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# Managing the Transition

## Enhancing the Efficiency of Eastern European Governments

Eric Rice

The consensus of dozens of Bank and outside experts on issues and measures essential to government reform in six Eastern European economies changing to a market economy — and on how external agencies can best aid the reform process.

The Policy, Research, and External Affairs Complex distributes PRE Working Papers to disseminate the findings of work in progress and to encourage the exchange of ideas among Bank staff and all others interested in development issues. These papers carry the names of the authors, reflect only their views, and should be used and cited accordingly. The findings, interpretations, and conclusions are the authors' own. They should not be attributed to the World Bank, its Board of Directors, its management, or any of its member countries.

This paper — a product of the Public Sector Management and Private Sector Development Division, Country Economics Department — is part of a larger effort in PRE to evaluate the economic and institutional issues surrounding Eastern Europe's current transformation. Earlier versions of this paper were presented in seminars at Harvard's Russian Research Center and the World Bank, and at an economics conference sponsored by IREX in Bucharest in April 1991. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Priscilla Infante, room N9-059, extension 37642 (45 pages).

The transition to a market economy in Eastern Europe requires eliminating some institutions and practices and introducing new agencies with new goals, staffed by people with different attitudes and behavior. After interviewing 42 World Bank experts and other experts in the donor and academic communities, Rice synthesizes their views on World Bank member countries in Central and Eastern Europe (Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia):

- Giving a broad-brush overview of what is known about capacity constraints in key public institutions involved in the transition.
- Identifying current and proposed actions of the World Bank and other donors.
- Indicating critical institutional issues on which future operational work and research might focus.

Rice finds that a consensus has emerged on five principles that establish the socially acceptable domain for government economic activity in Eastern Europe:

- Retreat from the discredited central government, as subnational governments and private enterprises assume many functions of central governments.
- Improved channels of communication between governments and their citizens, in

response to increasing demand for more transparent policy and an institutionalized voice for the public in policymaking.

- A hospitable business environment, which means clarification of property rights; policy stability, consistency, and accountability; low-cost provision of government services and infrastructure; and the protection of agents from abuses in the marketplace.

- Concern for public welfare and social justice, as citizens of post-communist Eastern Europe hope to obtain both the familiar basic securities (job security, subsidized consumption, and universal access to basic health care and education) as well as new rights and freedoms.

- Efficient government administration at all levels, under the scrutiny of elected legislatures, citizens groups, and internal audit and review agencies.

Rice identifies five areas in which external institutional assistance is needed: (1) policy advice on a range of issues; (2) more in-depth technical assistance; (3) a large-scale training effort to help close Eastern Europe's massive "skills gap" in economics and business; (4) diagnostic research; and (5) the design of broad, medium-term action plans. For each of these issues, he describes numerous measures to be pursued.

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## **INTRODUCTION**

Eastern European governments have been preoccupied with the grand questions of dismantling inherited socialist political structures and the command economy, rewriting their constitutions and laws to facilitate the emergence of democracy and markets, and responding to the resulting shocks and crises. Understandably, there has been no systematic evaluation to date of the capacity of these governments to implement the transformation.

Many individuals in these reforming economies, and in the World Bank, other multilateral organizations, bilateral donor countries and non-governmental organizations, have recognized the acute need for institutional reforms in support of the transition to a market economy. And in fact, institutional reform is rapidly, but so far haphazardly, entering into the dialogues and operations of Eastern Europe and these organizations.

The transition to a market economy clearly requires both the elimination of a range of existing institutions and practices in these countries, and the introduction of new agencies, with new goals, staffed with people having different attitudes and behavior. But there has been little specification of precisely what this means: which structures and procedures should be modified and how; what resources – human, physical, financial – are required to carry out the task.

This paper is a first effort to lay out the problem. It has three general purposes: (1) to determine what is known about capacity constraints in key public institutions involved in the transition;<sup>1</sup> (2) to identify current and proposed actions by the World Bank and other donors; and (3) to indicate critical institutional issues that might be the focus of future operational work and research by the World Bank and others.

