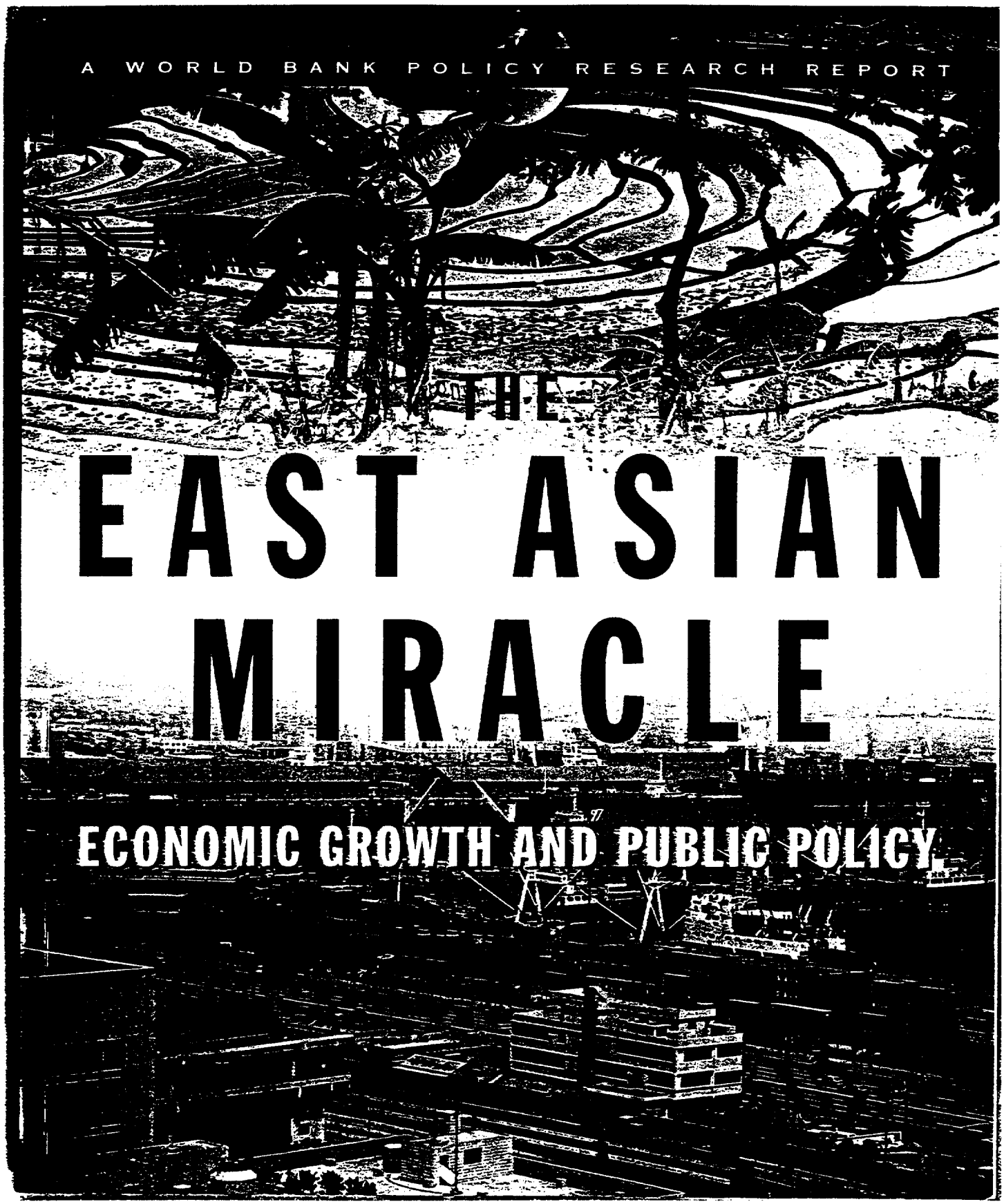

THE EAST ASIAN MIRACLE

ECONOMIC GROWTH AND PUBLIC POLICY

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A World Bank Policy Research Report

The East Asian Miracle

Economic Growth and Public Policy

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Using the International Market: Trade and Industrial Policy

WHILE THE LINK BETWEEN INTERNATIONAL TRADE AND economic growth is widely accepted, the precise nature of the relationship is controversial. Early writing on trade policy and growth stressed the benefits of neutral incentives between production for the domestic market and production for export. With neutral incentives, it was argued, resources would flow to sectors in which the economy was most internationally competitive (Corden 1971), and gains in technical efficiency (or "X-efficiency") would result from a more competitive environment (Nishimizu and Page 1991). Studies in the late 1960s and early 1970s convincingly demonstrated the extreme bias in incentive structures against exports and agriculture in most developing economies and the resulting high costs of import-substituting industrialization.[24] Recent theoretical work has argued that, where market power, economies of scale, learning, or externalities are significant, departures from neutral incentive regimes (low and uniform tariffs) may improve economic performance (Krugman 1986). This literature, however, unlike the earlier carefully documented studies of the costs of protection, provides very little evidence concerning the importance of these factors or the potential benefits to growth of departures from trade neutrality.[25]

Proponents of trade neutrality and intervention both cite the records of the high-performing Asian economies as evidence supporting their views. As we noted in chapter 1, international trade is important in all the HPAEs and is the factor most consistently correlated with their success. Balassa (1991), Krueger (1993), Hughes (1992), and others argue that openness to international trade, based on largely neutral incentives, was the critical factor in East Asia's rapid growth. Conversely, advocates of trade interventions, while acknowledging the importance of trade, note that incentives deriving from quantitative restrictions on imports, tariffs, and subsidies were not neutral among sectors (or firms) during their periods of rapid growth. They argue that the HPAE governments successfully intervened to change comparative advantage (Amsden 1989; Wade 1990; Singh 1992).

Industrial policy interventions, which often use trade policy instruments, are motivated by the belief that shifting industrial structures toward newer and more modern sectors increases the opportunities for

capturing dynamic scale economies that result from learning. During their heavy and chemical industries programs, Japan and Korea were the most active HPAEs in promoting individual industries and sectors. Singapore and Taiwan, China, have also actively provided incentives for technological upgrading. Malaysia had an HCI program reminiscent of Japan's and Korea's, while Indonesia has attempted to leapfrog from labor-intensive manufacturing to high-technology industries such as aircraft and electronics.

How have trade and industrial policies affected growth in East Asia? To answer this question we first examine those conditions that might justify government efforts to promote specific sectors. We then describe the trade and industrial policy regimes in the HPAEs and compare their domestic relative prices with international prices to determine the extent of interventions. Finally, we evaluate two approaches to increasing productivity. We find, on the one hand, that government efforts to promote specific industries generally did not increase economywide productivity. On the other hand, the evidence shows that broad government support for exports was a highly effective way of enhancing absorption of international best-practice technology, thus boosting productivity and output growth.

Market Failures, Trade, and Industrial Policies

Why should governments interfere with the level playing field created by the international market? Our discussion of coordination failures in chapter 2 touched on many of the reasons, but it may be useful to review some of the arguments specifically as they apply to trade and industrial policy.[26] Among the many reasons for discrepancies between social and private returns cited earlier, four stand out:

- *Interdependent investments and economies of scale.* Increasing returns from scale and capital market imperfections may mean that investments that could be internationally competitive at optimal scales will not be undertaken. This is especially true with large, interdependent projects for which optimum scale depends on simultaneous investment in upstream and downstream industries. The larger the indivisibilities and returns from scale, the more likely that private initiatives will be absent.
- *Strategic negotiations.* In negotiations with other economies and foreign companies, governments can alter the nature of the market environment by intervention. The outcome of any bargaining problem

depends on the strength of competition on both sides. By coordinating the actions of buyers of technology and trying to increase competition among sellers, governments can appropriate more of the surplus associated with the transfer of technology than they otherwise could (Stiglitz 1993a).

- *Pecuniary externalities.* Pecuniary external economies arise if, as the size of a competitive industry increases, the long-run supply curve falls (Marshallian real externalities). Such gains in productivity are attributable to economies of scope in the use of specialized equipment and greater specialization of individual skills. When economies are small, current prices may not convey adequate information about prospective lower costs of production through larger plant size (Scitovsky 1953; Chenery 1959).[27] Externalities can also arise from the interaction between suppliers and buyers about the design or production of a product leading to a better or cheaper good than is available internationally. In this case, the source of the externality is the nontradability of some types of inputs or knowledge—otherwise the improved method or product could be obtained from international suppliers.
- *Learning.* Externalities related to learning have traditionally been identified as important sources of market failures in developing economies. When firms gain knowledge of production from other firms without incurring costs, real externalities are present.[28] Because of incomplete appropriability of knowledge, individual firms may spend less on obtaining production knowledge than is socially optimal.[29] Externalities due to learning may also be conferred on other firms by the first entrant. These include the demonstration that the sector is physically and economically feasible and the leakage of information on technology and marketing (Pack and Westphal 1986; Rob 1990).

Economists initially responded to these market failures with arguments supporting the protection of so-called infant industries. Protection was seen as necessary so that firms could gain the experience needed to lower costs and become viable.[30] Industrial policy advocates take the argument a step further. Because they associate learning with capital- and knowledge-intensive industries, they advocate a rapid shift in industrial structure toward these activities, even if they are not internationally competitive at present levels of scale, knowledge, and factor prices. In this view, the short-run allocative costs of establishing internationally uncompetitive industries will be outweighed by the long-run benefits of rapid productivity change in the promoted and linked sec-

tors. But as the many infant industries that have never grown up amply demonstrate, protection does not ensure that the promised learning and economies of scale actually materialize.

Trade Policies in the HPAEs

Most HPAEs began industrialization with a protectionist orientation and have gradually moved toward increasingly free trade. Along the way (as we showed in chapter 3), they often tapped some of the efficiency-generating benefits of international competition through mixed trade regimes: they granted exporters duty-free imports of capital and intermediate goods while continuing to protect consumer goods. Export prices were set in the international market and were often substantially less than current marginal or average costs.[31] Losses on export production offset profits in the protected market, while competition in the international market ensured that the firm would not suffer from loss of cost discipline. More recently, all the HPAEs have reduced their protection of import-substituting industries.

Below we describe the evolving patterns of protection in the HPAEs, with the exceptions of Hong Kong and Singapore, which adopted essentially free trade stances early in their development.

Japan. Japan pursued an early import-substituting industrialization strategy, similar in many dimensions to those of Argentina, India, and other less successful economies. As late as 1968, effective rates of protection (ERPs) in Japan were still quite high and exhibited the cascaded pattern from raw materials (low) to consumer products (high) that is typical of most developing economies (see table 6.8). Unlike many import-substituting economies, however, there was surprisingly high protection of machinery (final producer goods), confirming other research indicating that the Japanese authorities engaged in an intensive effort to develop this sector. ERP levels in the machinery sector were reduced during the 1970s, only after it was evident from export performance that the sector had become internationally competitive (Itoh and Kiyono 1988). Quite high levels of protection were afforded sectors such as iron and steel and nonferrous metals as late as 1970. Protection in capital-intensive sectors such as pulp and paper and chemicals also remained high, to say nothing of the remarkably high levels in textiles.[32]

Korea. There is considerable evidence, summarized in Pack and Westphal (1986), that Korea selectively protected sectors that the gov-

Table 6.8 Effective Rates of Protection in Japan
(percent)

By type of goods

Type	*1963*		*1968*		*ERP-NRP*	
	NRP[a]	*ERP*[b]	*NRP*	*ERP*	*1963*	*1968*
Raw materials	3.1	0.8	3.9	0.9	-2.3	-3.0
Producer goods	13.7	29.6	15.2	22.3	15.9	7.1
Intermediate producer goods	12.3	28.0	14.1	21.7	15.7	7.6
Final producer goods	15.9	32.3	16.9	23.2	15.4	6.3
Consumer goods	21.6	44.6	23.6	35.8	23.0	12.2

By industry[c]

Industry	*1963*	*1968*	*1972*
Manufacturing	32.3	24.2	14.4
Textiles	54.3	28.2	18.6
Spinning	27.1	12.5	15.0
Weaving	44.6	30.5	15.5
Products	72.8	32.8	22.4
Wood products	14.0	25.6	16.1
Paper and pulp	9.7	18.0	11.0
Publishing	-16.7	1.0	-0.9
Leather and rubber products	30.9	21.8	12.3
Chemicals	33.4	17.7	8.8
Petroleum and coal products	19.5	14.5	7.1
Nonmetallic minerals	22.2	15.7	8.1
Iron and steel	30.1	30.0	17.1
Nonferrous metals	30.4	34.1	22.1
Metal products	13.8	19.9	9.9
Machinery	36.7	20.0	7.7
General machinery	23.0	14.5	8.7
Electrical machinery	30.9	16.5	5.4
Transport equipment	61.5	31.0	9.2
Precision instruments	34.9	22.9	10.4

a. NRP=Nominal Rate of Protection.
b. ERP=Effective Rate of Protection.
c. ERP based on simple averages of tariff rates.
Sources: For top panel, Itoh and Kiyono (1988); for bottom panel, Shouda (1982).

ernment hoped to promote. Protection consisted of both tariffs and nontariff barriers. Table 6.9 presents a summary measure that combines the effect of nominal tariffs and nontariff barriers.[33] The figures span the period 1966–85, and thus include the early efforts at industrial promotion, the HCI drive, and the subsequent liberalization. The 1966 figures show a relatively protectionist stance that becomes somewhat more

Table 6.9 Overall Degrees of Import Liberalization by Major Industry for the Republic of Korea, Selected Years (Consolidating Both QRs and Tariffs)
(percent)

Major industry	*1966*	*1970*	*1975*	*1980*	*1983*	*1985*
I. Primary Industry	42.0	56.5	55.1	58.8	65.3	71.2
II. Food, beverages, and tobacco	30.0	32.4	38.4	49.6	49.6	64.1
III. Textiles, clothing, and leather products	34.7	36.6	43.8	74.0	74.3	87.8
IV. Wood and its products	24.2	64.0	69.1	76.5	82.7	92.4
V. Paper, paper products, and printing and publishing	39.5	54.7	54.5	78.4	88.8	90.8
VI. Chemicals, petroleum, coal, rubber, and plastic products	47.9	57.1	58.4	65.9	75.2	80.0
VII. Nonmetallic mineral products	41.0	77.0	76.8	89.1	89.2	91.7
VIII. Basic metal products	44.7	73.3	74.8	86.2	90.1	92.0
IX. Metal products, machinery, and equipment	41.0	59.3	55.4	63.6	69.7	77.8
X. Other manufacturing	31.8	39.5	38.7	58.2	65.4	76.1
All manufacturing (II-X)	37.5	47.7	52.6	66.8	71.3	79.8
Light industry (II-VX)	33.7	38.2	43.7	62.3	63.8	76.8
Heavy and chemical industry (VI-IX)	44.5	62.5	61.2	70.5	76.5	81.7
All-industry average (I-X)	39.6	50.8	52.3	65.6	70.4	78.5

Note: This table gives the degrees of import liberalization by major industry; these are obtained by averaging sectoral data, weighted by the current price value of domestic production for respective years.
Source: Sakong (1993).

liberal by 1975. Nevertheless, even by 1983, when Korea's success had become an established fact, most sectors were still protected by some combination of tariffs and nontariff barriers. While Korea utilized a variety of instruments, especially export targets and rebates, to ensure that exporters faced international prices for their tradeable inputs, there was considerable protection of goods sold on the domestic market.

Taiwan, China. Wade (1990) provides a careful description of the extent of intervention by authorities of Taiwan, China, in product markets. The pattern of protection is not dissimilar from that of Korea. As late as 1972, a significant percentage of items were subject to nontariff barriers, and two-thirds of potential imports were subject to nominal tariffs in excess of 30 percent. As late as 1980, more than 40 percent of imports received nominal protection in excess of 31 percent.

Indonesia, Malaysia, and Thailand. As we described in chapter 3, Indonesia, Malaysia, and Thailand all had import-substitution regimes that while modest by international standards, nevertheless favored production of manufactured goods for the domestic market at the expense of

agriculture and exports. Malaysia was notable for low, if variable, protection of import substitutes, while protection levels in Indonesia and Thailand were higher. All three economies began export-push trade strategies during their periods of protection of the domestic market. Tables 6.10, 6.11, and 6.12 provide recent data on the structure of effective protection for these three economies. Effective protection rates are declining but in Indonesia and Thailand they remain sufficiently high to result in some anti-export bias. The free trade regime for exporters in these economies partially offsets the structure of protection.

The Closeness of East Asian Domestic Prices to International Prices

Notwithstanding the protection that exists in all the HPAEs except Hong Kong and Singapore, domestic prices in these economies are closer to international prices than in other developing regions. Two bodies of evidence lead us to this conclusion. First, nominal tariff rates ad-

Table 6.10 Selected Effective Rates of Protection, Malaysia, Selected Years
(percent)

Sector	*1969*	*1979*	*1987*
Food products	83	88	—
Beverages	20	38	-22
Tobacco	125	—	-26
Textiles	—	58	15
Apparel	400	45	6
Wood products	33	38	82
Furniture	40	84	43
Paper and paper products	140	66	29
Printing and publishing	—	26	-9
Industrial chemicals	230	32	12
Petroleum refineries	—	22	5
Rubber products	60	129	14
Plastic products	265	312	163
Iron and steel	84	63	289
Fabricated metal products	40	26	30
Nonelectrical machinery	1,600	89	19
Electrical machinery	130	4	12
Transport equipment	185	59	65

— Not available.

Note: The effective rate of protection is the percentage by which value added at domestic prices exceeds value added at world prices.

Source: Salleh, Yeah, and Meyanathan (1993).

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Table 6.11 Selected Effective Rates of Protection, Indonesia, Selected Years
(percent)

Sector	*1975*	*1987*	*1990*
Food, beverages, and tobacco	336.2	122	124
Textiles, cloth, and footwear	231.8	102	35
Wood products	-1.2	25	33
Paper and paper products	87.3	31	20
Printing and publishing	—	—	—
Industrial chemicals	28.4	14	13
Petroleum refineries	—	-1	-1
Rubber and plastic products	426	57	48
Iron and steel	18.2	13	10
Fabricated metal products	—	—	—
Nonelectrical machinery	—	—	—
Electrical machinery	—	—	—
Transport equipment	—	—	—
Non-oil	—	-1	1
Cement	63.6	60.2	53.6
Manufacturing total (excluding oil sector)	74.1	68	59

— Not available.
Note: The effective rate of protection is the percentage by which value added at domestic prices exceeds value added at world prices.
Source: Bhattacharya and Pangestu (1993).

justed for the presence of nontariff barriers are lower in the HPAEs than in most other developing economies. Second, comparisons of real GNP across a broad range of economies indicate that domestic relative prices for tradable goods in the HPAEs are closer to international prices than in other regions.

Table 6.13 presents one of the few systematic attempts to compare nominal tariff rates for a broad range of developing economies (Erzan and others 1989).[34] The authors have also attempted to adjust for the effect of quantitative restrictions on levels of protection. (We have added comparable data for Taiwan, China, and have computed the average nominal tariffs for Korea, Malaysia, Thailand, and Taiwan, China.[35]) Nominal tariffs in the HPAEs are lower than for any other grouping of developing economies except the island economies of the Caribbean and the oil states of West Asia. The difference between Latin America (albeit before its recent trade liberalizations) and the HPAEs is striking. Thus while these economies favored production of import substitutes, they did so less than most other developing economies.

Table 6.12 Selected Effective Rates of Protection, Thailand, Selected Years
(percent)

Sector	*1971*	*1974*	*1978*	*Sept. 1981*	*March 1983*	*Oct. 1984*	*Nov. 1984*	*April 1985*
Averages								
All sectors	87.2	18.6	70.2	—	—	—	—	—
Excluding food, beverages, and tobacco	44.2	45.9	90.3	—	—	—	—	—
Manufacturing	—	—	—	77.4	67.4	65.3	57.0	66.3
Textile products	—	—	—	248.5	144.4	127.8	108.0	118.4
Leather products	—	—	—	151.3	199.7	199.0	167.0	152.7
Wood products	—	—	—	60.7	53.7	55.0	49.7	62.0
Paper and pulp	—	—	—	39.5	43.0	43.0	39.0	53.5
Chemical products	—	—	—	54.3	52.9	51.9	46.6	44.5
Rubber products	—	—	—	48.7	46.0	46.0	39.3	42.0
Other nonmetal products	—	—	—	99.8	102.7	102.3	89.8	108.5
Metal products	—	—	—	63.3	62.0	61.9	53.9	70.9
Machinery	—	—	—	14.1	23.6	23.6	21.0	29.3
Consumer goods and motor vehicles	—	—	—	34.9	33.4	33.5	30.6	45.6

— Not available.
Note: The effective rate of protection is the percentage by which value added at domestic prices exceeds value added at world prices.
Source: Brimble (1993).