The paper synthesizes views expressed in interviews of 42 relevant Bank staff and selected experts in the donor and academic communities. These interviews were supplemented by a review of World Bank and Eastern European government documents, as well as other policy literature. The study

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<sup>1</sup>The paper does not focus on stabilization policy and macro-economic reform, private sector issues such as enterprise restructuring (even though it may be undertaken by the government), or issues that involve specific economic sectors. It pays little attention to areas where change is already well underway (for example, defining property rights), where there has already been extensive discussion (such as the privatization of public enterprises, or the demise of CMEA and liberalization of international trade), or where the issues are already reasonably well-understood (such as banking system reform and housing reforms). Finally, the paper discusses non-governmental organizations (NGOs) only insofar as they figure into potential solutions for other core problems discussed in the paper.

includes all World Bank member countries in Central and Eastern Europe – Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia.

A consensus emerges from interviews and available government position pieces<sup>2</sup> on a set of principles which establishes the socially-acceptable domain for government economic activity in Eastern Europe:

**Retreat from the discredited central government** as subnational governments and private enterprises assume many functions of central governments.

**Improved channels of communication between governments and their citizens**, as policy transparency and a voice for the public in the policy-making process are increasingly being demanded and institutionalized.

**Creation of a hospitable business environment**, including: clarification of property rights; policy stability, consistency and accountability; low-cost provision of government services and infrastructure; and protection of agents from abuses in the marketplace.

**Concern for public welfare and social justice**, as citizens of post-communist Eastern Europe are hoping to obtain both the familiar basic securities (job security, subsidized consumption, and universal access to basic health care and education) as well as new freedoms and rights.

**Efficient government administration at all levels**, under the scrutiny of elected legislatures, citizens groups, and internal audit and review agencies.

These principles constitute political constraints on the formulation of a successful institutional reform strategy and so guide the analysis of this paper.

For Eastern European countries that have made the greatest strides in terms of economic policy reform, many of those interviewed underscore the need to turn rapidly to neglected issues of implementation. For those which are still in the early stages of constitutional and legislative reform, respondents emphasize that certain institutional reforms must be addressed even in the early stages of macroeconomic stabilization and adjustment. The exercise identifies five critical areas for external institutional assistance: (1) policy advice on a range of issues; (2) more-in-depth technical assistance; (3)

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<sup>2</sup>*Report of the Bulgarian Economic Transition Project; "Scenario of the Economic Reform" (Czechoslovakia); Hungarian Economic, Financial and Monetary Policies: Proposals for a Coherent Approach and Hungary in Transformation to Freedom and Prosperity (the Blue Ribbon Commission report); "Memorandum of the Government of Poland on Economic Reform and Medium-Term Policies, 1991-1993"; Program of Working Out and Coordinating Reform Projects (Romania); Prasnikař and Pregl (1990), and Speech of Prime Minister Markovic, December 18, 1989 (Yugoslavia).*

a large-scale training effort to help close Eastern Europe's massive 'skills gap' in economics and business; (4) diagnostic research; and (5) the design of broad, medium-term action plans.

One caveat: the paper is a preliminary, broad-brush study, and does not offer a plan to resolve Eastern Europe's institutional impediments. Rather, it tries to identify the most important institutional questions affecting the prospects for a successful transition. The exercise is limited by the extent to which it is possible to generalize across the six reforming countries of Eastern Europe. Nonetheless, decades of socialist economic, political and social practice created important similarities across Eastern Europe, thereby allowing scope for meaningful generalization.

## **ISSUES IN INSTITUTIONAL REFORM**

### **TOP-LEVEL MANAGEMENT OF THE CENTRAL GOVERNMENT**

#### **(1) Policy-making capacity**

Many of those interviewed report that the design and direction of economic reforms is heavily taxing the macroeconomic policy apparatus of every country of Eastern Europe. Respondents point to three ways of enhancing the level of efficiency with which these governments make and implement policy: introducing policy coordination mechanisms, improving government access to information, and offering technical training for economic policy-makers. The first two areas are discussed below, while the last is taken up in "Civil Service Reform."

Respondents express a general concern that, in each government ministry, ministers and their senior staff tend to operate in relative isolation from other ministries. They believe that very few officials grasp the broad shape of their national reform program or can express the underlying motivations for the policies being enacted.<sup>3</sup>

The executive branches lack a top-level focal point for promulgating, debating, and approving specific economic reform measures. Many respondents therefore argue that governments need (1) to develop a strategic vision of the transition and to manage its broad direction, and (2) to enhance policy coordination across ministries to ensure the quality, consistency, and prioritization of these measures. Yet there remains substantial disagreement as to how this can best be achieved in each country. In particular, many observers worry about two risks of such a transition policy apparatus: that it might become large and bureaucratized, or that it might be marginalized unless it has considerable stature.