Table 6.13 Average Tariffs and Para-tariffs, by Region 1985

Tariff/ para-tariff	*Caribbean*	*Central America*	*South America*	*North Africa*	*Sub-Saharan Africa*	*West Asia*	*Other Asia*	*Developing HPEAs*[c,d]	*All regions*
Tariffs									
Economies unweighted[a]	16	23	34	29	32	7	36	19	26
Economies import-weighted[b]	17	24	38	30	35	4	22	17	[illegible]
Tariff plus para-tariffs									
Economies unweighted[a]	18	65	46	36	34	9	42	24	34
Economies import-weighted[b]	17	66	51	39	36	5	25	20	30

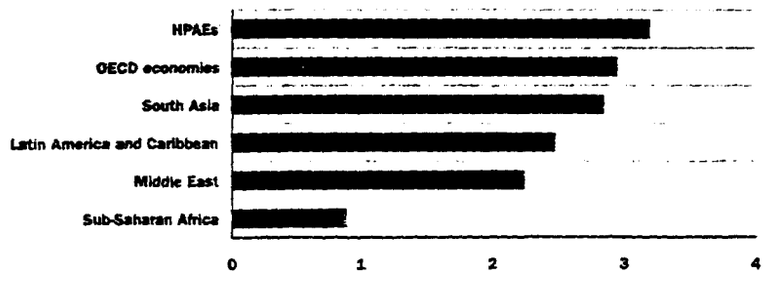
a. Simple averages across products and economies.
b. Simple averages across products; across countries, averages weighted by total imports.
c. Includes Korea, Malaysia, and Taiwan, China.
d. For Taiwan, China, 1981 data.
Source: Erzan and others (1989).

This is borne out by comparisons of international and domestic prices. Figure 6.4 shows an index of outward orientation based on international comparisons of price levels and price variability for the HPAEs compared with other regional groupings (Dollar 1990). The HPAEs as a group are more outward oriented than other regions; their relative prices are closer to and more consistently related to international prices. Of course, there is substantial variation among the HPAEs. As would be expected, Hong Kong, Malaysia, and Singapore rank in the top two deciles of the index, consistent with evidence on their structures of effective protection. Somewhat surprisingly, Thailand, with higher effective protection, also is ranked in the top decile, while Indonesia is in the top third. Japan, Korea, and Taiwan, China, rank in the fifth and sixth deciles, below such developing-economy comparators as Brazil, India, Mexico, Pakistan, and Venezuela. This is consistent with the evidence that the three northern HPAEs intervened far more frequently and systematically in their economies than the southeastern HPAEs (Dollar 1992). While any large, multi-economy effort at real price comparisons is subject to methodological and empirical criticism, the results are broadly indicative and consistent with other evidence: East Asia's relative prices of traded goods were closer on average to international prices than other developing areas.

Openness to Foreign Technology

An important factor in East Asia's successful productivity-based catching up was openness to foreign ideas and technology. Governments encouraged improvements in technological performance by keeping

Figure 6.4 Index of Outward Orientation



Source: Dollar (1990).

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several channels of international technology transfer open at all times, even though some, such as direct foreign investment (DFI), were restricted or closed for varying periods. In contrast to most economies with import-substituting industrialization strategies, even when protection was practiced with respect to the domestic market, the search for and absorption of foreign technology was encouraged. While Japan and Korea set obstacles to DFI, they were hospitable to licensing, though even here the Japanese attempted to ensure that they did not incur excess costs. Singapore was exceptionally welcoming to direct foreign investment, and a major task of the economic planning agency was to locate appropriate foreign investors. Malaysia has aggressively sought export-oriented DFI, particularly from Japan (see box 6.2). None of the HPAEs was hostile to the establishment of local buying offices by international purchasers, an important source of production and marketing knowledge. This selectively permissive attitude toward the acquisition

Box 6.2 Foreign Investment Brings Export Technology to Malaysia

IN THE 1970S AND EARLY 1980S, DIRECT FOREIGN investment was welcome in Malaysia. Government policy encouraged foreign investors, yet the effect was inhibited by the conflicting goal of increasing local participation in corporate ownership. Then, the recession of 1985–86, large fiscal and trade deficits, and declining investment brought an all-out push for DFI, especially for export. New policies offered greater tax incentives and relaxed domestic equity participation requirements for potential investors, bringing technology and export and employment opportunities.

The new flexibility had a dramatic effect on foreign investment. DFI approvals in Malaysia, which averaged US$300 million a year in 1983–85, jumped to US$2 billion by 1988. The investments became more dynamic. In 1988 a quarter of the DFI originated from Japan, followed by Taiwan, China, and the United States—in contrast to the previous ten years, when the greatest source of DFI had been Singapore, naturally attracted by historical ties and physical proximity. New investments were directed toward electrical and electronic products, chemical products, rubber products, basic metal products, and petroleum. More of the investments were dedicated to exports than ever before.

The benefits to Malaysia of DFI have been substantial, particularly in generating foreign exchange and employment. However, some critics argue that linkages with the local economy have not been strong—at least, not as strong as in neighboring recipients of DFI. Two important reasons for that are the young age of many of the investments in Malaysia and the relative scarcity of management capacity, skilled labor, and high-quality suppliers, a result of Malaysia's late start as an HPAE. But the foreign investment projects themselves have contributed to building know-how in the economy. In 1985 the thirteen American semiconductor manufacturers in Malaysia spent more than $100 million in training Malaysian workers, mostly engineers and technicians. Local value added has been rising as established firms upgrade their technology to keep up with world markets, and firms have added testing of

of knowledge of international best practice was a reflection of the view that the world market for goods and services provided an opportunity, not a threat.

In contrast, many other developing economies that tended to emphasize the dangers of opening to world markets were equally suspicious of open policies with respect to knowledge acquisition. Suspicion of external trade was often reflected in a mistrust of DFI and licensing. The absence of exports reinforced the suspicion. Even where DFI was permitted in inward-oriented economies, it was not viewed as providing access to international best practice but rather as a source of additional domestic production. Thus some economies in Latin America that were hostile to licensing nevertheless allowed DFI in production for the domestic market. The basic difference between these economies and Singapore, which was much more heavily dependent on DFI, is that the multinational corporations locating in the latter could only do so to export,

semiconductors to their assembly activities. There is also no doubt that DFI has created a lot of employment—often for poor rural Malay women—to the tune of 85,000 in electronics alone in the late 1980s.

Malaysia has found that, as investments mature and local and regional linkages are fortified, multinationals that are often thought of as "footloose" stay, and the positive spillovers created by successful ventures encourage more investment. For example:

- Since the 1970s, DFI has made Malaysia the world's third largest producer of semiconductors, garnering almost US$3 billion in net exports in 1986. In the late 1980s, Siemens built in Malaysia its fourth plant in the world to manufacture megachips (the other three were in Germany, Japan, and the United States). But foreign companies have not kept to semiconductors—investments in electronics have spread both backward and forward. National Semiconductor recently built Malaysia's first wafer fabrication plant to supply its local semiconductor plants; Motorola and Hitachi have followed suit. Seagate has expanded production of disk drives from Singapore to Malaysia. The expertise Malaysia has built up in electronics is considerable. Nixdorf Computer AG, which recently established a US$3 million software center to create applications for UNIX-based workstations, was attracted to Malaysia by the fact that its software engineers cost one-fifth of Germany's. Intel called in its Malaysian experts to help set up a chip assembly line in Arizona.
- Malaysian plants produce a range of products, from color TVs, radio cassette players, and toasters to computer peripherals. Many companies that started small in Malaysia have stayed and expanded. Sharp has become involved in several joint ventures in Malaysia, where it assembles color televisions and computer monitors. Sony began to manufacture in-house some of the components for its new color TV plant in Malaysia in the late 1980s. Matsushita's Malaysian operations, which grew in the mid-1980s as expenses rose in Japan, have come to supply 10–15 percent of the world market for room air conditioners.

Source: Lim and Fong (1991).

given the small internal market. Korea and Taiwan, China, with larger domestic markets, created a similar situation by encouraging DFI in production for export and in those sectors where substantial technology transfer could be anticipated. In contrast, the large import substitution economies, such as Argentina, Brazil, and Mexico lured investment of foreign firms by offering access to protected domestic markets.

Industrial Policies

We define industrial policies, as distinct from trade policies, as government efforts to alter industrial structure to promote productivity-based growth. Productivity-based growth may derive from learning, technological innovation, or catching up to international best practices. All the HPAEs, except Hong Kong, have employed industrial policies as defined above. Japan and Korea had the most systematic set of policies to alter industrial structure. Efforts in Taiwan, China, were less systematic but were nonetheless widespread. Industrial policy in Singapore was more functionally directed at the rapid upgrading of technology by direct foreign investors, regardless of type of output. Indonesia, Malaysia, and Thailand have all used industrial policies but much less systematically than the northeastern HPAEs.

Industrial Growth and Productivity Change. HPAE industrial growth patterns differ from the patterns in most other low- and middle-income economies in the relative size and growth rates of two important industrial subsectors: metal products, electronics, and machinery; and textiles and garments. Table 6.14 shows the share of value added in nine International Standard Industrial Classification (ISIC) subsectors as a percentage of the total value added of manufacturing. Among the HPAEs, metal products, electronics, and machinery (ISIC subsector 38, or MPM) have grown unusually fast. The sector's share of manufacturing value added doubled in Japan and Singapore, nearly tripled in Indonesia and Korea, and quadrupled in Malaysia. More surprising than the importance of growth in MPM, which provides vital inputs to numerous other manufacturing subsectors, is the continued importance of textiles and garments even as the rapidly developing Asian economies shifted from labor- to capital-intensive production.

Appendix 6.1 describes our method for determining the projected relative importance of specific industrial subsectors in cross-economy comparisons. As can be seen in table 6.15, both capital-intensive sectors

Table 6.14 Current Price Value Added as a Share of Manufacturing Value Added

Economy/ region	*Food, beverages, and tobacco*	*Textiles and clothing*	*Wood and wood products*	*Paper and printing*	*Chemicals and rubber*	*Non-metallic minerals*	*Basic metals*	*Metal products and machinery*	*Other*	*Total manufacturing*
HPAEs										
Hong Kong										
1973	0.05	0.48	0.02	0.05	0.12	0.01	0.01	0.23	0.03	1.00
1988	0.06	0.38	0.01	0.08	0.10	0.01	0.01	0.33	0.04	1.02
Indonesia										
1973	0.59	0.14	0.01	0.01	0.16	0.03	0.00	0.05	0.01	1.00
1988	0.26	0.15	0.11	0.03	0.15	0.05	0.09	0.14	0.01	0.99
Japan										
1953	0.09	0.16	0.04	0.10	0.16	0.05	0.12	0.24	0.02	0.98
1989	0.09	0.05	0.03	0.08	0.16	0.04	0.07	0.46	0.01	0.99
Korea, Rep. of										
1986	0.23	0.19	0.05	0.06	0.21	0.06	0.04	0.15	0.02	1.00
1988	0.11	0.15	0.02	0.05	0.18	0.04	0.07	0.36	0.02	1.00
Malaysia										
1969	0.16	0.05	0.07	0.11	0.27	0.01	0.06	0.06	0.23	1.02
1988	0.18	0.07	0.07	0.04	0.27	0.06	0.03	0.27	0.01	1.00
Singapore										
1969	0.14	0.05	0.07	0.06	0.30	0.03	0.03	0.29	0.02	0.99
1989	0.05	0.04	0.01	0.05	0.20	0.01	0.01	0.61	0.01	0.99
Thailand										
1968	0.26	0.17	0.13	0.04	0.09	0.16	0.02	0.12	0.01	1.00
1986	0.42	0.22	0.03	0.03	0.09	0.08	0.02	0.11	0.01	1.01
South Asia										
India										
1970	0.12	0.21	0.01	0.05	0.18	0.04	0.12	0.25	0.01	0.99
1986	0.12	0.15	0.01	0.04	0.24	0.05	0.10	0.29	0.01	1.01
Pakistan										
1970	0.24	0.34	0.00	0.03	0.20	0.04	0.02	0.08	0.04	0.99
1986	0.30	0.21	0.00	0.02	0.26	0.07	0.04	0.09	0.00	0.99
Latin America										
Brazil										
1970	0.17	0.13	0.05	0.06	0.19	0.06	0.12	0.20	0.02	1.00
1985	0.14	0.12	0.03	0.05	0.24	0.04	0.08	0.27	0.03	1.00
Chile										
1970	0.17	0.12	0.02	0.02	0.10	0.03	0.34	0.16	0.00	0.96
1986	0.25	0.08	0.03	0.10	0.16	0.04	0.28	0.07	0.00	1.01
Colombia										
1970	0.34	0.19	0.02	0.06	0.17	0.04	0.03	0.14	0.01	1.00
1988	0.30	0.15	0.01	0.07	0.19	0.06	0.06	0.15	0.01	1.00
Mexico										
1970	0.31	0.08	0.01	0.07	0.15	0.06	0.24	0.09	0.00	1.01
1984	0.28	0.05	0.00	0.05	0.17	0.11	0.19	0.15	0.00	1.00

Source: Pack (1993b).

(MPM) and labor-intensive sectors (textiles) play a greater-than-predicted role in manufacturing in most of the HPAEs (except Indonesia and Malaysia). Besides the unexpected prominence of textiles and garments, the analysis yields another surprise. Chemicals and nonmetallic minerals, two sectors often associated with industrial modernization, are not large in the HPAEs by international standards.

Detailed sectoral growth rates of total factor productivity are available for Japan, Korea, and Taiwan, China. There are now sufficiently long time-series data to conclude that in these economies, TFP growth has accounted for a substantial fraction of the growth of constant price value added in manufacturing. Table 6.16 shows a variety of estimates of long-

term TFP growth rates. Given the length of time of the observations, it seems unlikely that the measured growth rates of TFP could be attributable to cyclical phenomena or growing capacity utilization of initial large investments.[36]

Strategies of Selective Promotion. Here we describe the strategies of selective promotion that have evolved in the HPAEs as they developed their industrial policies.

Japan. Early Japanese industrial policy aimed to encourage sectors that faced income-elastic demands in the international market and exhibited economies of scale, large fixed costs, and the potential to learn from experience. This purely economic rationale was supplemented by a sense that some sectors were critical to national morale and the

Table 6.15 Actual/Predicted Share of GDP Originating in Manufacturing Sectors

Economy/ region	*Food, beverages, and tobacco*	*Textiles and clothing*	*Wood and wood products*	*Paper and printing*	*Chemicals and rubber*	*Non-metallic minerals*	*Basic metals*	*Metal products and machinery*	*Other*	*Total manu-facturing*
HPAEs										
Hong Kong										
1973	0.21	10.31	0.89	0.53	0.78	0.14	0.37	2.86	0.35	1.25
1988	0.43	118.95	0.36	0.65	0.67	0.14	0.17	1.96	0.38	1.26
Indonesia										
1973	1.63	0.75	0.30	0.18	0.40	0.20	0.00	0.44	0.06	0.62
1986	0.75[a]	0.25[a]	1.42	0.06	0.54	0.95	0.62	0.11	0.01	0.57
Japan										
1963	0.75	2.98	2.42	1.36	0.73	0.63	1.00	2.41	0.67	1.23
1989	0.98	13.52	0.88	0.66	0.69	0.52	0.71	1.69	0.14	0.97
Korea, Rep. of										
1968	0.99	1.75	2.03	1.04	0.94	0.73	0.52	2.07	0.20	1.04
1988	0.85	2.74	0.71	0.64	0.99	0.62	1.13	2.76	0.32	1.26
Malaysia										
1969	0.35	0.25	1.55	0.89	0.80	0.05	0.69	1.03	1.43	0.64
1981	0.94	0.68	3.28	0.57	0.89	0.70	0.57	2.44	0.07	0.97
Singapore										
1973	0.31	2.14	2.40	0.49	2.09	0.75	1.53	12.56	0.13	1.41
1989	0.26	11.32	0.51	0.47	1.72	0.27	0.61	5.10	0.14	1.38
Thailand										
1968	0.90	1.21	4.89	0.70	0.36	1.69	0.22	3.16	0.09	0.95
1986	0.34	3.33	1.85	0.71	0.65	1.39	0.33	1.82	0.22	1.68
South Asia										
India										
1963	0.50	6.00	0.54	2.33	0.33	0.37	0.80	3.74	0.32	1.10
1986	0.56	2.39	0.18	1.02	0.89	0.35	0.68	2.51	0.09	0.92
Latin America										
Brazil										
1963	0.91	1.80	1.84	1.03	0.69	0.51	1.31	2.28	0.00	1.02
1985	0.94	1.70	1.21	0.78	1.12	0.48	0.91	1.92	0.36	1.09
Chile										
1963	1.12	3.04	1.21	1.07	0.79	0.73	1.63	2.65	0.24	1.21
1980	1.18	1.06	1.25	0.94	0.67	0.48	4.36	0.88	0.03	1.01
Mexico										
1965	1.37	0.49	0.41	1.08	0.76	0.84	2.37	0.64	0.00	0.95
1984	1.57	0.64	0.15	0.60	0.70	1.05	1.94	0.82	0.00	0.92

a. Predicted value was negative; calculated here as positive.
Source: Pack (1993b).

Table 6.16 Long-Term TFP Growth Rates by Sector

	TFP growth rate		
Sector	*Korea*	*Japan, 1960–79*	*Taiwan, China, 1966–86*
Food	7.30	-1.76	2.0[a]
Beverages	7.90	0.0	—
Tobacco	13.40	—	—
Apparel	—	1.98	10.5
Textiles	10.70	0.47	7.6
Leather	12.60	1.03	—
Shoes	—	1.03	—
Wood	9.40	2.81	0.3[b]
Furniture	12.10	1.74	—
Paper	8.20	1.44	2.3[c]
Printing	10.70	-0.18	—
Chemicals	13.10	3.36	3.3
Petroleum	-0.30	-3.55[d]	0.0[b]
Rubber	11.40	1.02	6.3[b]
Nonmetallic minerals	2.80	—	2.4
Basic metals	—	—	7.2
Iron and steel	3.70	1.34	—
Metal products	7.60	3.41	4.4
Nonelectrical machinery	8.00	2.30	6.7[e]
Electrical machinery	10.70	5.37	—
Electrical equipment	—	—	7.1
Transport equipment	11.20	4.32	2.7
Precision instruments	—	—	11.0
Plastic products	—	0.92[f]	0.0
Other manufacturing	7.50	-1.76	—
Average	8.8	1.2	4.6

—Not available.
a. Food and beverages.
b. Rubber, petroleum, and wood products.
c. Paper and paper products.
d. petroluem ref. and coal.
e. All machinery.
f. Plastic.
Source: Pack (1993b).

achievement of international respect.[37] In later years, industrial policy had a narrower technological focus, for example, promoting establishment of the technological base for very large-scale integrated circuits (Borrus, Tyson, and Zysman 1986). Among the sectors carefully nurtured were steel, automobiles, textiles, shipbuilding, and aluminum refining in the earlier years and then electronics and semiconductors in

later years.[38] (Effective rates of protection in these industries can be seen in table 6.8.)

Japanese industrial policy until the early 1970s had several strands (Yamamura 1986; Yamamura and Yasuba 1985). The government directed credit to large firms and protected the domestic market to help the firms realize static and dynamic economies of scale. MITI allocated foreign exchange to favored large firms and tried to ensure that technology payments to foreign firms were neither excessive nor duplicated, often forcing licensees to share their information with other Japanese firms. Relatively high levels of protection were used as part of a strategy to help firms to export successfully. As late as 1978, the average of effective rates of protection across the manufacturing sector was 22 percent.[39] Such rates may have been responsible for the very low level of manufactured imports, an issue widely discussed in the scholarly literature (Balassa and Noland 1988).

Korea. Korea's policies were similar to Japan's with respect to selected credit, protection, and limitation of entry into specific sectors (Pack and Westphal 1986). However, the Korean government promoted individual firms more often to rectify perceived entrepreneurial and skill deficiencies, using export performance to determine whether firms deserved continued promotion. Other policies to encourage industrial growth and exports included making direct and indirect inputs to exports available at world prices. In Korea, the selectively promoted sectors were the heavy and chemical industries: iron and steel, metal products, machinery, electronics, and industrial chemicals. The motivation for these appears to have been both strategic—to increase defense capability—and economic—to shift to capital- and technology-intensive sectors in anticipation of a loss of competitive advantage in labor-intensive sectors.[40] The costs of the HCI drive are still not fully known, but they were high (see box 6.3). Although there are no recent estimates of Korean rates of effective protection, there is considerable anecdotal information suggesting that the government afforded these sectors relatively high protection.

Taiwan, China. The intervention of Taiwan, China, in manufacturing has been similar to Japan's and Korea's, though less important quantitatively. Wade (1990) has documented tariffs, quantitative restrictions, and selective credit policies, maintaining that the success of Taiwan, China, was at least partly attributable to an intensive government effort to direct the economy's sectoral evolution. This conflicts with the standard neoclassical view that its development was primarily attributable to

low protection, the availability of inputs to exporters at international prices, a conservative macroeconomic policy reflected in low inflation, and competitive factor markets (Little 1979).

Unlike the situation in Japan and Korea, in Taiwan, China, it is difficult to discern a pattern of economic incentives. Wade (1990) notes that a guiding principle in the 1960s may have been the existence of

Box 6.3 The HCI Drive: Costs of Intervention

THE KOREAN GOVERNMENT'S INTERVENTION policy, most notably the HCI promotion, has often been evaluated from the perspective of the success or failure of industrial policy. Another important approach in evaluating intervention policy, however, would be to estimate the fiscal/financial cost associated with intervention. Government intervention incurred direct costs in the form of subsidies to strategic sectors through policy loans and tax exemptions, especially during the 1973–79 period of HCI promotion. Intervention also incurred indirect costs in the form of accumulated nonperforming loans and the resulting portfolio difficulties of commercial banks.

The promotion of the HCI sector was supported by a broad range of fiscal and financial instruments. Government funds devoted to the HCI sector amounted to 5 percent of the total budget during the promotion period. In addition, profit tax exemptions of up to 100 percent for the first three years and 50 percent for the next two years provided effective tax rates about two-thirds lower for strategic industries; at the height of the HCI drive in 1977 alone, about 82 billion won in tax revenues (3 percent of total taxes collected) was lost. The predominant source of financial support for HCI was preferential policy loans directed to key industries. In 1977, for example, 45 percent of the total domestic credit of the banking system was engineered in direct support of the HCI sector. Implicit interest subsidies to the HCI sector in 1977 alone were an estimated 75 billion won, or 0.4 percent of GNP (calculated by applying an interest differential of 3–4 percent vis-à-vis the interest rates for general bank loans). This estimate should be considered the lower bound, however. Those industries whose credit was squeezed were forced to borrow at curb market rates. The real effective subsidies for HCI borrowers were therefore as high as 3 percent of GNP.

As the Korean government opted to bail out the struggling heavy machinery, shipbuilding, overseas construction, and shipping industries in the mid-1980s, nonperforming loans of commercial banks accumulated rapidly, and accordingly bank profitability seriously deteriorated. During 1986–87, for example, the share of nonperforming loans in total assets reached almost 10 percent. Between 1985 and 1988, 78 corporations were "rationalized." During this process, write-offs of principal alone amounted to 1 trillion won, or about 1 percent of GNP in 1985. Far more damaging was the further issuance of subsidized funds to rationalized firms and the preferential access to Central Bank discounts, which has hurt the balance sheet.

As the Korean government abandoned HCI preferences during the traumatic economic adjustments of 1979–81, the direct costs of interest subsidies all but disappeared. In contrast, it has taken more than a decade to begin to deal with the indirect costs in the form of accumulated nonperforming loans and squeezed bank profitability. Not until 1993 did the Korean government announce a medium-term plan to transfer policy loans—which still account for more than 40 percent of total domestic credit—to separate accounts and to handle their financing through the budget at yet to be determined costs.

Sources: World Bank (1987); Leipziger and Petri (1993); Nam (1991); Kim (1990).

gaps in the domestic input-output table that revealed potential areas of import substitution. The autobiography of a major architect of the island's development supports this view (Li 1989). Although anecdotal evidence summarized by Wade demonstrates considerable intervention in many sectors, there are no studies of effective rates of protection or subsidy after the early 1970s. The more recent intentions of the government may be discerned directly from two infrastructural efforts, namely, the Hsinchu Science Park and the Industrial Technology Research Institute. Both were major investments undertaken by the government to provide the basis for a rapid shift toward higher-technology sectors.

Malaysia. In the 1980s Malaysia experimented with a heavy and chemical industries drive similar in focus to those of Japan and Korea but dependent on public investment. The Look East policy adopted in 1981 was, apart from its sociocultural aspects, an explicit attempt to emulate the heavy industrialization efforts of Japan and Korea, which were regarded as successes. The government created the Heavy Industries Corporation of Malaysia (HICOM) to be the vehicle for the heavy industrialization push. HICOM targeted a number of large-scale, capital-intensive projects for development including iron and steel, nonferrous metals, machinery and equipment, paper and paper products, and petrochemicals. While public investments were intended to be catalytic in each of these activities, the government actively promoted joint ventures with private (usually foreign) investors. By 1988 HICOM had set up nine companies, employing a total of 4,350 workers, involved in steel, cement, motor vehicle, and motorcycle engine manufacturing. The highest profile of these investments was the PROTON car project, a joint venture with Mitsubishi designed to produce 100,000 units per year.

The ambitious targets of the HICOM program ran into the macroeconomic constraints described in chapter 3—declining terms of trade and a deteriorating fiscal position. Prompt responses to the deteriorating macroeconomic situation included reductions in public investment in the HICOM program. Poor management and low profitability also forced the treasury to bail out loss-making enterprises, a practice it could not sustain under the fiscal austerity of the adjustment program. With the shift to policies of privatization of public enterprises and private sector development in the late 1980s, the HICOM period had ended (see box 6.4).

Indonesia and Thailand. Neither Indonesia nor Thailand has made the systematic efforts to change industrial structure characteristic of

Box 6.4 Recognizing a Mistake, Malaysia Privatizes

THE PUBLIC SECTOR IN MALAYSIA WAS RELATIVELY small until the late 1970s, when the government rapidly expanded the number of state firms, partly to give Malays opportunities and partly out of a conviction that the government could speed development. Much of the growth in the early 1980s was due to HICOM, the Heavy and Industrial Corporation of Malaysia, which established nine subsidiaries in such areas as steel, automobiles, cement, and paper.

State firms, especially in HICOM, performed less well than expected, and in 1984 the deficit of the public enterprises reached 3.7 percent of GNP. As rising fiscal deficits and declining terms of trade threatened macroeconomic stability, the government began to privatize in 1983. Of more than 800 state firms existing in the mid 1980s, about a hundred had been sold by 1990. Many were small commercial and manufacturing operations, but some were quite big, including an airline, a shipping company, and a telecommunications firm.

There have been glitches. For instance, the public offerings have been heavily oversubscribed, suggesting that the government underpriced its shares, perhaps losing as much as US$150 million in the sale of four big companies. Also, more attention to promoting competition in monopolistic situations would benefit consumers, whether firms are privatized or not. Finally, privatization has proceeded very slowly; while it continues to this day, the Malaysian public sector remains formidable.

In any case, privatization in Malaysia has meant more than outright sales. It has included a host of schemes that have reduced the control of the state over productive activities even where the public sector has retained a controlling interest, as with PROTON, the automobile company in HICOM. Even when firms have not literally been privatized, the firms have experienced a change in regime: managers increased their control over decisionmaking and responded more to the market. The result was that many so-called privatized firms became more productive and innovative. Nor can the macroeconomic benefits be overlooked: in the end, the federal government anticipates that at least 15 percent of its outstanding debt will have been transferred to privatized firms.

Malaysia's slow but steady divestiture and the benefits it realized by adapting flexibly to the circumstances of each case provide an example for many other developing economies, where privatization is an official goal, yet much less has been achieved. A detailed analysis of the companies that were privatized shows consistent gains in social welfare. As two cases below illustrate, changes in incentives and a broader role for private sector interests have frequently been more important than the change in ownership per se.

Malaysian Air Systems Berhad (MAS). When 48 percent of MAS was sold to the public in 1985, there was no change in management or de jure authority. Even so, management gained de facto control over investment decisions and eventually won permission to raise domestic fares. While the fare increase hurt consumers, less rationing of tickets raised consumer welfare. Moreover, while MAS had about broken even in the early 1980s, it became a profitable tax-paying corporation.

Kelang Container Terminal (KCT). In 1985, 90 percent of KCT was sold to decentralized public enterprises and 10 percent to the private sector. Although the public sector retained control, the state firms that took over, many representing Bumiputera interests, had a direct incentive to earn profits. KCT was a lucrative company before the sale, monopolizing container traffic in and out of the capital region, and remained so afterward; but the quality of its services was substantially improved, worker productivity increased, and its market share rose.

Sources: Jones and Abbas (1992); Lim (1992); Salleh (1991); World Bank (1988).

Japan, Korea, Malaysia, and Taiwan, China. Thailand's Board of Investment (BOI) has attempted to promote various activities viewed as having the potential for technological learning, but, as we pointed out in chapter 3, it is difficult to discern any systematic effort to change industrial structure from the pattern of promotion of the BOI. Indonesia has used public investment in an effort to move toward high technology industries. Indonesia's technology development efforts represent an extreme case of state-supported technological upgrading, but the public sector research facilities and strategic industries have few links with the private industrial sector. One experiment with leapfrogging into high technology industries—Indonesia's attempt to create an aircraft industry—is described in box 6.5.

Did Industrial Policy Increase Productivity?

Have attempts to alter industrial structure helped accelerate productivity change? We attempt to answer this question by addressing two related issues in appendix 6.1:

- First, did industrial policy alter the sectoral configuration of industries in ways that we would not predict based on factor intensities and changing relative factor prices? If changes in the sectoral composition of output are largely market-conforming, industrial policies must have failed in at least one of their objectives: to guide industrial development along paths that it would not take if it were guided by market forces.
- Second, what were the rates of productivity change in industry in the HPAEs, and what were their sectoral patterns? If rates of productivity change in industry are low overall or in promoted sectors, prima facie, industrial policy did not meet its productivity-enhancing objective.

In both cases, our answers lead us to conclude that industrial policies were largely ineffective.

Industrial Policy Only Marginally Altered Industrial Structure. The cross-economy comparisons of industrial structure raise questions about the efficacy of government efforts to promote or discourage specific sectors. In Korea, for example, despite the government's extensive efforts to speed the private sector's shift from labor-intensive to capital- and technology-intensive industries, the relatively labor-intensive textiles and garments

sector was nearly three times bigger than international norms predicted in 1988, a substantial increase relative to international norms from 1968. During the same period, Korea merely maintained the international norm in chemicals, a heavily promoted sector; while other heavily promoted sectors, basic metals and metal products and machinery, achieved only modest improvements. Similar surprises are evident in Singapore, which, like Korea, has a government that aggressively inter-

Box 6.5 Indonesia's Turbulent Leap into High Technology

SECTORAL TARGETING TO ACHIEVE RAPID PRODUCTIVITY change is a risky business—particularly when publicly funded firms are permitted to rely on protected domestic markets rather than being subjected to international competition. The dangers of such a course are evident in the difficulties encountered by Indonesian aircraft producer P.T. Industri Pesawat Terbang Nusantara (IPTN), which has absorbed $1 billion in government funds since its establishment in 1979 but has yet to become internationally competitive or genuinely profitable.

In theory, IPTN is expected to use the domestic market as a springboard to international sales. The strategy is to shift from producing aircraft under license, to co-design and co-production, to sole design and production. In practice, IPTN's captive domestic market is too small to generate the economies of scale necessary for efficient aircraft production. Moreover, the company has had little exposure to the world market. Of the 230 aircraft (130 helicopters, 100 fixed-wing) that IPTN has manufactured since its inception, about 90 percent have been sold to Indonesian airlines, the military, the police, and the state-run oil industry.

Foreign sales are unlikely to improve. While other aircraft manufacturers have been busy forging technological alliances to shrink the time from design completion to production, IPTN is increasingly trying to go it alone. Its major product for this decade, an independently designed fifty-seat turboprop, is not scheduled for delivery until 1995, five years after design completion. By then, the world market for similar aircraft, already crowded, will have several other new entrants, all pricing their aircraft aggressively. IPTN can ill afford a price war. Company results through 1985, the most recent available, indicate that IPTN was not profitable when capital costs are taken into account. Nothing in the company's performance since then indicates that the situation has improved.

vened through a variety of mechanisms to promote capital- and technology-intensive industries. Here, the importance of textiles relative to the predicted norm has increased even more sharply. The textile sector went from double its predicted size in 1973 to eleven times in 1989. Over the same period, metal products and machinery declined from twelve to five times its predicted size.

Appendix 6.1 describes a simple test of the impact of industrial policy on the basis of the factor proportions theory of comparative advantage (Hecksher-Ohlin-Samuelson). We assume that given the relative labor abundance in all of the HPAEs early in their industrialization, the share of labor-intensive manufactures in total manufacturing should rise as they begin exporting. We compare statistically the pattern of growth of the industrial sector in each economy with its pattern of factor intensities. We argue that if industrial structure is determined primarily by market forces, low wages and low capital intensity at the beginning of the period of active industrial policy will predict the pattern of industrial growth. If industrial policy to promote capital- and knowledge-intensive sectors was important in determining the sectoral pattern of growth, however, this should not be the case. Indeed, the opposite should be true; high wages (a measure of human capital intensity) and high capital intensity at the end of the promotion period should predict changes in industrial structure.

We have performed these tests on each of the Four Tigers plus Japan for periods relevant to their industrial promotion efforts, using two-digit ISIC classifications of industrial sectors (see table A6.2 in appendix 6.1). Our effort to differentiate between a comparative-advantage-based evolution of industrial structure versus one characterized by significant intervention is notable mainly for a number of negative results. In particular, in Korea—the economy for which significant intervention is best documented—during 1973–80 the most rapid growth in sectoral shares of value added occurred in lower-wage or lower value-added per worker sectors. In Korea at the two-digit level, sectoral growth was broadly market conforming in terms of traditional factor intensities. The results for Japan are inconclusive. In Hong Kong there is no relationship between our explanatory variables and patterns of production. In Singapore, for the period 1980–89, output grew more rapidly in more capital- and knowledge-intensive sectors, supporting the view that the Singaporean authorities successfully intervened to encourage increasingly capital-intensive development. But, given the

rapid growth in the capital-labor ratio in Singapore, this result also conforms to factor proportions theory predictions.

These findings do not imply that governments were not attempting to influence industrial structure. They undoubtedly were. But they suggest that, despite government intentions, the manufacturing sector seems to have evolved roughly in accord with neoclassical expectations; industrial growth was largely market conforming.

Rates and Patterns of Productivity Change in Industry. There is both good news and bad news for advocates of industrial policy in the productivity performance of East Asian industry. The good news is that, on average, rates of productivity change in industry in Japan (before 1973), Korea, and Taiwan, China, which are the only economies for which we have detailed sectoral estimates of TFP growth, were high by international standards; productivity-based catching up was taking place (Page 1991). The bad news is that, in general, productivity change has not been higher in promoted sectors. Japan may be an exception. Between 1960 and 1979 chemicals and the metalworking machinery complex have unusually good TFP performance (Jorgenson, Kuroda, and Nishimizu 1987). Japan's industrial structure differs from international norms in these sectors and exhibits quite high values of the share of value added in total manufacturing. These industries are those that observers usually point to as having received significant government support, including efforts to stimulate productivity growth.

A number of calculations of TFP have been carried out for Korea for a variety of periods (Dollar and Sokoloff 1990; Lim 1991). From these studies a number of patterns can be identified that are broadly consistent with one another. Most striking are the high values of TFP change in most sectors by international standards (Nishimizu and Page 1991). Although the Korean government selectively promoted chemicals and iron and steel (included in basic metals), the large growth in the share of iron and steel was accompanied by quite low TFP performance between 1966 and 1985; textiles and clothing, conversely, had very high rates of TFP growth. The promoted chemical sector, whose relative size was decreasing, was characterized by considerably higher-than-average TFP growth during this same period.

The government in Taiwan, China, did not attempt to influence sectoral evolution as strongly as the government of Korea. Nevertheless, there was more than a small effort devoted to encouraging specific sectors, particularly those viewed as either capital- or technology-intensive.

The three sectors that exhibited the greatest expansion in the share of value added—apparel, electrical equipment, and metal products—are all characterized by below-average wages, capital-labor ratios, and labor product. Moreover, there is no statistical relationship between wage or capital intensity and productivity change at the sectoral level. In fact, the highest sectoral rates of TFP change are recorded in textiles and apparel.

Recent sectoral TFP growth rates for industry in Malaysia from 1973 to 1989 show a similar pattern of great variability in the TFP growth rates in promoted sectors, from high in nonelectrical machinery and paper and paper products to low in iron and steel and transport equipment. Textiles and apparel, a nonpromoted sector, are among the TFP leaders (Maisom 1992). In short, there is no apparent relationship between the sectors promoted under the HICOM drive and rapid productivity growth.

Overall, the evidence that industrial policy systematically promoted sectors with high productivity change is weak. In Japan there is some support for the assertion that TFP growth was higher in selected sectors, while in Korea and Taiwan, China, activities that were not promoted (for example, textiles) had TFP performance as impressive as those that were. Moreover, attempts to determine whether high rates of TFP growth combined with rapid growth of promoted sectors can plausibly explain the very high overall rates of TFP change in manufacturing yield mostly negative results (see appendix 6.1). The main reasons for manufacturing's success in Japan, Korea, and Taiwan, China, lay in the high general rates of TFP growth, including those in labor-intensive, nonpromoted sectors.

How Manufactured Exports Increased Productivity

DOES THIS MEAN THAT PUBLIC POLICY HAD NO ROLE IN THE rapid rates of TFP change found for many of the HPAEs? We believe not. In chapter 1 we described how rapid TFP change in developing economies can be a result of the ability to move quickly closer to international best practices. We termed this "productivity-based catching up." We believe that rapid growth of exports, a result of the export-push policies of the HPAEs, combined with the superior performance of these economies in creating and allocating human capital, provided the means by which they attained high rates of productivity-based catching up and TFP growth.

How did the unusually high rates of growth of exports and human capital contribute to the productivity performance of the East Asian economies? Most explanations of the link between TFP growth and exports emphasize such static factors as economies of scale and capacity utilization. While these may account for an initial surge of productivity soon after the start of an export push, they are insufficient to explain continuing high TFP growth rates. Rather, the relationship between exports and productivity growth may arise from exports' role in helping economies adopt and master international best-practice technologies. High levels of labor force cognitive skills permit better firm-level adoption, adaptation, and mastery of technology. Thus, exports and human capital interact to provide a particularly rapid phase of productivity-based catching up.

Of course, it is possible that the move to a higher production function occurred before the growth in exports—that TFP growth caused export growth rather than the reverse.[41] But even if exports began on the basis of productivity change due to such domestic efforts as plant reorganization, the cumulative magnitude of productivity growth over many years is most unlikely to have been a result of purely domestic efforts.[42] It stretches credibility to suggest that the large cumulative effects of TFP growth in Japan, Korea, and Taiwan, China, could have been achieved by the plant floor innovations proposed as important sources of productivity growth at lower TFP growth rates (Pack and Page 1993). Were that the case, it would be difficult to explain why these gains far outstrip productivity increases in the industrial economies during their own rapid-growth periods, when TFP growth was attributable largely to domestic factors. Clearly, then, an increased ability to tap world technology has been an important benefit of exports.[43]

Exports' Role in Imperfect Knowledge Markets

Why do exports facilitate the move toward international best-practice technologies? The knowledge that permits this shift is available only in quite imperfect markets. Often the markets do not exist—some knowledge is simply not sold, because its owners fear that licensing or direct foreign investment will eventually leak the knowledge to future competitors. Even where markets exist, they are likely to be characterized by bilateral monopoly, so that a variety of difficulties confront firms trying to purchase such knowledge (Arrow 1969).

In markets with imperfect knowledge, mechanisms that help an economy or firm obtain technology can confer an externality—a pecuniary one if knowledge is obtained at a lower cost, a real externality if the knowledge transfer is more efficient. For example, the transfer may be more beneficial if knowledge is obtained as a result of the self-interest of purchasers of exports in the OECD economies, rather than through arm's-length purchase.