Several countries are evaluating alternative types of transition policy apparatus, and each country will require a structure that fits its particular circumstances. This may simply consist of formal and informal contacts among economic ministers (as in Poland), an inter-ministerial coordination council (such as the one Romania proposes to introduce), or a temporary transition office or ministry, possibly including a technical secretariat.<sup>4</sup> The Czech and Slovak Federal Republic's (CSFR) new hybrid system shares the

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<sup>3</sup>Nonetheless, macroeconomic reform policy outcomes have generally been excellent from the perspective of the multilateral institutions.

<sup>4</sup>This technical secretariat could reside under either a transition minister (or coordinator), a council of economic ministers, the Council of Ministers, or the Ministry of Finance.



coordination function between a cabinet-level inter-ministerial council for the economic transition, and a financial council composed of the federal and republican ministers of finance plus the president of the central bank.

Those interviewed suggest that multilateral and bilateral advisors can help by advising governments about experiences outside the region, stressing the importance of coordination and the impact of economic linkages. Especially in countries where there are few expatriate or international resident advisors -- as in Romania and Bulgaria -- resident World Bank missions could provide "a few good people on the ground" for advice concerning policy alternatives and their trade-offs.

For the medium-term, it seems that all governments of Eastern Europe will have to expand their capacity to formulate economic projections and strategies. There now exist few government mechanisms for making multi-year estimates, and for laying out indicative strategies for the public and private sectors. Respondents believe that establishing formal economic projections and strategies would be particularly helpful for determining the priorities and design of legal, regulatory, and public finance reforms, and of government services. Along these lines, Bulgaria has supplanted its large planning ministry with a new, small agency for indicative planning.

Some suggest that the countries which experimented successfully with mechanisms for developing economic strategy (e.g. France, Japan, Korea, Taiwan, and Thailand) could offer Eastern Europe organizational models and technical assistance.<sup>5</sup> An integral part of these mechanisms is the forging of stable coalitions among representatives of a fairly wide of interests, including government, business and labor. This is intended to ensure that government policy-making in these countries accounts for the needs and concerns of the private sector, and also to enhance popular support for policy. In this respect, Hungary's incipient National Reconciliation Council may prove to be a model for the region of such a tripartite advisory agency.

In many critical areas, governments' ability to make sensible policy is also sorely hampered by a lack of information. For example, across the region countries have essentially no data on goods prices outside the public sector, or on the changing condition of the poor. They also lack knowledge of economic policy alternatives and reform experiences elsewhere in the region and in the developing world. These governments' need for information demands activity in at least three areas: overhauling their statistical systems, exploiting non-governmental resources, and information-sharing across the region.

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<sup>5</sup>Of course, certain social differences between these societies and those of Eastern Europe will call for appropriate adaptations of any model.

The statistical systems of Eastern Europe were designed to serve the needs of a planned economy. And except in the CSFR, and for some types of data in Poland and Hungary, the quality of these statistics is judged by respondents to be poor. For instance, there are limited data on the emerging private sector. So as private businesses appeared alongside state enterprises in Hungary and Poland last year, government data reported massive declines in (state) industrial production and (state) employment - even though the dip in private consumption appears to be much smaller.

There is broad agreement on the pressing need for Eastern Europe countries to develop statistical systems and new data series to serve the policy needs of business and of their new governments. Such efforts would include the adoption of modern international concepts, methods, and standards for statistical collection and reporting.<sup>6</sup> A number of current projects aim at expanding statistical capabilities in Eastern Europe are underway. Substantial consensus has been reached concerning the specific needs of individual countries among a loosely-coordinated donor group, which includes the IMF, the World Bank, Eurostat (an agency of the European Community), the OECD, the UN Economic Commission for Europe, and numerous bilateral agencies. Eurostat has assumed the lead role in coordinating and managing the group's assessment and technical assistance efforts.

Although World Bank staff members indicate that Poland and Hungary are now relatively well-served by technical assistance from many sources, sufficient resources have yet to be applied to statistical development elsewhere. Limited activity has begun in Czechoslovakia, although its needs are apparently less acute than those elsewhere. Romania, Bulgaria, and Yugoslavia have rather extreme statistical needs, which are now beginning to be assessed through bilateral assistance. In general, respondents would like to see each country eventually develop a blueprint of its statistical needs, indicating the agencies and material resources required to meet them.