Exporting helps to overcome some imperfections in the market for knowledge and permits its acquisition through a variety of mechanisms. These include:

- *Purchase of new equipment.* The purchase of new equipment is a straightforward method of obtaining new technology insofar as it is embedded in equipment. The two main impacts of exports in this case are in providing the competitive pressure for firms to make such purchases (if the equipment is used to produce exports), and, more generally, in earning the foreign exchange to finance the purchase of machinery.
- *Direct foreign investment.* The firms that generate much of the world's new technology are reluctant to part with it. They perceive that the best use of their new knowledge with respect to developing economies often is through exports of products to them. In East Asia, however, most of the incoming DFI has been intended for production of exports rather than as a strategy for domestic sales. An economy's recent export performance frequently signals whether it is a desirable location for export-oriented DFI. Economies with rapid export growth are preferred in part because such growth often reflects good macroeconomic management. Moreover, economies with significant export growth have generally provided more infrastructure useful to exporters than internally oriented economies.[44] DFI makes crucial production and marketing knowledge available to developing economies. It permits them to begin manufacturing along the world's best-practice production function by substituting foreign physical and human capital for absent local factors.[45] As local labor learns from the presence of best-practice knowledge and equipment, knowledge tends to become diffused through labor mobility and informal contacts among managers. Even when the investing firm attempts to hinder such diffusion, significant knowledge transfers are inevitable.[46]
- *Technology licensing.* Licensing existing technologies, both rights to proprietary equipment and details about production processes, offers developing economies substantial opportunities for improving their levels of best practice. During the 1950s and 1960s, Japan benefited considerably from licensing (see, for example, Nagaoka 1989). The net gains were

large, as the licenses were obtained at relatively low cost compared with the domestic research expenses avoided. However, there is some evidence, and a growing subjective sense, that arm's-length licensing is decreasing as an option for closing technology gaps. Technology developers, the licensors in the OECD economies, have become wary of helping potential competitors, even if contracts preclude exports to other economies for the duration of the license. Particularly in R&D-intensive sectors such as chemicals, machinery, and electronics, firms are increasingly unwilling to license technology; they believe royalties provide an inadequate return for actions that may impair their own long-term competitiveness. This creates an imperfect or nonexistent market for critical technology transfers.

Exporting economies have an advantage in coping with this situation. Licensing firms prefer cross-licensing agreements in which they obtain access to the licensee's own technology or to its manufacturing skills. Given asymmetries in knowledge, the best test of the potential partner's abilities is its performance in export markets. Moreover, the fact that a firm has exports and the requisite technical and commercial skills to produce them improves the bargaining position of the licensee. Sales of licenses contain a significant element of rent (Pack 1993c), so the cost of licenses will be lower where the seller perceives the strengths of the purchaser as signaled by exports. Finally, where a market does exist for technology licenses, the foreign exchange to pay for fees is more likely to be available in economies experiencing rapid growth in exports.

- *Transfer of nonproprietary technology.* The free or inexpensive transfer of nonproprietary knowledge is easier if an economy begins its industrialization effort in labor-intensive sectors using relatively old machine designs and production technology. When exports are based on comparative advantage, precisely these conditions are met. Hong Kong, Korea, Singapore, and Taiwan, China, all began rapid industrialization in labor-intensive and low-technology manufacturing. The equipment was readily purchased, and the production knowledge was available at low cost from engineering publications, trade literature, and independent consultants.[47] The simpler equipment was conducive to local productivity-enhancing improvements, often on the part of blue collar workers (Ranis 1973). Moreover, in labor-intensive industries it was easier to acquire and absorb information from customers without a large stable of educated engineers.

- *Information from customers.* In the presence of imperfectly traded information, knowledge provided by purchasers of an economy's ex-

ports can be quite important. This has been shown by Westphal, Rhee, and Pursell (1985) in Korea and independently corroborated in Taiwan, China, by a number of researchers (see, for example, Gee 1989). Buyers want low-cost, better-quality products from major suppliers. To obtain this, they transmit tacit and occasionally proprietary knowledge from their other, often OECD-economy, suppliers. Such knowledge transfers are more common in simple production sectors such as clothing and footwear and with older technologies that are either in the public domain or are not closely guarded.

- *Knowledge from returning nationals.* Drawn partly by the high wages made possible by exports, many residents of Korea and Taiwan, China, trained abroad, particularly in new sectors such as electronics and computing, have returned home to work. Many returning nationals have received education in OECD economies and then worked for OECD-economy firms.[48] Their return has provided significant transfer of best-practice methods. For example, foreign-educated nationals account for *all* the postgraduates employed in the industry of Taiwan, China (Pack 1993a). This source of knowledge of international best practices becomes more important as changing factor prices dictate a shift to more capital- and technology-intensive sectors in which higher-level skills are needed to unlock knowledge that may be embodied in patents, licenses, or the use of specialized nontraded equipment.
- *Domestic research.* In both Korea and Taiwan, China, a considerable proportion of R&D has been devoted to improving exports and reducing production costs. There is no evidence that the gap between R&D and commercial needs frequently seen in the import-substituting economies has been a problem.

How Exports and Human Capital Increase Productivity

Access to international best-practice technology and rapid formation of human capital supplement and reinforce one another. It is doubtful that the HPAEs could have made as productive use of foreign knowledge and imported capital without highly skilled domestic engineers and workers. Conversely, without foreign knowledge it is very unlikely that total factor productivity growth would have been as large. Intensive efforts by highly skilled managers and technicians in individual plants in inward-oriented Latin American economies to improve the productivity of existing capital stock with internal innovations did not generate high- productivity growth.[49]

The HPAEs' rapid export growth has often generated positive interaction between human capital, physical capital, and knowledge. The externalities generated by manufactured exports in the high-performing Asian economies in the form of cheaper and more effective knowledge transfers would have undoubtedly been less productive had there been fewer skilled workers to facilitate their absorption, while the HPAEs' rapid increase in education levels reflected in part rising private rewards for greater education made possible by exports and export income.[50] Thus labor force skills, flexible markets for labor, low domestic distortions, and export incentives all interacted to promote high rates of technological upgrading and productivity change.

We can use the cross-economy regression framework developed in chapter 1 to look at the impact of trade and industrial policies on growth (see table 6.17). We introduce two variables into the basic cross-economy regression: the index of openness (as described above, the degree to which domestic prices conform to international prices) and measures of export performance.[51] Openness to the world economy captures not only efficiency gains induced by the need to remain globally competitive but also the likely allocative benefits of having relative prices close to international prices.

Introducing these two trade-related variables substantially increases the explanatory power of the cross-economy regression. The effect of openness is positive. Economies with limited relative price distortions grew more rapidly.[52] We choose as our measure of export performance two indicators—the average share of manufactured exports in total exports and the share of manufactured exports in GDP.[53] Manufactured export performance is strongly correlated (at the 1 percent level) with high rates of per capita income growth. When the share of manufactured exports in total exports is introduced together with the openness index, only the latter is significant. Conversely, when the share of manufactured exports in GDP is used, the openness index remains positive and significant. One possible interpretation of these results is that a high concentration of manufactured exports relative to total exports, rather than openness, contributes relatively more to productivity change in a cross-economy framework, which would be consistent with our reasoning concerning export externalities.[54]

Estimates of the sources of total factor productivity growth (described in appendix 6.2) confirm the results of the cross-economy regressions and add some insights into possible interactions between exports

Table 6.17 Output, Growth, and Investment
(dependent variable: rate of growth of real GDP per capita, 1960–85)

Number of observations:	*92*	*86*	*69*	*97*	*79*
Intercept	-0.4237 *	-0.0124	-0.2324	-0.0055	-0.3943 *
	(0.1650)	(0.0083)	(0.1550)	(0.0085)	(0.1748)
GDP relative to U.S., 1960	-0.1033 **	-0.0459 **	-0.0837 **	-0.0381 **	-0.0892 **
	(0.0268)	(0.0108)	(0.0256)	(0.0123)	(0.0280)
Primary enrollment, 1960	0.0259 **	0.0210 **	0.0216 **	0.0221 **	0.0239 **
	(0.0081)	(0.0064)	(0.0079)	(0.0069)	(0.0085)
Secondary enrollment, 1960	0.0317	0.0211	0.0218	0.0206	0.0156
	(0.0203)	(0.0134)	(0.0210)	(0.0148)	(0.0210)
Growth of population, 1960–85	0.1322	0.2693	0.2054	0.1856	0.1222
	(0.2699)	(0.2346)	(0.2806)	(0.2376)	(0.2870)
Average investment/GDP, 1960–85	0.0568 *	0.0659 **	0.0625 *	0.0444	0.0436
	(0.0259)	(0.0232)	(0.0291)	(0.0242)	(0.0276)
Dollar openness index	0.0042 *		0.0023		0.0040
	(0.0017)		(0.0016)		(0.0018)
Average manufactured exports/total exports, 1960–85		0.0002 **	0.0003 **		
		(0.0001)	(0.0001)		
Average manufactured exports/GDP, 1965–85				0.0011 **	0.0011 **
				(0.0003)	(0.0004)
Adjusted R^2	0.3947	0.4912	0.5217	0.3530	0.3938
RMSE	0.0159	0.0124	0.0132	0.0147	0.0155

** Statistically significant at the 0.01 level.
* Statistically significant at the 0.05 level.
Note: Coefficient is top number. Standard error is bottom number in parentheses.
Source: World Bank staff estimates.

and human capital. We attempt to explain variations across economies in TFP growth rates in terms of relative income, educational attainment (as measured by the average stock of education per person), openness, and our measures of manufactured export performance (see table 6.18). The education stock variable, while positive, does not explain variations in TFP growth among economies. This is appropriate, since we have measured TFP growth net of human capital's contribution. Openness is consistently

associated with superior TFP performance, controlling for other variables. Both indicators of export performance are also consistently and positively correlated with higher rates of TFP growth.

We also find some evidence of a positive interaction between the share of manufactured exports in total exports and in national income and the stock of education. The coefficient of the interaction term between these two variables is positive but not significant at conventional levels, and the export share variable becomes insignificant. When we consider the contribution of the variables taken together to explaining the variation in TFP growth rates, however, it is statistically positive. We conclude that export

Table 6.18 Determinants of Total Factor Productivity Growth, 1960–89
(dependent variable: rate of growth of real GDP per capita, 1960–89)

Number of observations:	*67*	*67*	*51*	*51*
Intercept	-64.9123 **	-71.1186 **	-72.0692 **	-70.8604 **
	(14.0585)	(14.8657)	(15.6104)	(15.4608)
GDP relative to U.S., 1960	-4.8047 *	-5.5757 **	-2.3509	-2.1562
	(1.9771)	(2.0637)	(2.3225)	(2.3008)
Educational attainment, 1960	0.1471	0.0680	0.1574	0.0738
	(0.0874)	(0.1082)	(0.1064)	(0.1207)
Dollar openness index	0.6493 **	0.7154 **	0.7225 **	0.7134 **
	(0.1417)	(0.1508)	(0.1574)	(0.1558)
Average manufactured exports/total exports, 1960–85	0.0314 **	0.0159		
	(0.0066)	(0.0142)		
Interaction term: Educational attainment 1960 times manufactured exports/total exports, 1960–85		0.0032		
		(0.0026)		
Average manufactured exports/GDP, 1965–85				-0.0686
				(0.0966)
Interaction term: Educational attainment 1960 times manufactured exports/GDP, 1965–85			0.0625 *	0.0284
			(0.0269)	(0.0201)
Adjusted R^2	0.6333	0.6376	0.4507	0.4628

** Statistically significant at the 0.01 level.
* Statistically significant at the 0.05 level.
Note: Coefficient is top number. Standard error is bottom number in parentheses.
Source: World Bank staff estimates.

performance and education interact positively; higher levels of education raise the contribution of manufactured export concentration to TFP growth.[55] This is consistent with our hypotheses that manufactured export orientation and high labor force skills interact to facilitate the acquisition and mastery of technology with attendant spillovers.

The evidence from our cross-economy estimates is supported by a number of recent microeconomic studies that attempt to test the link between exports and productivity growth. Pack and Page (1993) present evidence from Korea and Taiwan, China, that at the sectoral level rapid export growth is correlated with the pattern of productivity change; exporting sectors have higher sectoral rates of TFP growth. Wei (1993) uses city data from China and finds a statistically significant relationship between export growth and productivity growth. Perhaps most compelling, Aw and Hwang (1993), using firm microeconomic data from Taiwan, China, find a statistically significant relationship between productivity differences among manufacturing firms and export orientation.

How Have Trade and Industrial Policies Contributed to Growth?

The early admirers of HPAE trade policy clearly overstated the neutrality of incentives between domestic and foreign sales and understated the variation across sectors. But the revisionists who see in the HPAEs' success evidence that highly targeted industrial policy worked overlook the fact that the calculations on which both relied were static, that firms based their decisions not only on current levels of protection and factor prices but on the certain knowledge that they would need to compete in the future. Effective rates of protection may shape short-term tactics but the long-term strategies of currently protected firms are more likely to reflect their expectations of the future.

Thus, the emphasis on exports was decisive for the entire manufacturing sector; promotion of individual sectors was less important, since all but the very dull knew that their turn to export would come sooner than they would have preferred. Given the widespread national understanding established by government statements and actions in Japan, Korea, and Taiwan, China, that exporting was the standard by which all economic activity would be judged, even firms benefiting from higher-than-average rates of protection in the domestic market understood that in the near future they would be forced to compete in world markets. Sustained reduction in import protection sent a similar message to pro-

ducers in the Southeast Asian newly industrializing economies. Governments were credibly committed to export competition. Exports were important because they ensured that, given the HPAEs' high human capital base, productivity growth would be facilitated by the improved ability to tap international knowledge.

■ ■ ■

What are the main factors that contributed to the HPAEs' superior allocation of physical and human capital to high-yielding investments and their ability to catch up technologically? Mainly, the answers lie in fundamentally sound, market-oriented policies. Labor markets were allowed to work. Financial markets, although subject to more selective interventions to allocate credit, generally had low distortions and limited subsidies compared with other developing economies. Import substitution, although an early objective of public policy in all the HPAEs except Hong Kong, was quickly accompanied by the promotion of exports and duty-free admission of imports for exporters. The result was limited differences between international relative prices and domestic relative prices in the HPAEs. Market forces and competitive pressures guided resources into activities that were consistent with comparative advantage and, in the case of labor-intensive exports, laid the foundation for learning international best practice and subsequent industrial upgrading.

Does this mean that selective interventions played no role in East Asia's superior growth? Our conclusion is that selective interventions were neither as important as their advocates suggest nor as irrelevant as their critics contend. All eight economies succeeded in establishing automatic access to credit for exporters; this simple contest was an important component of their export-push strategies. Other directed-credit programs were less successful. Where they appear to have resulted in allocation of credit to high-yielding activities, mainly in Japan, Korea, and Taiwan, China, it was because of careful screening and monitoring of projects and an orientation toward the private sector. Where they failed, governments limited the damage by offering more limited subsidies than the credit programs in other developing economies. Finally, we have concluded that industrial policy, with the possible exception of Japan, did not alter industrial structure or patterns of productivity change. The most successful selective intervention in the HPAEs—the commitment to manufactured exports—was also the most general.

Flexible markets, low price distortions, high levels of human capital, and industrial and trade policies that tilted incentives in favor of exports—all combined to allow rapid growth of manufactured exports and, through it, rapid technological catching up.

Appendix 6.1: Testing the Impact of Industrial Policy on Productivity Change

GOVERNMENT POLICIES THAT CORRECT MARKET FAILURES should give rise to growing total factor productivity in the entire industrial sector, though the resulting pattern of TFP growth across subsectors is not easily predictable. Knowledge-based imperfections are likely to yield TFP gains, primarily in the subsectors in which the intervention occurs. Subsidization of knowledge acquisition in textile production will mainly benefit other textile firms as knowledge seeps out to them or trained engineers go to other textile firms. Some knowledge in textiles may benefit closely related sectors such as clothing through production of fabrics that are better suited to local conditions, that is, are not obtainable on the world market.

The sectoral locus of gains is important for several reasons. First, empirical efforts to relate government intervention to productivity growth are desirable as a weak test of the effects of intervention. Productivity gains in the entire industrial sector or the entire economy attributable to other factors might mistakenly be ascribed to the intervention, even if it had actually reduced productivity growth. Undoubtedly, the productivity gains from correcting various market failures may diffuse to many sectors, but most should have a major impact in the initial sector of intervention.

Empirically, many of the intersectoral interactions will be measured as intrasectoral at the two-digit level. Improved production engineering in spinning may improve TFP in weaving. Both, however, are included in the two-digit ISIC textiles branch. Equal diffusion to all sectors seems implausible. While there are individual examples in economic history (Rosenberg 1976), there is no evidence that this is the general prototype. Moreover, recent research on the pattern of spillovers of R&D in industrial economies demonstrates that the major beneficiaries are closely related sectors, often sectors that would be identical within a two-digit classification (Jaffe 1986). The nonsubstantiated claim that the spread of external-

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PROMOTING TRADE AND INVESTMENT IN CONSTRAINED ENVIRONMENTS:

A.I.D.'S EXPERIENCE IN LATIN AMERICA AND THE CARIBBEAN

Submitted By:

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To:

The Center for Development Information and Evaluation (CDIE), U.S. Agency for International Development

For:

The CDIE/LAC Bureau Workshop on Trade and Investment: November 13-14, 1989

November 1989

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CHAPTER II

ANALYTICAL FRAMEWORK

A. A Typology of General Approaches and Services

Our analysis of how project design should take the country economic environment into account starts with a characterization, or typology, of A.I.D. export/investment promotion projects. The three approaches described below are presented as points along a spectrum, rather than as mutually exclusive models. Any trade and investment project, whether an export or investment promotion project, or an agriculture or manufacturing sector project, falls at some point along the spectrum. The three general approaches are:

1. The "Transmitter" approach relies mostly on developing and transmitting market information, through maintaining databases and answering investor/exporter queries.

2. The "Facilitator" approach seeks to establish multi-sectoral investment and export promotion services, such as product promotion campaigns through trade shows and missions, on-site investment services, general training assistance, producer/buyer travel facilitation, and general investor search services.

3. The "Promoter" approach generally aims to provide enterprise-specific technical assistance and brokering services to a limited number of producers in a limited number of sectors.

Each approach can be placed along a spectrum of attributes ranked from low to high. The attributes used to define each approach include:

a. Degree of project targeting in product development, markets, and beneficiaries.

b. Degree of "proactiveness" associated with project services. That is, does a delivery mechanism exist that actively seeks out and provides services to a few target groups? Or are project services made available to the general public, albeit in a much more passive, first come, first serve approach?

c. Degree of impact attribution -- the extent to which a given project service can be attributed to a development impact (jobs, investment and foreign exchange generated).

d. Degree of confidence in market forces -- the extent to which the approach assumes that markets are efficient and that there

are sufficient numbers of producers in the market that are able to take advantage of project services.

Below is a table which summarizes the relative ranking of the general approaches according to the factors mentioned above as well as the type of services provided:

	"Transmitter"	"Facilitator"	"Promoter"
Level of:			
1. Targeting	Low	Medium	High
2. Proactiveness	Low	Medium	High
3. Direct Impact Attribution	Low	Medium	High
4. Belief in Efficient Market Forces	High	Medium	Low
Service Emphasis:			
	--Business Environment --Market Information	--Export/ Investment Promotion Services	--Enterprise Specific Technical Assistance

The **"Transmitter"** approach ranks low on the three characteristics -- targeting, proactiveness, and impact attribution. The underlying premise behind the transmitter approach is that trade promotion is constrained by a lack of information about market opportunities and pricing information. Rather than target specific producers for assistance, transmitter projects develop data bases that provide information to numerous sectors and producers/investors. The project is passive in nature since it will transmit information to whomever asks for the information. In terms of services, the transmitter approach emphasizes the following services: policy development and research, database development, and market research.

The **"Facilitator"** approach normally involves a medium level of targeting and proactiveness. It assumes that potential investors are constrained by a lack of promotion services. While a "Transmitter" project would provide the potential exporter with a brochure of trade shows, the "Facilitator" project would assist the producer in going to a trade show. "Facilitator" projects focus more on services that facilitate individual investors at a

discrete point in his marketing or production cycle, such as trade fairs, training, or general investor search.

Finally, the **"Promoter"** approach usually ranks high in each of the above criteria. The main emphasis is on high value-added and enterprise-specific services. The promoter approach assumes that there are major constraints placed on local producers and investors that can only be overcome by a varied and concentrated level of services. Overcoming most of these constraints requires substantial -- but narrowly targeted -- technical assistance either in production or marketing, or both. The cost of individual services tends to be higher than those of the Facilitator and Transmitter. But the targeting and focus on capitalizing on a few opportunities can limit the overall program cost of the Promoter approach.

Every investment and export promotion project is comprised of a "basket", or range, of services that are typical of its general approach. The services commonly associated with promotion projects are shown in Table II.1. The various services are grouped into four categories: "business environment", "market information", "export/investment promotion services" and "enterprise-specific services".

There is some overlap between the services offered in each type of project, but the differences are often of targeting and the degree to which a service is tailor-designed to a specific enterprises needs. While both the facilitator and promoter approaches offer training, the facilitator would typically do so in the form of generic workshops to which several firms would be invited. The promoter would work much more closely with one firm, usually to overcome a specific problem that has impeded the firm's ability to expand.

The rest of this paper will focus on the three general approaches -- Transmitter, Facilitator, and Promoter -- more heavily than on the types of services associated with each type of project. It is recognized, however, that a full project strategy requires careful attention to the actual scope of services to be provided.

B. A Typology of Economic and Institutional Environments

All trade and investment-related activities are shaped and bound by the country-specific setting in which they are implemented. This much is obvious. The purpose of this section is to develop a typology with which this setting can be broken down and analyzed. When evaluating past A.I.D. projects, this approach is an attempt to isolate the many economic, political, and institutional factors that have affected project success. And just as important, the approach is an attempt to isolate the key factors that future project design must take into account in order to achieve success.

Table II.1

GENERAL APPROACHES AND PROJECT SERVICES: A CLASSIFICATION SCHEME

Transmitter	Facilitator	Promoter
Services Relating to the General Business Environment and Market Information	Export and Investment Promotion Services	Enterprise Specific Assistance
Private/Public Sector Coordination Policy Analysis/Reform Information Services Market Research Sector Feasibility and Pre-Investment Studies Infrastructure Development: FPZs, Roads, Power, Communications	Expert Awareness Promotion (ad campaigns) Product Promotions Exhibitions, Trade Shows, Trade Missions Producer/Buyer Facilitation, both local and foreign Investor Search (overseas offices, cold calling, directories) Pre-investment services (one-stop shop, pre-feasibility studies, wage rate analysis, etc.) Post-investment services	Dealmaking/Contract Production/ Joint Ventures T.A./Production (quality control, production) T.A./Marketing (transport, distribution marketing) T.A./Management (accounting, financial management) Training Assistance (specific to companies/subsectors) Credit/Financing Assistance

Our typology consists of seven variables which are defined as follows:

1. **The productive structure:** the stage of development of a country's trade sector, and of its potential for increasing exports (especially with the assistance of a project intervention).

2. **The policy environment:** the basic free market orientation of the economy in such key areas as trade, foreign exchange, pricing, and fiscal policy regimes.

3. **The target group export capability:** the size, experience, and ownership (local/foreign) of the targeted firms.

4. **The host country support for a project.**

5. **The project delivery mechanism:** the choice of public, mixed, and private sector delivery mechanisms to deliver project services.

6. **A.I.D. Management Effectiveness:** the role of A.I.D. management involvement in the project.

7. **Risk:** the likelihood that project objectives can be accomplished within the target time frame and budget.

The first two variables, productive structure and policy environment, are considered to be, from the point of view of the promotion projects, "uncontrollable". The productive structure, almost by definition, can only change over the medium- and long-terms in conformance with changes in fundamental real economic parameters. The policy environment can change much more rapidly -- as has been witnessed in Bolivia in recent years -- but typically as a result of a large policy reform dialogue and reform program. From the point of view of the projects considered here, the policy environment is uncontrollable.

The second two variables, target group export potential and host country support for the project, are considered to be "influenceable". They cover areas in which A.I.D. can exert some influence or control both during the period of project design and project implementation. Even though a particular target group may not have an export orientation at the beginning of the project, it is possible that during project implementation the target group could be persuaded to adopt a more outward-looking orientation. The same holds true for host country support. Even if a government does not actively support a project at the outset, it is possible that it would provide more support during project implementation, particularly if the project demonstrates some successes.

A.I.D. Evaluation Special Study Report No. 71

Export and Investment Promotion: Sustainability and Effective Service Delivery

Volume 1: Synthesis

July 1991

U.S. Agency for International Development
Bureau for Program and Policy Coordination
Center for Development Information and Evaluation

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A.I.D. Evaluation Special Study Report No. 71

Export and Investment Promotion: Sustainability and Effective Service Delivery

Volume 1: Synthesis

by

Nathan Associates Inc.
and
Louis Berger International, Inc.

The views and interpretations expressed in this report are those of the authors and should not be attributed to the Agency for International Development.

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Foreword

Since the early 1980s, support to institutions promoting export and investment in developing countries has been a focal point of the Agency for International Development's (A.I.D.)private sector assistance strategy. In 1989, A.I.D.'s Center for Development Information and Evaluation (CDIE) and the Bureau for Latin America and the Caribbean initiated a major review of A.I.D.'s experience with trade and investment projects in Latin America and the Caribbean. Three factors prompted the study: the large volume of resources committed to trade and investment projects, the critical importance of supporting private sector investment and nontraditional export growth, and the expected increase of funding for export promotion and investment promotion.

In the summer of 1990, CDIE published the initial study: *Promoting Trade and Investment in Constrained Environments: A.I.D. Experience in Latin America and the Caribbean*, A.I.D. Evaluation Special Study No. 69. The study provides a conceptual framework permitting a comparative analysis of trade and investment strategies used by A.I.D. in constrained environments.

This field assessment is a follow-up to that study. It focuses on 10 promotional institutions operating successfully in favorable policy environments in Chile, Costa Rica, the Dominican Republic, and Guatemala. The study addresses a central question facing A.I.D. decision-makers: Do export- and investment-promotion organizations merit continued support from A.I.D.? and if so, Which programs have the most impact on export and investment? The study arrives at three important conclusions:

1. Promotional institutions can make a modest but important contribution to building nontraditional exports, and, in a favorable policy environment, their services can accelerate the process of export growth. Support to these institutions also offers an attractive return to donor resources. However, the total impact of promotional programs on nontraditional export performance is marginal, unless a major investment is made in a sector poised for take-off.

2. The single most important service a promotional institution can provide is information, particularly market information and contracts, but given the different needs of local and foreign firms, investment programs should not be combined with export promotion programs.

3. Promotional institutions are not effective substitutes for policies favoring export-oriented investment.

We believe this study provides some important insights into the effectiveness and limitations of A.I.D. support to export- and investment-promotion institutions. We encourage A.I.D. senior managers and staff to draw on this review in their planning, implementation, and monitoring of export promotion and investment promotion projects.

John Eriksson
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August 1991

Summary

A.I.D. has made assistance to promotional institutions a focal point of its trade- and investment-promotion strategy worldwide. Support to these institutions in Latin America and the Caribbean alone has totaled more than a quarter of a billion dollars over the past 10 years. The central issues for A.I.D. decision-makers are simply stated:

- Do trade- and investment-promotion organizations merit continued support from A.I.D.? and, if so, Which programs have the most impact on exports and investment?

This study, sponsored jointly by the Bureau for Program and Policy Coordination/Center for Development Information and Evaluation (PPC/CDIE) and the Bureau for Latin America and the Caribbean (LAC), examines the experience of promotional institutions in the Caribbean Basin Initiative (CBI) region and Chile to answer these questions. It measures the programs' impact on three levels: impact on the assisted firms, impact on national export performance, and total economic return. On the basis of these findings, the study assesses the strategies used by successful promotional programs to suggest the institutional structure and service mix promising the greatest impact on exports, investment, and jobs.

The study focuses on 10 promotional institutions in Chile, Costa Rica, the Dominican Republic, and Guatemala. The findings rely heavily on a survey of 162 foreign and local exporting firms in the four countries, including 110 firms assisted by the promotional institutions and 52 unassisted firms in the agricultural and light manufacturing sectors. (See Appendix A, Methodology, in Volume 2 of this study. Volume 2 is available as CDIE Working Paper No. 146 from the A.I.D. Library.)

1. Trade- and Investment-Promotion Organizations Merit Continued A.I.D. Support

The study reached three main conclusions on the value of promotional institution programs:

- Promotional institutions provide services that are highly valued by the firms receiving them, particularly in the agricultural sector. A.I.D.-supported institutions provided a high proportion of services rated by the firms as having an impact: 48 percent in the agricultural sector and 23 percent in the manufacturing sector. The value of the services to the firms is confirmed by their performance: Assisted firms in both sectors registered more rapid growth in exports than did unassisted firms, and assisted manufacturing firms also generated greater growth in total employment than did unassisted firms.

- Promotional institutions provide an attractive rate of return to A.I.D.'s investment, conservatively estimated on the order of 25 percent in real terms. This estimate is based on direct, short-term benefits generated by increased employment and does not include benefits from future investment, impact on policies, or other sources that are hard to measure but nonetheless important.

- Despite the benefits generated at the firm level, the total impact of promotional programs on nontraditional export performance at the national level is generally not dramatic: promotional institutions accounted for a modest 5 to 30 percent of the growth in nontraditional exports by the assisted sectors. Their assistance was valued by the firms that they reached, but they reached

only a small proportion of the total export firms. Thus, they have the potential to make a major contribution to national nontraditional export growth only when the sector is beginning to take off and the program is large relative to the export sector.

Investment- and export-promotion programs implemented by local promotional institutions appear to offer an economic return meriting continued A.I.D. support. However, even in a favorable policy environment, they have the potential to achieve major gains in nontraditional exports at the national level only when a major investment is made in a sector that is poised for a take-off. If the sector is large relative to A.I.D. assistance, or already growing rapidly on its own, the impact of promotion is marginal.

2. *How Should A.I.D. Structure Promotional Programs for Maximum Impact on Trade and Investment?*

The study identified information as the single most important service that promotional institutions can provide to speed up the investment process. The types of information needed are different for foreign and local firms but fall into two broad categories:

- Facts about the market and how it works: For foreign firms, market information needs to focus on the cost of production in the target country; for local firms, information needs include price data in overseas markets and information on import regulations.

- Contact names: For foreign firms, contact information includes referrals to local professional firms, suppliers, free zones, and so on. The most important contacts for local firms are potential foreign buyers.

The differences in the types of information and other assistance needed by local and foreign firms suggest that investment-promotion programs should not be combined with export-promotion programs. The study identified two basic strategies for providing information to local and foreign clients, each of which is linked to an institutional structure best suited to its implementation.

- Standardized information provided to a broad clientele: For foreign investors, standardized information is best provided by a government promotional agency, one with strong institutional ties to the private sector. For local investors, a membership organization performs this function well. Both models are potentially sustainable, but political factors are likely to prevent them from targeting priority sectors.

- Customized information provided to a targeted clientele: An independent private entity is the best option for intensive support to foreign investors, and this expensive assistance must be carefully targeted to ensure maximum impact. A project implementation unit is best able to provide the specialized technical knowledge needed by local firms. Neither program has the potential to be self-sustaining, and efforts to achieve financial independence may actually undermine program effectiveness.

Promotional programs of either type appear to be most effective when they work on the frontier of investment activity where information is the critical input needed by potential investors. For maximum impact, investment programs must continually encourage foreign investment in new sectors, whereas export-promotion programs must seek out local firms that are ready to export and assist them in making contact with buyers.

On this frontier, the strategies that provide basic but essential information to a large number of firms may well have a greater total impact than those that provide intensive assistance to a few. However, this conclusion is tentative; additional analysis should be a priority to determine the most cost-effective way to support firms' decision-making processes.

In summary, promotional institutions can make a modest but important contribution to building nontraditional exports. In a policy environment

attractive to export investment, they can speed up the process whereby firms learn of profitable opportunities and take advantage of them. However, promotional programs are by no means a substitute for policies that favor export-oriented investment. If there are no profitable opportunities, or if firms are already moving to take advantage of them, there is nothing to promote.

GLOSSARY

A.I.D.	- Agency for International Development
CBI	- Caribbean Basin Initiative
CEDOPEX	- The national export documentation center of the Dominican Republic
CENPRO	- the Center for Promotion of Exports and Investment
CINDE/PIE	- the investment promotion division of the Coalition for Development Initiatives
CINDE/CAAP	- the agricultural development division of the Coalition for Development Initiatives
CORFO	- the Development Corporation, a Chilean Government organization
Fundación Chile	- a private Chilean entity supporting agribusiness technology transfer
GEXPRONT	- the Guild of Nontraditional Exporters
IPC	- the Investment Promotion Council
JACC	- the Council for Agribusiness Cooperation and Co-investment
LAC	- Bureau for Latin America and the Caribbean
PPC/CDIE	- Bureau for Program and Policy Coordination/Center for Development Information and Evaluation
PROCHILE	- a new governmental unit charged with promoting Chilean exports
PROEXAG	- the Support Project for Exporting Nontraditional Agricultural Exports in Central America

1. Introduction

The Agency for International Development (A.I.D.) has made promotional institutions a focal point of its trade- and investment-promotion strategy worldwide. Institutions promoting export and investment have received substantial assistance from A.I.D. over the past 10 years, totaling more than a quarter of a billion dollars in Latin America and the Caribbean region alone. As A.I.D.'s trade and investment portfolio expands and matures, the Agency must decide whether to continue funding these institutions and where they fit into the Agency's strategy.

The central issues for A.I.D. decision-makers are simply stated:

- Do trade- and investment-promotion organizations merit continued support from A.I.D.? and, if so, Which programs have the most impact on exports and investment?

This study,[1] sponsored jointly by the Bureau for Program and Policy Coordination/Center for Development Information and Evaluation (PPC/CDIE) and the Bureau for Latin America and the Caribbean (LAC), looks at the experience of promotional institutions in the Caribbean Basin Initiative (CBI) region and Chile to shed light on these questions.[2] It assesses the impact and value of their promotional services to suggest future directions for A.I.D. programming in trade- and investment-promotion, but it does not seek to evaluate in depth the institutions funded or the projects that funded them.

Four Nontraditional Export Success Stories

To answer the questions posed earlier, the study focused on 10 promotional institutions in four countries that experienced very rapid growth in nontraditional exports during the 1980s: Chile, Costa Rica, the Dominican Republic, and Guatemala. Figure 1 summarizes their export growth over the 1983-1989 period.

Three of these countries participated in the CBI.[3] The special provisions of this program, designed to help the CBI region diversify its export base, appear to have contributed to the strong growth of the three CBI-region countries.[4] Chile, which has a somewhat longer history of favorable policies, succeeded without these provisions.

All four of the countries studied pursued policies strongly favoring exports over this period (with occasional lapses), and, in particular, maintained foreign exchange rates that made export-oriented investment attractive to both foreign and local firms. Although the study was not designed to measure the contribution of macroeconomic policies, it is impossible to look closely at these countries without being struck by the overwhelming importance of policy in determining nontraditional export growth.

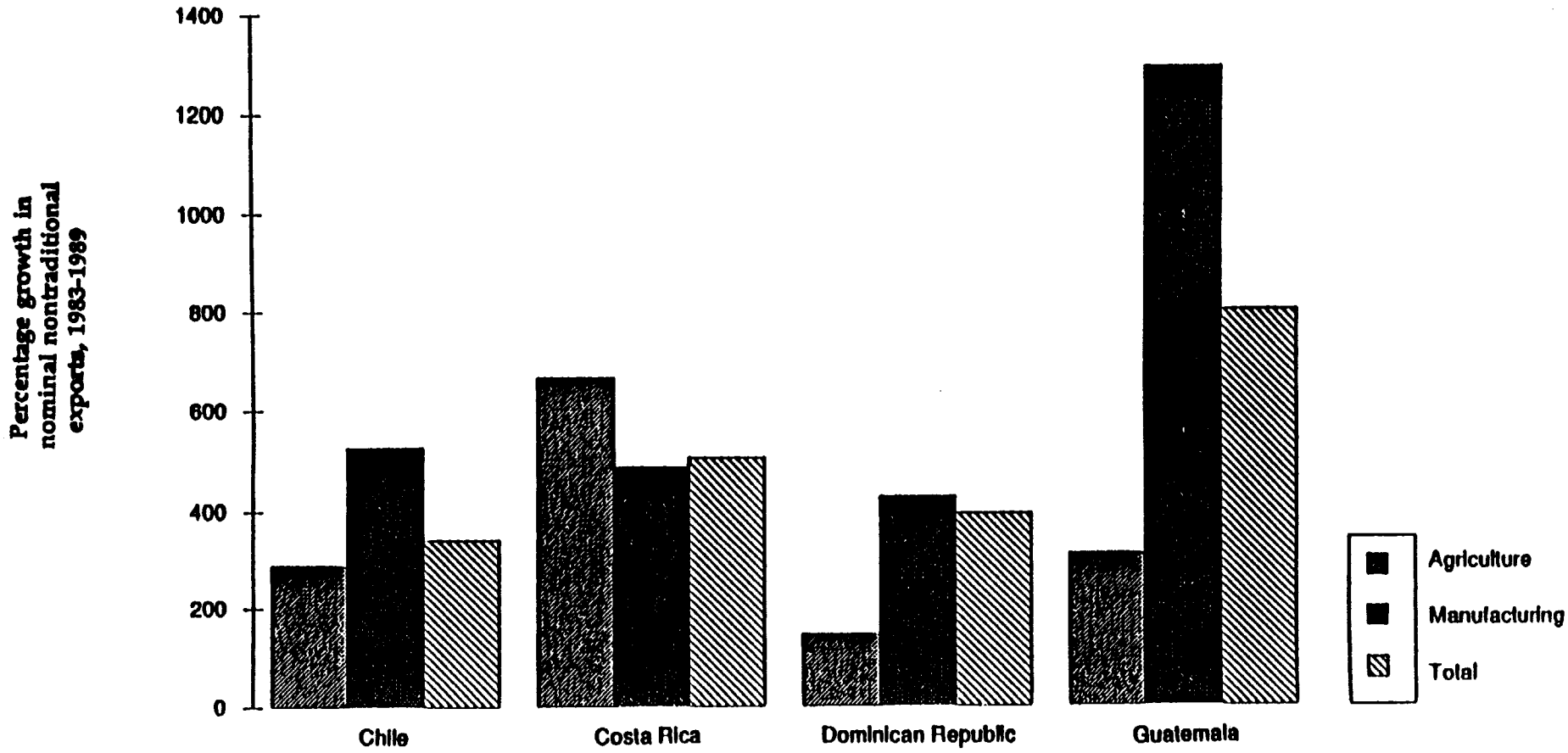
Figure 2 pools the data for Chile, Costa Rica, and the Dominican Republic to plot the relationship (in nominal terms) between nontraditional exports to the United States and the effective exchange rate for these countries.[5] The graph clearly shows the close linkage between exchange rates and nontraditional exports. This relationship was confirmed econometrically at the country level in Chile: the real exchange rate accounted for more than 90 percent of the variation in nontraditional exports during the 1983-1989 period.

A closer look at the Dominican Republic experience also confirms the role of macroeconomic policies: Industrial firms in the country's dynamic free-zone sector increased exports by 275 percent between 1984 and 1989 (in nominal dollar terms). Their colleagues outside the zones faced virtually identical prices but a far less favorable export regime, and industrial exports increased by only 82 percent.[6]

Why Meddle With the Market?