With regard to extra-governmental sources of information, academic institutes of economics and finance -- both inside and outside the government bureaucracy -- already provide substantial policy analysis in Czechoslovakia, Hungary, and Poland. So do some university faculty and independent groups of eminent citizens and experts (such as Hungary's Blue Ribbon Commission and Bulgaria's Economic Transition Project). A similar role may be in store for Walesa's recently proposed "Council of Important

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<sup>6</sup>For instance, the Material Product System (MPS) found in Socialist economies is being replaced by the System of National Accounts (SNA) used elsewhere. Because the former excludes service sector activity, governments will have to install systems for collecting data relevant to this sector. And since the government will not automatically receive information from service sector firms regarding their activities, it will be obliged to introduce a system of regular business surveys.

Persons" in Poland. Since governments are strapped for analytical expertise, they might make greater use of such extra-governmental resources.

The governments of the CSFR and Hungary have been quite successful in their concerted efforts to attract expatriate advisors, some funded by external non-governmental foundations or bilateral assistance programs. Some of those interviewed suggest that Eastern European countries expand their policy analysis and implementation capabilities by stepping up efforts to exploit the technical expertise of expatriate nationals (both as short- and long- term advisors, and as senior civil servants), using private external financing.

It has also been recommended that the governments of the region can learn from each others' experiences by increasing their information-sharing. For instance, Poland's unfortunate experience with hyperinflation taught the rest of the region how to design better anti-inflation policies, and the urgency of doing so. Not only would information-sharing enable governments to borrow successful programs from their neighbors, but it would help them sustain public support for difficult policies by showing that the policies worked elsewhere.

The governments of the CSFR, Hungary and Poland continually exchange views and experiences among themselves (on privatization programs, for instance). Many of these contacts take place informally, while others occur in regional or international conferences or through the intermediation of outside advisors or agencies. Borrowing good ideas from other countries in the region offers the advantage that the ideas tend to embody "appropriate technology," involving policies that are likely to be relatively inexpensive and simple to manage. Foreign donors can facilitate this dissemination of information, by virtue of their cross-country experience.

(2) Building and strengthening elected legislatures

Many of those interviewed worry that the elected legislatures of Eastern Europe lack the ability to provide an institutionalized check on the power of the bureaucracy. Unlike legislatures in Western Europe and the U.S., none of those in Eastern Europe has an active committee structure<sup>7</sup> or formal access to qualified outside expertise. Rather, they are forced to rely on the executive branch for data and analysis, which limits their ability to reach informed, independent decisions on the large volumes of pending legislation they face.

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<sup>7</sup>Hungary and Poland now have nascent Parliamentary committee structures.

For the present, it seems that parliamentarians will have to rely to some extent on academic institutes – as they currently do in Czechoslovakia, Hungary, and Poland – to substitute for their lack of research and analytical capacity. In addition, some individual OECD countries and other organizations have begun to offer technical assistance, including proposals by parliamentary research groups in OECD countries to set up similar groups in Eastern Europe. (Respondents do not believe that this is an area in which the World Bank has either a mandate or experience).

The most direct involvement with parliaments comes from the European Community, whose assistance includes political conditionality. The desire of Eastern European countries for eventual affiliation with the European Community gives them extra encouragement to continue developing their democratic institutions. However, external advice and technical assistance will not provide a "quick fix" for what is expected to be a difficult and long-term development problem.

Similarly, the OECD is undertaking a "policy dialogue" (the OECD's name for technical assistance in public management) with some countries of Eastern Europe, which includes some areas of parliamentary strengthening. In particular, the OECD has a long history of such dialogue with Yugoslavia by virtue of the latter's associate status. This might also become an area of activity for bilateral donors, some of whom have assisted in strengthening parliamentary institutions elsewhere in the world. The development of democratic institutions is also served by existing parliamentary exchanges with Western Europe and the U.S., and by technical assistance from independent public interest organizations.

### (3) Maintaining political support for the transition

It is widely believed that, even under the best conditions, the reforms now being initiated in Eastern Europe will take years to come to fruition. Yet the more governments are able to build and retain popular support for their policies, the less will be the costs and risks of the reform process. In this regard, respondents insist that governments must pay particular attention to two sensitive areas: their frail legitimacy and what has come to be called an "expectations gap."

Eastern Europe's governments face a substantial challenge to change the perception of government from that of an agent that cheats its citizens to one which responds to its citizens' demands. Some respondents worry that newly-won government legitimacy might be eroded by perceived arbitrariness, corruption, or patronage.