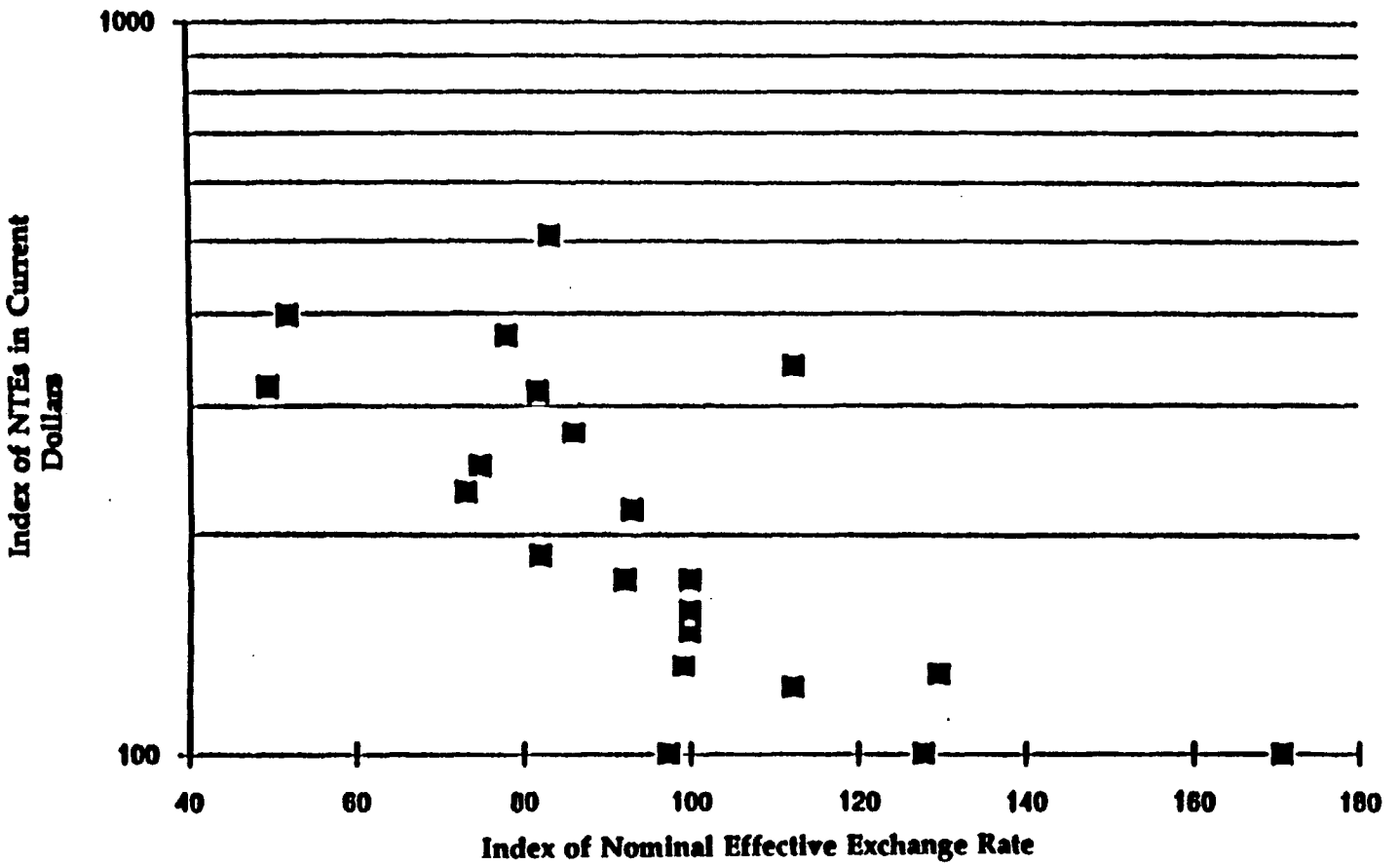
Given the importance of policies, why bother with promotional programs at all? Why not put all the emphasis on establishing an export-oriented

Figure 1. Export Performance of Chile, Costa Rica, the Dominican Republic, and Guatemala, 1983-1989



Source: U.S. Department of Commerce, Imports for Consumption, Customs Value

Figure 2. Nominal Exchange Rates Versus Nominal Nontraditional Exports to the United States for CBI Countries, 1983-1989



Source: U.S. Department of Commerce and International Monetary Fund

policy regime and then trust market forces to attract foreign and local investors?

The rationale for using promotional institutions to give an extra push to market forces is threefold:

1. Market forces work, but not fast enough, when firms must make significant investments to learn about new opportunities on their own. This inefficiency justifies a temporary subsidy to the export sector to improve access to information and speed up private response to market forces.

2. The first foreign investment in a profitable but underexploited sector (for example, electronics assembly in the Dominican Republic) makes it more likely that other firms will recognize the opportunity and follow. This "bandwagon effect" is an externality from which the country and subsequent investors benefit, but from which the first firm does not, and it justifies a subsidy to encourage such path-breaking investment.

3. Promotional institutions themselves can make a major contribution to achieving and, equally important, maintaining export-oriented policies by serving as a voice for the export sector, both foreign and domestic; their role in the policy arena is a public good that deserves more support than the market is likely to provide.

These three arguments share a common weakness: they are easy to make but very hard to prove or disprove. The impact of these indirect factors on exports is virtually impossible to measure. This study has therefore focused on the direct link between the promotional institutions and export-oriented investment, looking in depth at the services provided to foreign and local firms and assessing the impact on their export performance. The authors do not deny that the indirect impacts cited above may be important and may, in and of themselves, justify investing in promotional institutions in a specific instance; but we believe the analysis is strengthened by excluding benefits that are nearly impossible to substantiate.

Key Issues Addressed in This Study

This study examines five factors that together determine whether promotional institutions are worth supporting and how their programs should be structured for maximum impact on exports, investment, and jobs:

1. Firm-level impact: Do these institutions have an impact on the firms they assist?

2. National-level impact: Do these institutions have an impact on exports and foreign investment at the national level?

3. Economic return: Is support to these institutions economically attractive and cost-effective?

4. Service mix: What service strategies appear to have the greatest impact?

5. Institutional structure: What institutional models appear to offer the best vehicles for delivering these services?

Methodology

The study followed a modified form of the case study methodology, focusing on 10 promotional institutions but considering as well the country context in which they operate. The seven CBI-region institutions studied in depth have received heavy A.I.D. assistance and as a group will be referred to as A.I.D.-supported institutions (ASIs), although they were not selected as typical institutions supported by A.I.D. Rather, since the study's aim is to find approaches that work, it targeted institutions identified as good programs working in favorable environments in which non-traditional export growth has in fact been rapid and in which there is a sufficiently long institutional track record to make the search for impact meaningful.

The study's analyses are organized by five issue areas, each of which is treated in a separate issues paper presented in the second volume of this study:

1. The country export performance and the role that macroeconomic policies have played in contributing to this performance.

2. The assistance strategy followed by each of the promotional institutions, and the translation of this strategy into direct services to firms and other activities.

3. The use of these services by exporting firms, and their impact on firm performance.

4. Program sustainability, with or without continued A.I.D. support.

5. The level of economic benefits generated by A.I.D.'s investment.

The 10 institutions studied in detail include both established organizations and institutions whose creation was directly related to A.I.D. sponsorship and funding (see Box).

The programs made available by these institutions were analyzed primarily in terms of 32 direct services offered to client firms, which were organized into five broad categories: information, private contact-making, investment and export support (site visits, accounting, legal services, and so on), technical assistance, and government facilitation. These services and their use and usefulness, costs, and impacts were studied through review of available documents, interviews with the promotional institutions, USAID Mission personnel, and other in-country sources; and a survey of 162 exporting firms in the four countries (including 110 firms drawn randomly from lists of assisted firms supplied by the A.I.D.-supported institutions and the Chilean organizations, and 52 unasisted firms drawn randomly from lists of exporters).

The study gave special attention to three distinctions identified as central to A.I.D.'s strategy: the

Promotional Institutions Studied

CENPRO, the Center for Promotion of Exports and Investment, a public sector promotional unit in Costa Rica targeting both local firms and foreign investors

CINDE/PIE, the investment promotion division of the Coalition for Development Initiatives, an A.I.D.-sponsored private entity in Costa Rica targeting primarily foreign investors in the manufacturing sector

CINDE/CAAP, the agricultural development division of the Coalition for Development Initiatives, an A.I.D.-sponsored private entity in Costa Rica targeting local and foreign agricultural firms

CORFO, the Development Corporation, a Chilean Government organization charged with a broad range of credit and promotional functions for private firms and parastatals

Fundación Chile, a private Chilean entity supporting agribusiness technology transfer

GEXPRONT, the Guild of Nontraditional Exporters, an established membership organization in Guatemala targeting primarily local firms in the manufacturing and agricultural sectors

IPC, the Investment Promotion Council, an A.I.D.-sponsored private entity in the Dominican Republic targeting primarily foreign investors in the manufacturing sector

JACC, the Council for Agribusiness Cooperation and Co-investment, an A.I.D.-sponsored membership organization in the Dominican Republic targeting primarily local firms in the agricultural sector

PROCHILE, a new governmental unit charged with promoting Chilean exports

PROEXAG, the Support Project for Exporting Nontraditional Agricultural Exports in Central America, an independent project implementation unit operating in Central America and targeting local and foreign agricultural firms

assistance sector (agriculture versus manufacturing), the target clientele (export promotion aimed at local firms versus investment promotion aimed at foreign firms), and the country level of development (established exporters versus new entrants).

This synthesis makes no effort to retrace each element of the analysis; the specific findings are detailed in the issue papers presented in the companion volume. This synthesis focuses instead on the bottom line—the study's implications for A.I.D. trade and investment programming. It is organized by the five issues cited, focusing on whether assistance to promotional institutions has an impact, whether it provides an attractive return on A.I.D.'s investment, and how the Agency can best carry out promotional programs. No study can answer these questions definitively, but the authors believe that the study findings imply a need to rethink some of the assumptions underlying A.I.D. support to trade- and investment-promotion organizations.

2. *Do Promotional Institutions Provide Useful Services?*

The survey of assisted and unassisted firms provides overwhelming evidence that firms use and value the services provided by promotional institutions. Perhaps the most convincing evidence that the services provided by the promotional institutions have real value is that assisted manufacturing firms have generally outperformed unassisted firms in generating exports and jobs. Figure 3 compares the performance of these two groups over the 1986-1989 period.

Investors clearly value some services more than others. The Table shows the services that are ranked the most useful by exporters and investors, based on the survey of assisted firms. This table supports three conclusions:

- Information on markets and buyer contacts is highly valued by all categories of firms.
- ASIs are an important source of information services for assisted firms.
- Other professional services, for example, legal and accounting services are used and valued by the firms but are adequately supplied by the private sector.

The usefulness of each of the services was assessed by using the survey data to measure how closely service use (regardless of the source) was related to export or employment increase. This approach supports the overall conclusions reached, although the specific list of high-impact services inevitably varies somewhat from one analytic approach to another.

3. *Do Promotional Institutions Have an Impact?*

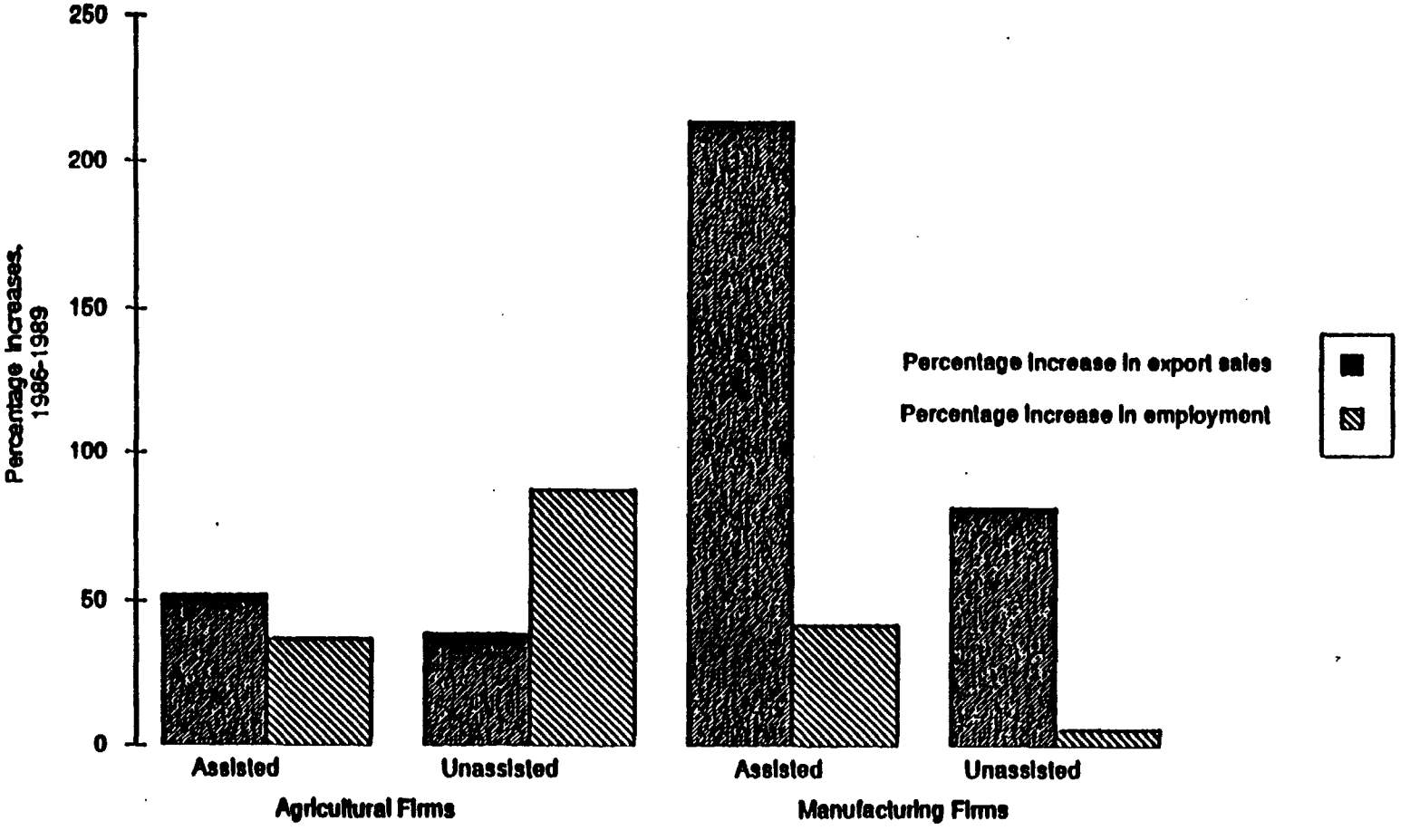
The evidence in this study strongly suggests that promotional institutions have a positive impact on trade and investment. Export- and investment-promotional institutions can make a contribution to export growth and diversification.

Sound promotional institutions and programs are therefore good candidates for donor support as part of a program to promote trade and investment. Particularly where the climate for foreign investment and exports has improved soon after a long period of neglect, promotional institutions play a role in helping both local and foreign investors respond to the opportunities available.

Nevertheless, an important reservation attaches to this affirmative conclusion: The direct impact of the promotional institutions on exports is not very large in national terms. The study found that exports for which the promotional institutions were directly responsible amounted only to a small share of the total growth in nontraditional exports, on the order of 5 to 30 percent.[7] Consequently, promotional institutions by themselves do not provide an adequate response to the need to increase nontraditional exports. Their impact is simply too small at the national level, unless A.I.D. support is very large relative to national exports.

The study suggests a rough rule-of-thumb of a $5 increment to exports in the short term for each

Figure 3. Comparison of the Performance of Assisted and Unassisted Firms, 1986-1989



Source: survey data

Table. Services Ranked Most Useful by Exporters and Investors, and the Role of A.I.D.-Supported Institutions in Providing Them

	Percentage of Firms Rating the Services as Important to Their Operation	Percentage of Firms Receiving Services From an A.I.D.-Supported Institution
Investment Promotion		
Client: Foreign Manufacturing Firms		
Legal Assistance	59	0
Customs Assistance	54	4
Assistance with Government Approvals	52	17
Site Visit Support	50	59
Printed Information on the Country	45	60
Question-and-Answer	45	40
Export Promotion		
Client: Local Manufacturing Firms		
Buyer Contacts	78	29
Information on Foreign Markets	67	17
Technical Assistance for Production	56	0
Accounting	50	0
Credit	50	0
Training	50	33
Client: Local Agricultural Firms		
Information on Foreign Markets	73	36
Buyer contacts	73	48
Technical Assistance for Production	71	75
Question-and-Answer	53	94
Printed Information on the Sector	50	72
Trade Shows	50	65

Note: Shown are the six services in each category receiving the highest impact rating. This rating is expressed as the percentage of all firms surveyed that stated that the service either had an impact on their export operation or was critical to their operation.

Source: Survey data.

dollar invested in foreign investment promotion, and perhaps one-third that level for agricultural export promotion (about 30 cents per year).[8] To double nontraditional exports from $100 million to $200 million in a 5-year period would require assistance of $20 million for foreign investment promotion over the period, and $60 million for local agricultural firms.

These are extremely rough estimates, but they suggest that promotional institutions are likely to have a substantial impact on exports in percentage terms only when expenditures are high relative to the nontraditional export base. Costa Rica's experience with CINDE/PIE, which claims direct involvement in exports amounting to roughly half the increase in nontraditional exports since 1983, is an example of a large impact achieved through large expenditures; IPC is an example of a relatively small impact achieved by spending much less money to support a much larger and more established export sector.

All of these findings apply only to cases in which policies favor export and investment. For situations in which the policy environment is not favorable to exports, the returns to promotional investments are far less certain. Because the cases studied were chosen to represent promotional programs in a favorable policy environment, the study's conclusion applies only to such situations. In a favorable policy environment, promotional institutions can help to expand exports and can provide an attractive return on the donor dollar; this conclusion does not necessarily apply to an environment in which export-oriented investment is not financially attractive.

The value of promotion comes from helping firms recognize and act on profitable opportunities more quickly than they would on their own. In a negative policy environment, such as one characterized by overvaluation, severe restrictions on imports, and complex investment regulations, profitable opportunities are few and far between. A promotion campaign cannot disguise, much less change, this reality.

4. *Does Support to Promotional Institutions Pay Off Economically?*

Support to promotional institutions offers an attractive economic return to donor resources. The cost-benefit analysis estimated the economic rate of return on the total costs of the promotional institutions to be about 25 percent in real terms. This rate of return, however, is quite sensitive to how the benefits are measured or, in other words, how the role of the promotional institution is measured.

Promotional institutions generate benefits by increasing the number of jobs and the amount of exports, but only indirectly; the firms they assist generate the benefits directly. How much of these benefits should be attributed to promotional institutions? For example, if a given investment would not have taken place without an institution's support, is it appropriate to attribute all or only a part of the economic gains to the institution? What if the investment might have or surely would have taken place without the assistance?

To produce the analysis reported here, the study asked the assisted firms that were surveyed to attribute credit for making their investment go forward, and it used their responses and other measures of attribution to assign a portion of the estimated economic benefits to the promotional institutions. By using this method, the portion of economic benefits credited to the institutions ranged from a low of 31 percent for IPC to a high of 73 percent for CINDE/PIE.[9]

Despite the difficulties associated with measuring attribution, the rate of return estimated must be regarded as highly conservative, for two reasons. First, the analysis looked only at the direct and short-term employment benefits generated by the investments for which the institutions claimed credit. Other benefits, including future growth of the firms or spin-off investments that resulted from the initial venture, were excluded. Second, the

analysis did not include any benefits derived from the general promotion activities of the institutions (such as advertising campaigns) or their participation in the export-policy process, although the costs associated with both activities were included.

5. *What Are the Best Service Strategies?*

As the discussion of service use and impact in Section 2 demonstrates, no single service mix is optimal for all conditions; there is no magic formula for effective promotion. The study does, however, suggest several ingredients that should be at the top of the list in developing the right mix for a specific situation.

Determining the Institutional Structure

Based on analysis of the various combinations of services and institutions, the study found several alternative strategies that appear to work. Each viable strategy consists of three elements:

1. Clientele: Local exporters need services altogether different from those needed by foreign firms. Agricultural and manufacturing firms need the same general types of services but the nature of the service is sector- and product-specific.

2. Service strategy: Services may be customized (adjusted to the needs of the individual client) or standardized (provided in the same form to a large number of clients). Services may be concentrated on a few clients, generally members of a specific target clientele, or they may be diffuse, providing a little assistance to a lot of firms. Customized service programs tend to be concentrated, because of budgetary constraints, and standardized programs tend to be diffuse.

3. Institutional structure: Each strategy identified uses one (or at most two) of the following institutional structures: a membership organization, a government unit, an independent private entity, or a project implementation unit.

The study arrives at three key findings for these elements and their interaction to form a viable strategy:

1. An effective promotional program can be developed for each of the clientele groups—foreign firms, local manufacturers, and agricultural firms—but the different needs of each group imply that any given program should be directed at only one clientele group.

2. A customized, concentrated service strategy can be made to work well for each clientele group as can a standardized, diffuse strategy, but not both at the same time in the same institution.

3. Once the clientele and service strategy are selected, a single institutional structure appears to work best.

The type of information needed by each group, and the service strategy best suited to providing that information, emerged as the critical determinants of the institutional assistance strategy.

Determining the Needs of Different Clientele Groups

Capturing new firms in the net of potential investors may be a more important determinant of the success of a promotional program than how well the program serves firms once they are identified. Firms, whether foreign or local, make investment decisions based on expectations of profit, which are shaped by fundamental factors such as wage rates and foreign exchange policies, not by a sales job. Thus, information, including standardized information on prices and operating conditions, emerges as the single most important ingredient in a strategy to expand the pool of candidate investors and exporters.

For promotional institutions, the best way to bring more firms into the net is to find as many firms as possible that are considering overseas investment, and then to do everything possible to

get the promoted country on their short list. Once a given firm decides to seriously examine the target country, the most important work of the promotional institution is done. The firm's decision will be based primarily on the fundamental suitability of the country for the planned investment, not on how well the site visit was planned. Additional promotional support is important primarily to ensure that the firm obtains the right information on the country and makes the right private sector contacts; the information and the contacts, not the assistance as such, will make the difference.

A similar picture emerges for local export firms. For local firms, the number of firms in the net is expanded most easily by finding firms that are ready to export and helping them contact overseas buyers and learn how overseas markets are organized. For manufacturing firms (and agricultural firms selling a specialized product for processing), this may be enough. Most of these firms engage in contract production, and the study found that their buyers provide the technical assistance they need.

For agricultural firms selling into the fresh market, however, information may not be enough. These firms sell to dealers who, unlike contractors, have no real interest in helping their suppliers improve the quality, efficiency, or productivity of their operation. Miami melon dealers buy and sell melons; they do not provide technical advice to growers in Guatemala, Florida, or elsewhere. Technical assistance for production is therefore important to this type of agricultural firm, and they have few alternative sources to turn to for help. Technical assistance may also be important for foreign firms, which must wrestle with the same location-specific technical problems as local firms when trying to introduce the same crop.

In all three cases, the missing ingredient provided by the promotional institution is information, but the specific nature of the information varies with the clientele. Generalizing across all three groups, two types of information are needed:

- Facts about the market and how it works: For foreign firms, market information needs focus on the cost of production in the target country; for local firms, they include price data in overseas markets and information on import regulations.

- Contacts: For foreign firms, contact information includes referrals to local professional firms, suppliers, free zones, and the like; for local firms, the most important contacts are potential foreign buyers.

Standardized information should not be overemphasized. Customized services, particularly technical assistance, were highly valued by local firms that received the services. However, the study found that technical assistance is much more expensive per recipient; moreover, local manufacturing firms were often able to get assistance from their buyers. With a limited level of funding, many more firms can be provided with information than can be provided with technical assistance. If the right firms receive this assistance at the right time, the total impact could well be much higher than that of intensive assistance to a few.

The finding that information is the key ingredient in service is attractive for both practical and theoretical reasons. On the practical side, standardized information is one of the cheapest services to provide on a per-firm basis. Nevertheless, it would be premature to conclude that relatively inexpensive forms of information outperform more expensive forms, dollar for dollar; additional research is needed on this issue.

A second practical advantage of standardized information is the relative ease with which it can be offered. Local personnel with little experience or specialized knowledge can be trained to assemble, organize, and provide their clients with information from existing databases on prices, directories, and other readily available sources.

From a theoretical standpoint, information for the public good provides a justification for the subsidy inherent in donor support to promotion. Subsidies are most appropriate when there is market failure, and poor or uneven availability of information is among the most common causes of market failure, particularly in developing countries emerging into export markets.

What about firms that are not in a position to benefit from information? Does a strategy designed around information needs mean that a firm requiring more help should be pushed to the back of the queue? Yes, it does, if the same amount of assistance can help several firms to export (and create jobs and earn foreign exchange), instead of helping one firm to almost export.

Working on the Investment Frontier—Key to Success

A strategy based on information does not imply that promotion should be a temporary activity, continued for a relatively brief period at the end of which all firms have the information they need. On the contrary, information-based promotion should arguably continue indefinitely, always seeking to operate at the frontier where a new crop of firms needs assistance:

- For local firms, the frontier moves as new firms reach the point at which they have the basic capability to export but need help in contacting a buyer who can provide the technical assistance and marketing expertise to enable them to move into the export market.

- For foreign investors, the frontier shifts as changing conditions in the target country make it attractive to firms in sectors that do not have an established presence in the country.

The frontier is not stable across countries or even within the same country over time. Even a country that is well-known in a particular sector—as the Dominican Republic is in textile assembly—may be all but unknown to potential foreign investors in another sector, such as pharmaceuticals or data processing. A change in the local policy climate (or, equally likely, a change in U.S. import restrictions) may create a newly profitable niche that foreign investors will fill if they know it exists.

The frontier is equally mobile for local export firms. In export promotion, just as in investment promotion, a shift in policy can create a new opening for exporters or can slam shut a window of opportunity. At any given point in time, the national entrepreneurial base is made up of a relatively small number of firms that are already established exporters (and therefore do not need assistance), a very large number of firms that are not even close to being ready to export, and a number of firms in the middle. This last group is the most appropriate target for assistance, whether support is intensive and customized or diffuse and standardized.

Promotional organizations need flexibility and the planning capability to locate the frontier and then to adjust their program to serve firms in its vicinity. If the institution plans to exist for long, it needs the capability to keep up with shifts in the frontier over time, as local and international market conditions change. It is noteworthy that very few of the institutions studied have these capabilities.

Services: Customized and Targeted or Standardized and Widely Available?

If there is a conventional wisdom in trade and investment promotion, it is that customized, targeted, intensive services have an impact and standardized, diffuse services do not. Taken to the extreme, the conventional wisdom characterizes standardized services as the choice of government institutions that lack the resources and expertise to do anything else, and customized services as the preferred option, the Cadillac of promotional programs.

A principal finding of this study is that this conventional wisdom may well be wrong. Standardized services, such as printed information and foreign market price information, are among the services that firms are most likely to receive, and, more important, are among the services most likely to have an impact on the recipient—foreign or local. Whether the measurement of impact is based on the statistical correlation with export growth or on the firms' own assessment of impact, standardized information services consistently ranked among the most important services.

Contrary to the team's expectations, the investors interviewed repeatedly emphasized the value of standardized information provided by brochures, handbooks, and short courses. One free-zone investor in the Dominican Republic, for example, stated that even with several years of experience in the country, he never made a move without consulting the American Chamber of Commerce investor's handbook.

Furthermore, several investors were highly disparaging of special studies conducted on their behalf, both by ASIs and by the private sector, criticizing them as inaccurate, too general, too optimistic, and lacking vital information on how to make contact with buyers.

6. *Choosing the Right Institutional Models*

Models With Potential for Success

The study identified five viable models for delivering services, based on the different needs of each clientele group. All five models emphasize information, but they differ depending on the answers to three key questions:

1. Is the primary clientele foreign investors or local exporters?

2. Will the program primarily provide concentrated, customized assistance to a few targeted firms or standardized assistance diffused across a large number of firms?

3. How important is sustainability?

The models identified by the study represent refinements of existing strategies rather than major modifications to A.I.D.'s trade and investment program. At the same time they suggest a need to change some of the current assumptions and modify certain design elements now widely used, as further discussed below.

Export promotion and investment promotion require different services and different skills, and, as a result, should arguably be housed in different organizations or at least in separate programs within a single institution. The same is true of customized versus standardized studies and of agricultural versus manufacturing firms. The study identified five models that combine viability with effectiveness to serve these different groups. These models, shown in Figure 4, provide a range of options to fit different target groups and varying levels of resource availability.

Two of the models can be structured for sustainability without a large and continuing infusion of donor funding: the government promotional unit supporting foreign investment and the membership organization supporting local exporters.

Two of the models are unsustainable: they rely on outside funding for continuation of the program. These include the independent private entity promoting foreign investment and the project implementation unit supporting local exporters. These models should be either structured with a predetermined life span or provided with a permanent source of revenue that is not directly related to services (such as an endowment). The remaining model falls somewhere in between: the standardized services provided by the membership organization can achieve sustainability but the customized services cannot.

Why We Cannot Say Which Model Works Best

The study was not able to determine which model has greater impact and offers a higher return, for two related reasons. First, most of the programs examined combine customized services to a few firms with standardized services to a larger clientele, making the impact difficult to separate. Second, none of the programs that rely most heavily on a diffuse service strategy (JACC, GEXPRONT, CENPRO) keeps a tally of exports or investments for which it claims credit. This failure is not evidence of sloppy management (or at least not entirely so); by their nature, programs following a diffuse strategy do not have sufficient contact with any given firm to make it feasible or appropriate to track export performance.

Figure 4. Viable Models for Investment and Export Promotion

INVESTMENT PROMOTION

Model 1
Diffuse Impact, High Sustainability

Government Unit

Standardized Services:
Supported by donor funding, government funding, other non-fee sources

Country information
Question-and-answer
Site visit support
Assistance with government approvals

Market strategy:
Reactive, respond to demand

Example: CENPRO

Model 2
Concentrated Impact, Low Sustainability

Independent Private Entity

Customized Services:
Supported by donor funding, government funding, other non-fee sources

Country information
Question-and-answer
Site visit support
Assistance with government approvals

Market strategy:
Proactive, aggressively target clients

Examples: CINDE, IPC

EXPORT PROMOTION

Models 3 and 4
Diffuse Impact, High Sustainability

Membership Organization

Core Services:
Supported PRIMARILY by member fees and dues

Buyer contacts (standardized)
Market information (standardized)
Training
Question-and-answer
Sectoral information

Examples: GEXPRONT, JACC

Model 5
Concentrated Impact, Low Sustainability

Project Implementation Unit

Targeted Program:
Donor-funded with some fee income

Technical assistance
Trade shows
Buyer contacts (customized)
Market information (customized)

Examples: CAAP, PROEXAG

Targeted Program:
Model 3A: small, donor-supported program within organization
Model 4: Cooperation with larger program separate from institution

Technical assistance
Trade shows
Buyer contacts (customized)
Market information (customized)

Although the lack of data prevents a definitive comparison of concentrated and diffuse assistance strategies, the survey findings cast significant doubt on the assumption that intensive, customized services for a few firms have a greater total impact than standardized services diffused across a larger population of firms. As noted in Section 5, many of the services that garnered high praise from the assisted firms fell into categories suited to providing a standardized service to a large number of firms.

The lack of impact data inherent in diffuse assistance strategies is a disadvantage from the standpoint of the donors: these programs do not generate the proof of impact that donor agencies like to see (and be able to show). Programs following the concentrated service model work intensively with a few, targeted firms. They tend to maintain records on the performance of their flock over time, particularly if they are keen to keep donor funds flowing. They can argue that gains made are due to their assistance (although they generally cannot offer proof in the form of a control group).

The bottom line is that low-intensity, diffuse-service programs may have just as much (or more) impact as, and may be more cost-effective than, the concentrated service models, but they cannot prove it.

What Needs To Be Changed in A.I.D.'s Support to Promotional Institutions?

What is excluded by the five models presented? At first examination, it might seem that they include everything A.I.D. is already supporting and more, but this is not the case. The models imply a need to modify A.I.D.'s assistance strategy for trade and investment promotion in order to recognize several realities:

- Increasing fee income alone is not the answer to achieving sustainability and may not even be desirable.
- Expertise in U.S. markets and production technologies cannot be maintained by local institutions.
- Targeting is generally not feasible for membership organizations.
- Export- and investment-promotion programs have different needs that do not necessarily fit well together.
- Customized, targeted programs are not sustainable but may be worth supporting anyway.

Does Greater Reliance on Fee Income Provide Sustainability?

Project designers have been somewhat cavalier in assuming that fees could and should be collected to improve institutional viability and performance. The study suggests that fees have a useful role to play but that fees are not an adequate source of revenues for sustainability, nor are increased fees necessarily conducive to promoting better institutional effectiveness.

Fee income is highly desirable for institutions that work with local firms (both membership organizations and independent project implementation units) as a means of rationing services, generating income, and, for membership institutions, building ties to their clientele. Fees do not provide an adequate basis for sustainability, however, because full-cost recovery fees on customized services would have to be unrealistically high, particularly if they are also to cover the costs of vital policy and promotional services that cannot be supported by fees. Membership organizations should be able to become self-sustaining if they focus on inexpensive, standardized services, for which costs can be recovered fully, and if they rely on dues to supplement their overhead and to support a modest program of lobbying and other indirect services.

Fee income is much less desirable and appropriate for investment-promotion organizations for several reasons. First, these organizations would have great difficulty in charging fees for much of what they do (making collect cold calls, for example) without damaging their image and that of their countries'.

Second, and perhaps more important, pressure to generate fees may actually interfere with effectiveness:

- A need to generate fees encourages investment promotion institutions to target the easy sectors (e.g., textiles in the Dominican Republic), rather than new sectors on the frontier.

- Many fee-generating schemes would interfere with the institutions' credibility as an impartial source of reliable information for investors.

A.I.D. must think much more carefully and realistically about fee income and its role in the service strategy and long-term viability of the institutions supported. Fee income is not the only answer to financial sustainability. On the contrary, as argued above, overreliance on fee income may be prejudicial to effectiveness. Alternative sources of income include donor-funded endowments, taxes on exports or free-zone licenses, and income from highly profitable services (such as preclearance of horticultural exports) offered by the institution on a monopoly basis.

Nor is fee income the only way to build in accountability, or necessarily the best. The example of PROCHILE in Chile suggests that, even for public sector organizations, a management structure that provides for direct private sector management input tends to improve performance. Both Chile and the Dominican Republic provide examples of power struggles between public and private sector interests over who will control an independent private entity. A.I.D. cannot realistically prevent such power struggles in investment-promotion organizations, which by their nature serve a clientele that is not involved in management: potential foreign investors. But by withdrawing funding A.I.D. can ensure that any government triumph in such struggles will be a Pyrrhic victory.

The problem of private sector accountability is by no means limited to public sector organizations. Membership organizations that are heavily dependent on A.I.D. financing tend to be unresponsive to their membership. To avoid this danger, A.I.D. should accept a slower growth rate for services provided by these organizations to ensure that they do not expand beyond the capability of their membership to control and finance their activities.

Is In-House Technical Expertise Always a Realistic Goal?

With the exception of the independent project implementation unit, none of the organizational structures examined has proved adept at establishing and maintaining a high level of technical expertise. They tend to be staffed at the operational level by capable but inexperienced personnel and have a high turnover rate. This lack of technical expertise is not a problem for investment-promotion organizations, which serve a comparatively sophisticated clientele and can quickly train new hirees in the local knowledge needed.

Lack of expertise is a problem, however, for export-promotion organizations, which serve local firms needing technical assistance and buyer contacts. This situation has two alternative solutions: (1) limit services to standardized services (such as referrals from published directories) requiring little expertise or (2) provide a mechanism to make additional technical expertise available to these institutions.

Because production knowledge and buyer contacts tend to be highly sector-specific, and because they are expensive, they should be targeted. As a result, they are best structured as separate, temporary, donor-supported programs rather than as permanent, membershipwide services wholly supported by fees. As noted earlier, membership organizations have great difficulty in favoring subgroups within their membership.

Within export promotion, the areas of expertise required by local firms in the agricultural and manufacturing sector are similar in type but different in content. Many local firms are likely to need technical assistance in production, for example, but the nature of the help needed by an avocado producer is very different from that needed by a textile firm. The breadth and specificity of technical and market information needed suggest that export-promotion programs providing customized

support for agricultural and manufacturing firms may need to be implemented separately, although standardized services can be provided to both by the same organization.

Can Membership Organizations Target Services?

The study found that membership organizations had particular difficulty in providing customized, concentrated services. Because these organizations depend on membership support, they face strong pressure to make their full service menu available to all of their membership. The combination of a highly diverse membership (producing many different products) and technical needs that vary greatly by product is not consistent with efficient provision of customized services. JACC, for example, has 33 "priority" products. Avocado growers are not willing to see their money used to provide technical assistance to pineapple growers, at least not if they do not have access to the same assistance.

Three ways out of this dilemma are represented by the three viable models presented for export promotion: (1) use a project implementation unit, which is not answerable to a membership and which can serve whatever audience A.I.D. defines; (2) confine customized, targeted services within a relatively small and separate program clearly labeled "donor-funded," not "member-funded," or (3) provide customized services through a project implementation unit in cooperation with more widespread standardized services provided by a membership organization.

Can the Same Institution Do a Good Job at Both Export Promotion and Investment Promotion?

Several of the programs examined combine export and investment promotion (CINDE, for example, started as an export promotion program and then shifted to investment promotion and is now shifting back to give more emphasis to local firms). The study suggests that each organization should have a clear mandate to serve either foreign investors or local firms but not both. This is particularly true for the customized service model, but it is also true for standardized service strategies, for two main reasons:

1. Foreign firms need different services and information than do local firms, so the gains from combining services to the two clientele groups are unclear. Unless the special information and assistance needed by local firms can be managed and provided by an outside source (such as the International Executive Service Corps), it will be difficult to manage the range of services required by the two different groups.

2. Each type of promotion requires a different level and type of technical expertise. Export promotion generates a much greater demand for technical expertise (including detailed knowledge of foreign markets) than does investment promotion, particularly when customized services are provided, and therefore requires a different and more experienced personnel base.

The need to separate the programs and provide a separate staff for each does not necessarily rule out parallel programs within a single organization, although the gains from doing so are far from self-evident. Additional time is needed to determine whether CINDE's attempt to carry out these different functions through parallel but separate divisions within the same organization will prove effective.

It should be emphasized that the need for technical production knowledge is greater in the agricultural sector for both foreign and local firms. Whereas the technology for most manufacturing operations poses the same problems wherever it is applied, each country's climate, soil, and pest conditions raise special problems. Foreign firms are likely to encounter almost as many difficulties as local firms in introducing a crop to a new location, but their greater resources and experience base nonetheless mean that they have less need of assistance from an institution supported by A.I.D.

Is Sustainability an Appropriate Goal?

A private enterprise officer interviewed in one of the non-case study countries suggested that sustainability is not an appropriate goal for promotional programs. He argued that ASIs have done their job when a sufficient number of export-oriented firms has been developed. Once this is achieved, the firms themselves will maintain pressure for policies favoring exports and will attract new investors through private contacts. This argument is attractive.

It was argued earlier, however, that promotion is never completed: there is always a new frontier for promotion of foreign investment and a new crop of local firms ready to graduate to the export market. This conclusion by no means implies, however, that export- and investment-promotion programs are only worthwhile if they continue indefinitely. On the contrary, the study found that these programs can be justified economically on the basis of their short-term and immediate benefits alone, regardless of any later benefits provided by the institutions developed. This finding is fortuitous, because many of the programs will indeed cease to exist for all practical purposes once A.I.D. funding is cut off.

Three of the models presented are viable only as long as outside funding is provided. They can survive the withdrawal of A.I.D. funding, but only if another source of funding, such as an endowment or other donor support, takes its place. As a practical matter, a Mission undertaking a program based on one of these models must either build in such support or plan for the program to wither away.

Sustainability is equally problematic for public and private institutions, although for different reasons. Public investment-promotion institutions can be effective and sustainable, as shown by the experience of Malaysia and Ireland, but only where they are a component of (not a substitute for) a strong export-oriented policy. If the government's commitment to building exports and attracting foreign investment is weak, any program dependent on its support will flounder. Private-sector promotion of off-shore investment is fundamentally unsustainable, because it lacks a paying clientele. Private promotion of local exports is sustainable, but only at the fairly low level that is consistent with modest income from membership dues and fees for services. Large-scale programs providing customized technical assistance do not appear to be either financially or technically sustainable, wherever they are based.

Endnotes:

1.Volume two of this study, CDIE Working Paper No. 146, available from the A.I.D. Library, contains the Appendixes, which discuss in more detail the issues addressed in this study.

2.A finding that promotional institutions merit A.I.D. support does not by any means imply that A.I.D. should fund such institutions in every country or sector, much less that every export- and investment-promotion program will work. These are country-specific programming decisions that depend on the country assistance strategy, the existence of a policy environment favoring export-oriented investment, the state of development of the export sector, and the nature of the institutional candidates for support.

3.Firms surveyed cited repeatedly the value of preferences provided by the CBI and by related programs, particularly the 807 and 807a programs, which grant partial duty exemption on contract apparel assembly, and the 936 program, which encouraged establishment of Caribbean twin plants by firms investing in Puerto Rico.

4.The tariff preferences included in the CBI legislation excluded several of the economic sectors that have experienced the most rapid growth, notably textiles. Parallel legislation (the 807, 936, and 807a programs), however, did assist these sectors. The export community generally considers all of these programs together as part of the CBI.

5.Nominal effective exchange rates were used instead of the theoretically preferable real effective exchange rates due to the absence of a consistent source for the latter covering the relevant time period and countries.

6.This analysis is based on data provided by CEDOPEX, the national export documentation center of the Dominican Republic.

7.The availability of impact measures limited this analysis to three promotional institutions. The gain in nontraditional exports at the national level attributable to the promotional institutions' efforts ranged from a low of 4 percent for the IPC to 31 percent for CINDE/PIE (both measured against the base of total growth in nontraditional manufacturing exports), with PROEXAG in the middle, at 12 percent of additional nontraditional agricultural exports. These measures are based on the total exports generated by investments for which the institutions claim credit, adjusted downward to reflect the proportion of these exports judged to be attributable to the assistance (which ranged from 30 to 70 percent).

8.A similar estimate was not possible for promotion of exports by local manufacturing firms, because none of the institutions studied was able to provide a detailed list of exports by assisted firms in this group.