There seems to be a consensus that clear and simple rules, impartially enforced, will go a long way toward strengthening government legitimacy. For this reason (as well as for the sake of efficiency), simplicity be an important litmus test of good policy design.

It appears that legitimacy will also require that administrators earn the public trust, something which will be difficult for governments seen to include large numbers of communists or former communists. To this end, citizens are demanding policy transparency, a right which governments are beginning to guarantee legally. For instance, Romania's reform program mandates that the "budget shall be made public during its making, approval and execution stages." As legislatures, business, and other outside entities expand their capacity to digest such information, this demand is likely to become more important and more institutionalized. Several respondents felt that freedom of speech and the press, as well as political pluralism, will exert pressure on governments to eliminate remaining restrictions.

Legitimacy will also require that governments overcome the risk of pervasive corruption. Respondents find this especially worrisome at the local level, where control is weaker and most government services are actually delivered. Stories of corruption have already splashed across headlines in Eastern Europe. As the region's free press develops, it should help make corruption more difficult to perpetrate. Some suggest that support should be made available for some form of technical assistance to preempt and fight corruption. Possible measures might include a national diagnostic study of the nature and causes of the corruption problem in a country; the upgrading of government accounting, disclosure and auditing requirements for certain government functions;<sup>8</sup> the introduction of legal limitations on political patronage and of conflict-of-interest rules; contracting-out of some government services; and efforts at public education in civic values.

Governments elsewhere have two other important mechanisms for denouncing corruption, abuse and mismanagement by their agents: various kinds of "whistle-blowing" mechanisms and internal auditing. Neither has yet garnered much attention in the reforms of Eastern Europe. The former is considered an area of secondary importance, although some countries are giving thought to the eventual introduction of a citizens' advocate (as has existed in Poland since 1988). However, internal government auditing is recognized as being of prime importance, and is discussed further in the section "Public Finance Reform."

Many also feel that government legitimacy would be enhanced by expanding participation in policy-making. Several countries -- including France, Japan, Korea, and Taiwan -- have successfully given interest groups a voice in government policy. Their experiences show how to mitigate the political risks and economic costs of reform by making business, labor, and other groups<sup>9</sup> "owners" of the

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<sup>8</sup>OECD countries might provide support in building such institutions, given that they all have some form of internal financial reporting requirements and self-auditing.

<sup>9</sup>In Eastern Europe, such participation might also include representatives of regional and local governments and state enterprises.

policies, who stand to benefit from them. This may be particularly critical in Eastern Europe. The degree of formality of such arrangements would depend on the individual country, ranging from membership in government councils, to regularized public hearings, debate and referenda, to casual consultations on individual pieces of legislation.

Other respondents stress the opening of channels for grassroots empowerment and "voice" vis-a-vis the government. For example, many foreign legal systems offer private citizens recourse to challenge the legality of government policy via such mechanisms as class action suits and grand juries. Another approach has been the creation of citizens panels to monitor the functions of certain government agencies. In addition, introducing a liberal legal environment for private expression, including that of the press, is a further means of enabling non-government interests to communicate with the government.

At the outset of the reforms, it was assumed that the Communist Party and its nomenklatura<sup>10</sup> would strenuously resist or sabotage economic reforms. But government actions have proven successful in neutralizing old guard resistance within the bureaucracy. Today at the national level, nomenklatura power bases are largely marginalized in all but Romania and some republics of Yugoslavia (and of course, the USSR and Albania).

The remaining threat of the old guard comes in two forms. First, public morale and support for the reforms are damaged by perceptions that the nomenklatura are continuing to receive economic advantages. Second, substantial Party influence remains in some of the regions and localities. In these sub-national governments, which are charged with delivering many public services, entrenched nomenklatura may prevent the implementation of central government reforms.<sup>11</sup>

It is Eastern Europe's labor unions which may possess an even greater potential to derail the region's economic reforms, and respondents feel that averting that risk should be a priority government objective. Some unions have demonstrated a capacity to block economic reforms that might adversely affect their constituents.<sup>12</sup> Yet external observers are not well-informed about labor unions in Eastern Europe. Therefore, some suggest that a future study of the region's labor unions might be warranted to

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<sup>10</sup>"Nomenklatura" is the name given to Eastern Europe's privileged former elite.