9.Only three of the ASIs—CINDE/PIE, IPC, and PROEXAG—were able to provide a specific list of investments and exports for which they claimed credit, and the cost-benefit analysis was therefore limited to them. One other institution provided an estimate based on a percentage of the value-specific nontraditional export products with which it had been involved and for which it claimed partial or full credit, but the team considered this measure unacceptable. The other institutions, including two membership organizations and one government unit, could not provide measures of impact at all. As discussed later in this synthesis, these organizations tend to implement programs that provide limited services on request to a broad clientele rather than concentrate assistance on a few firms. This approach makes it impractical to track impact and difficult to claim credit.

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Economic Growth Training Workshop
Trade Development
Presentation Notes
Thursday, September 21, 1995

Concepts in International Trade Theory and Trade Strategy

Presenter: *Dr. Vijaya Ramachandran*, Center for International Development Research, Duke University

Topics: Key concepts in international trade theory; changes in theory over time; relationships between trade and growth; current world trade environment (GATT, trading blocks); alternative trade strategies (e.g., import substitution versus export-led growth).

I. The Theoretical Approach to International Trade

A. Trade Instruments: Quotas, Tariffs and "Hybrids"

In this introductory session, I will discuss the effects of tariffs, quotas and hybrid trade instruments on the exporting and importing country. I will also examine the pros and cons of using these policy instruments and the gains and losses associated with each. Finally, I will look at some of the recent adaptations in the use of these instruments.

B. Export Subsidies, Trade Agreements, and Voluntary Restraints

New research on trade policy suggests that export subsidies may be more useful than tariffs and quotas. I will examine the pros and cons of this policy tool as well as consider some other recent developments in trade policy. I will focus on trade agreements and trade organizations, with an emphasis on the contributions of these institutions to economic growth. Finally, I will look at the impact of voluntary restraints on the importing and exporting country.

II. The New Approach to Trade Strategy

A. Targeted Trade

The idea of targeting certain industries for exports has generated debate about the choice of industries and the mechanisms that can be used. I will consider some of the main arguments forwarded in this segment of the trade literature, in the context of developing countries. I will also look at the effect of targeted trade on economic growth and the prospects for implementing this idea in the developing

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world. The discussion will include the literature on identifying comparative advantage in a rapidly changing economic environment.

B. The New Role for Tariffs and Import Penetration

This section will focus on whether there is any role for tariffs and quotas in trade policy. I will review the literature on import substitution versus export-led growth as well as raise some of the more recent arguments that re-examine the validity of tariffs and quotas. The prospects for export-led growth strategies will be examined, with emphasis on the pre-requisites for pursuing this type of strategy.

III. Key Concepts in Trade Reform

A. The Removal of Trade Barriers: Conceptual Issues

How do countries go about removing trade barriers? This section will look at some of the conceptual issues that need to be taken into account when designing trade liberalization policies aimed at the reduction of tariffs and quotas. Special emphasis will be given to political as well as economic factors that play a role in this process.

B. Devaluation and Liberalization

I will explore the linkages between currency devaluation and trade liberalization in this section. Following up on the previous section, I will discuss the political and economic variables that determine the success of a joint devaluation-liberalization strategy. Some of the recent literature that attempts to construct a conceptual model of trade liberalization will be explored.

C. Trade Reform, Government Credibility, and Economic Growth

In the concluding section, I will look at the relationship between government credibility and trade liberalization. In particular, I will describe a simple model that links the credibility of a government to the success of trade policy. In conclusion, I will also focus on some of the policy options suggested by the various aspects of trade policy discussed in the entire presentation.

Measuring Financial and Socio-Economic Gains from Trade

Presenter: *Dr. Kostas Axarglolou*, Babson College

Topics: Trade experience of developing countries; measuring and assessing gains from trade - empirical aspect; social effects; impacts of liberalization on indigenous economic sectors; financial mechanisms and balance of payments implications. The issues discussed by Dr. Axarglolou include the following:

I. Basic Concepts

A. Problems of Interest

- Implications of international trade on the economic performance of developing countries
- Economic implications of trade liberalization on developing countries

B. Stylized Facts About Developing Countries

- Economic structure
- GDP Composition
- Trade Composition
- Terms of Trade

C. The Contributions of Trade to Economic Development

- Resource utilization
- Market size
- Transfer of technology
- Flows of capital
- Competition
- Efficiency

II. Trade, Trade Liberalization and Economic Performance of Developing Countries

A. Methodology: Two Approaches Using Cross-Country Data

- Trade orientation and economic performance
- Trade liberalization and economic performance (event studies)

B. *Trade and Macroeconomic Growth*

- Trade orientation and growth (inward versus outward countries)
- Trade regime changes and economic growth

C. *Trade Openness and Economic Convergence in Growth Rates*

- Growth differences between inward and outward oriented countries

D. *Trade, Macroeconomic Structure, and Growth of Developing Countries*

- Growth differentials between countries exporting primary, oil, or manufacturing goods

E. *Trade and Productivity Growth*

- Trade, technological transfers, intermediate products, and growth of total factor productivity

F. *Trade Liberalization and (Un)Employment*

- Trade, economic restructuring and (un)employment

G. *Trade, Trade Liberalization, and Income Distribution*

H. *Trade Orientation and Macroeconomic Crises*

III. Conclusions

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Trade Application: GATT's Implications for Agricultural Trade

Presenter: Dr. Philip Chase Abbott, Department of Agricultural Economics, Purdue University

Topics; What GATT means to developing country agricultural exports; agricultural market access under new tariff quotas; impacts on agricultural stabilization programs; use of import tariff ceilings; potential initiatives for USAID Missions.

Introduction

Agricultural trade came under GATT disciplines for the first time in the 1994 Marakesh Agreement (Uruguay Round). The GATT Agreement included, among other provisions less relevant to Agriculture, and Agreement on Agriculture, and Agreement on Sanitary and Phyto-Sanitary Regulations, and the World Trade Organization.

Agricultural exports (and imports) have been important in the past to developing countries. Trade in food and agricultural products is increasingly in high value, such as processed products. Developing countries loking to increase exports of agricultural and food products must comply with new trade regimes and regulations required under GATT/WTO.

What in the GATT Uruguay Round Agreement affects agricultural trade?

The Agreement on Agriculture:

Principles: Rules and reduction commitments for export subsidies, domestic support, and market access restrictions.

Tariffication: Import quotas and non-tariff barriers are replaced by tariffs, Minimum Access commitments and tariff-rate quotas. Tariffs are bound and are to be reduced over time.

Specifics: Export subsidies will be reduced 36 percent from the 1986-1990 base period. Export quantities subsidized will be reduced 21 percent. The agreement will be applied to specific products or groups of products; a phase-in process allows tradeoffs between products. The U.S. Export Enhancement Program (EEP) will need to be scaled back, and EU variable levies and export restrictions will be limited.

Regarding domestic support (subsidies), trade distorting farm subsidies will be bound, and reduced 20 percent from the 1986-1988 base, with credit for reductions since 1986 using the aggregate support measure (AMS across commodities. The U.S. and several other countries (e.g., South Korea,

Argentina, and Brazil) need not modify their farm programs, due to reforms in the 1985 and 1990 Farm Bills, structural adjustment programs and domestic reform measures. Regarding Green-box non-distorting support measures, policies with minimal trade or production effects are exempt from reductions. There will be a "decoupling," with direct income rather than price supports encouraged.

With respect to tariffication and market access, current access opportunities will be maintained. There will be minimum access commitments when imports are less than 3-5 percent of use.

Tariffication, with 36 percent average reduction, 15 percent minimum
24 percent average, 10 percent minimum for developing countries
Tariff rate quotas implemented (low tariff up to market access commitment, with higher tariff thereafter.
The time frame for the phase-in of reductions: 6 years for developed countries and 10 years for developing countries.

Rules: Countervailing duties may be applied on subsidized imports except on domestic support measures in the "green box" which have an exemption of 9 years.

Agreement on Sanitary and Phyto-Sanitary Regulations

This agreement is designed to eliminate health and sanitary regulations as disguised non-tariff trade barriers while still achieving the objectives of protecting human, plant and animal life and safety. It seeks to ensure that regulations are based on scientific principles. There has been slow progress on the use of international standards and the harmonization of standards, but fewer disputes when international standards are used. Equal access and equal treatment (MFN treatment) is preferred; if domestic measures are used, they cannot distinguish between countries, or between domestic and foreign producers.

World Trade Organization

GATT was a treaty. WTO is an international organization with enforcement powers, which will insure better enforcement of GATT requirements. The WTO Committee on Sanitary and Phyto-Sanitary measures will settle disputes and set international standards.

Special Provisions for Developing Countries

Tariff and subsidy reduction requirements are lower. A longer adjustment period (10) is allowed. Special bilateral agreements may continue during the adjustment period, but may be altered. Export taxes and consumer subsidies are not addressed.

What is the Significance of this Agreement for Agricultural Trade?

Agriculture is no longer a special case. Tariffication will be applied and NTBs will be eliminated. Certain special provisions will be eliminated or reduced.

Domestic agricultural policies which affect trade will now be regulated by GATT. To deal with world market surpluses, subsidies to producers (not consumers) will be reduced, and decoupled measures will be encouraged.

The Agreement will reinforce ongoing reforms, and will lead to more open trade regimes. It will lead to more rational, scientifically based technical regulations.

Problems with the Agreement

On tariff rate quotas, tariffication efforts in the past have failed due to timing of market access commitments, quota rends, market dynamics and static commitments.

Water in the Tariff Bindings (or Dirty Tariffication) -- bindings are maximums, not applied tariffs. The tariffication process led to very high bindings and greater protectionism in some instances. Rules required in setting offers make proposed reductions of some developing countries irrelevant to their actual market conditions. In some cases, institutional changes are more significant that the level of protection proposed.

The health and sanitary commitments are vague. Industry standards such as ISO 9000 and 14000 may be more important. There are no individual country commitments.

Assessment of Trade Negotiation Outcomes for Agriculture

Distorting subsidies will be reduced but not eliminated; it is not a "free trade" agreement. The tariff rate quota has emerged as a new policy measure, not tariffication due to market access commitments. Domestic measures will now be negotiated under GATT.

The evolution of policy reform in the U.S., EU, Japan and elsewhere (South Korea, Latin America) will be profoundly influenced by GATT talks, and reforms may be more permanent. Therefore, there is enthusiasm in many countries about increased trade and fairer export market potential.

Non-tariff restrictions such as grades and standards, health, safety and sanitary requirements, and environmental policies are likely to be the source of future controversy.

The test of this agreement will be how countries will behave if agricultural surpluses mount or if we face another world food crisis (like in 1973), as may now be occurring.

Development of Trade and Trade Institutions

Presenter: Rick Koskella, IMCC

Topics: Overview of the institutional framework for trade; lessons learned on trade promotion; institutional networks for exporter assistance; examples of institutional best practices.

I. MODELS OF TRADE PROMOTION ORGANIZATIONS

Centralized Government Services

- Traditional approach for government agency or department to provide a wide range of services, essentially trying to act as a monopoly supplier.

- Organizations typically have a strong focus on trade missions, providing basic information, and developing services based on their own initiative, as opposed to in response to market demand.

- The general view is that these organizations have not been successful in developing countries for a number of reasons, including inappropriate staffing, limited resources, inability to target high potential firms, etc.

- The fact that a number of countries with these organizations are also incorporating innovative schemes reflects the questioning of this approach.

Specialized Autonomous Agencies

- In this model, the organization is autonomous from the government, but may receive all or a substantial part of its budget from public sources.

- Autonomous agencies typically have higher quality staff than do purely public organizations, and can focus on targeting high export potential firms. There are many possible approaches within this model:

  - The Hong Kong Trade Development Council focuses on providing trade leads to foreign buyers seeking to purchase goods in Hong Kong, and providing Hong Kong exporters with information on the foreign buyers.

  - The Swedish model, in contrast, uses its overseas Chambers of Commerce to provide services on a demand basis to companies. Likewise, AUSTRADE of Australia provides tailored services to companies. Both of these organizations charge fees comparable to commercially provided services.

- CINDE in Costa Rica used its overseas offices to promote trade and investment.

Targeted Export Activities

- In this approach, a specific sector is identified as having high export potential and is targeted for specific technical and marketing assistance.

- This approach has been increasingly tried and supported by donor agencies, especially as it has become more understood that centralized trade promotion organization have not worked well.

- This approach can have many problems. One is the difficulty of choosing which sectors are truly competitive. While a sector may appear to be competitive, in practice the firms in that sector may not be. There is no guarantee of the commitment of firms to use these services, nor of their readiness to absorb the services provided. Consultants providing the services are not selected by the end users, but by the organizations providing the services. This does not create a market for services and is therefore not sustainable.

- Another targeted sector approach is buyer programs. In this approach, buyers from export markets are brought to the country, expenses paid, to meet potential suppliers. The main problem is that local firms are often not technically able to meet buyers' needs and are not committed to work with the buyers who are brought to their country.

Private Sector Led Approaches

- A number of new approaches are being used in developing countries. One approach which is becoming increasingly accepted is the **cost sharing grant scheme**, in which firms receive part of the cost of using private sector service providers.

- This approach has been in use in the UK for a number of years, and is now being implemented in a number of countries, including Argentina, Indonesia, Israel, Kenya and India.

- Grant schemes have tended to focus on exports, but are now being developed for other areas such as the technology scheme in Mauritius.

- The advantages of these schemes are (1) services provided respond to real market demand; (2) they help create a sustainable market for business services; (3) experts are providing appropriate services to firms, as opposed to government officials or

development consultants; (4) they ensure the commitment of firms to using the services through the payment of their fees; and (5) by keeping the percentage contribution of the firm relatively high (50 percent appears to be the accepted standard), they ensure that firms are ready to use the services.

- As states in a recent review of these schemes, ". . . evidence suggests that trade promotion efforts which have been undertaken within public institutional or organizational structures have frequently been ineffective instruments for assisting private sector firms in expanding their export activities. An alternative project-based approach, which concentrates on providing targeted firms with expert consultant advice centered on supply-related tasks, is identified as having greater potential as a means of export promotion.[1]

- Another private sector led approach has been association programs. Many associations provide a range of services to members, including market information, standards, training and education, and trade promotion.

II. LESSONS LEARNED

Trade promotion organizations have a poor track record. Most assessments conclude that these organizations have not been successful. In the case of those organizations which are considered a success (which primarily follow the autonomous model), the relevance to other countries is questionable. These organizations (e.g., in Hong Kong and Singapore) have been operating in a business environment which would almost certainly have been successful without their existence.

Services provided must be appropriate to the needs and capabilities of local companies. Organizations and programs which support businesses must take into account the degree of sophistication, as well as the product range, of local companies. It would not make sense, for example, to provide the trade lead program offered by the Hong Kong Trade Development Council to an economy with few export-ready producers.

Focused, in-depth tailored services are the most critical and useful to firms. Firms need to obtain information and expertise which is unique to their situation.

Development of private sector support services is the key to firm success and sustainability. Firms in any economy have a wide range of needs that can best be met by private sector suppliers.

Services to firms need to be on a fee basis. This ensures both the commitment and readiness of

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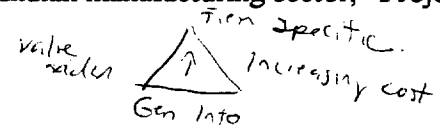
[1] Rahzeb Chowdhury and Colin Kirkpatrick, "Project assistance for export marketing in developing countries: an impact evaluation study for the Indian manufacturing sector," Project Appraisal, September 1994, pp. 173-182.



Value added Info Pyramid.
usefulness of Services.

firms. It also ensures that the supplier of the service is accountable to their client.

III. THE ROLE OF THE GOVERNMENT IN BUSINESS SUPPORT SERVICES

The private sector should take the lead in developing and providing business support services. Public institutions should not provide services which the private sector can provide them in an economically efficient manner. The government should not compete with individual firms trying to provide services. The goal is to develop a functioning and effective private sector business support service network.

Where the government does have an appropriate role in providing services, services must be provided in an efficiency manner and reflect real demand for services. Services must be provided on a fee basis, to ensure that demand exists, as well as to encourage quality service provision. Services or activities which have a regulatory nature must be provided in an efficient manner, minimizing the cost to firms in terms of the length of time and management time.

The government can support mechanisms which encourage the development of private sector business support services in a selective and time bound manner. The government can act as a catalyst to speed up the development of a private sector support sector. This should be done, however, on a temporary basis, and must be done in a way which ensures services provided are demand driven, and that firms receiving the services have demonstrated a commitment to using the services, as is evidenced by significant proportion of fees.

IV. GUIDELINES FOR THE PROVISION OF SERVICES

- **Fees for Services**. All services to be supported must be on a substantial fee for service basis. This will help ensure that firms are committed to use the services provided, and have the readiness to incorporate the necessary actions resulting from the services.

- **Private Provision and Choice**. Services should be provided by profit-driven private sector specialists at the choice of the firm receiving the services.

- **Market-Driven Services**. Services provided must be based on actual market needs.

- **Create Support Service Network**. Services provided must encourage the development of a support service network, and not displace or crowd out private sector activity.

- **Time Bound**. As the market for business services develops, the need for continued intervention should disappear.

- **Donor Coordination**. Governments should seek to manage donor supported activity to ensure that the activity is coordinated to support business knowhow and a service market, following the guidelines noted above.

Trade Growth and Commercial Policy Environments

Presenter: *John Mathieson*, SRI International

Topics: The importance of appropriate trade and commercial policies; a framework for measuring and comparing policies across countries and regions; policy benchmarking, best and worst practices; alternatives for effective USAID policy reform initiatives.

Developing country leaderships and the development community itself should devote more attention to trade development for at least three reasons:

- Almost all countries that have achieved sustainable, rapid economic growth rates have done so through export-led growth strategies. Trade growth doesn't solve all economic problems, but it has been clearly proven by experience to represent the most likely route to growth and higher standards of living.

- The establishment of a successful export sector signifies that a country can compete against all nations -- including the most competitive. This reflects that domestic resources have been marshalled efficiently and that comparative advantages are being utilized, which in turn is a central goal of development.

- The process of identifying constraints to export growth is highly instructive, since it uncovers economic biases, policy and bureaucratic impediments, infrastructure problems, capital market deficiencies, and the need to improve education and training. In this sense, trade development is an effective means to diagnose and address fundamental hindrances to sustainable development.

While all countries have relatively abundances and shortages of different resources, and therefore face varying export growth prospects, all nations do possess comparative advantages on which trade growth can be based. The experience of most countries indicates that the greatest constraints to export expansion are policy induced. Various commercial policies and regulations build up over the years to protect various interests, and in doing so create layers of restrictions and excessive costs which reduce efficiency and freedom of action.

- **Commercial policies establish the environment within which exporters and other businesses must operate.** A consensus has been reached on the need for a "market friendly" policy approach to stimulate economic activity. This is particularly true for exporting, given the high degree of competitiveness in world markets.

- **Inappropriate commercial policies are the easiest export constraint to remove.** It takes considerable time to improve labor productivity, infrastructure, or other input-related problems, but policy change can take place quickly.

- **Governments and donor programs should concentrate efforts on creating an appropriate commercial policy climate before other interventions.** Without market friendly policies, money and time spent on infrastructure, trade promotion or exporter services will be wasted.

How does one get started in identifying commercial policy reform needs? An analytical framework and database has been prepared by SRI International under the Private Enterprise Development Support (PEDS) Project. The model includes 36 commercial policy variables covering the following areas:

1. Business start-up
2. Pricing policies
3. Import policies
4. Export policies
5. Foreign exchange policies
6. Domestic investment policies
7. Foreign investment policies
8. Labor policies
9. Taxation

Data on these policies were collected for over 70 countries worldwide. A rating system was developed to score each country, both overall and in each of the above categories. The total scores were then assessed with long-term growth variables (GDP, industrial output, domestic investment and exports).

- **The Commercial Policy Model provides quantitative information on the strengths and weaknesses of national commercial policy frameworks.**

- **The scores of individual countries can be compared to regional competitors and to international "benchmarks" and "best practices."**

- **Average policy scores for geographic regions indicate general regional policy competitiveness and change over time.**

Overall, the commercial policy climate scores as well as functional policy clusters are found to be closely correlated to economic performance. The highest scoring countries and regions are also those with the highest growth rates. For example, over the 1980s, the top ten developing country scorers achieved much higher cumulative growth than the bottom ten. GDP growth was 75 percent higher, investment stock expanded by 30 percent rather than shrinking by 12 percent (in the bottom ten), and export growth was six times as high.

Development and presentation of country-specific applications of the policy matrix can offer a powerful tool for informing policy and business communities of important constraints, but in a non-confrontational manner. Leaders are always interested in comparisons with competitors. This approach has been used successfully in pilot projects in Egypt and Guatemala.