<sup>11</sup>In light of the apparent reassertion of conservative leadership forces in the Soviet Union, one must acknowledge the possibility that the nomenklatura could act as willing instruments for any conservative political backlash in Eastern Europe. This serves to emphasize the need for civil service reform.

<sup>12</sup>One example is the blocking of privatization legislation in Poland's parliament by labor union interests seeking rights to worker self-management.

clarify their present and future roles. It would evaluate their positions on the reforms, and examine the merits of alternative efforts to incorporate them into the reform process.<sup>13</sup>

Many sources express concern regarding a dangerous, popular "expectations gap." Their fear is that present optimism will turn to a paralyzing pessimism as citizens confront the difficult realities of economic restructuring. Some argue that clear exposition to the public of a medium-term, comprehensive, coherent and credible program of economic and social priorities, goals, policies and trade-offs would go a long way toward bridging this expectations gap.

A failure to communicate to economic agents a comprehensive vision of the desired future economic order can inflict actual economic costs. For example, if a government neglects to provide a clear strategy, economic agents will be less willing to invest in either physical capital or their own human capital. Many of those interviewed argue that little change can follow until the rules of the game are written,<sup>14</sup> and that message is credibly communicated (even if enunciating a plan may circumscribe a government's room for manoeuvre). As a legacy of misinformation and concealment by past governments, it is felt that governments must frankly present both the risks and the uncertainty of the outcome of reforms.<sup>15</sup>

Communicating the reform program message demands a deliberate and honest public information effort in each country, aimed at citizens, businesses, parliaments, and potential donors and investors. Although some Eastern European governments are beginning to act in this domain, they apparently do not have experience preparing credible public information programs. The CSFR seems so far to have succeeded best in communicating to its people a realistic assessment of its economic reform program, along with the idea that the payoff will be many years in coming. And at least for now, the program retains generous popular support. Historically, Hungary has mounted impressive external public

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<sup>13</sup>Such efforts might consist of inclusion of labor unions in certain kinds of policy decisions; "co-determination" on the West German model, at the level of the firm; stipulation with civil servants that they trade their right to strike for the right to binding arbitration (as has been used successfully in the U.S. public sector); finding ways to encourage cooperative, independent labor unions in place of confrontational unions; or encouragement of competition between labor unions, as has emerged in Hungary and Poland.

<sup>14</sup>Starting points for devising a reform program may be found in the national "economic agenda" documents referenced in Footnote 2.

<sup>15</sup>Some respondents fear that, by advising the public, interest groups will coalesce against it. Many others, including virtually all Eastern European respondents, argue that the need to build popular good-faith in government calls for full disclosure of transition policy (even at the cost of some loss of direct policy impact).

information efforts. Romania has recently introduced a public information office, placing it under the council responsible for the reform program. It also intends to introduce public relations at the city and prefecture levels, with the stated objective of opening these councils' decision-making to the public.

Many of those interviewed call for external technical assistance in public relations and information (although the issue's highly political nature probably renders it unsuitable for World Bank involvement). This effort would be guided by three principles: first, avoid raising expectations unjustifiably (such as Walesa's pledge to avoid any worker layoffs during the privatization process); second, enhance public morale and support by raising the profile of East European success stories; and third, recognize that a neatly-sequenced program is not realistic in the present context of social and economic revolution. It is critical to distinguish between an effective "public information effort" and the aggressive propaganda campaigns that were so familiar under the previous regimes. The former might include putting forward government spokespersons to participate in public panels and debates, or holding seminars and discussions in academic institutions and non-governmental organizations.

As part of these public information efforts, the public should be educated about the nature of a market economy and about citizens' new relationship to their governments. This type of project will certainly be difficult, expensive, and time-consuming, but respondents feel that it is essential to gaining enduring support from the populace. The mass media methods required for this sort of education are analogous to some of those discussed under "Civil Service Reform."

(4) Lack of coordination of foreign assistance, external debt, and technical assistance

The capacity of government ministers and domestic administrations has been strained by incoming visitors from the 24 OECD countries, the multilateral institutions, creditors' representatives, and numerous academic and non-governmental organizations. Such contacts are taxing, given that ministry staffs are small and that each foreign institution has its own demands, rules, and procedures. Many respondents stress that improved coordination of foreign assistance, debt, and technical assistance would help alleviate the confusion, inefficiencies, and bureaucratic fatigue that these extensive foreign contacts can engender.

It would also appear that some countries have failed to exploit many available sources of financial and technical assistance -- especially from non-governmental organizations -- due to a lack of information about them. An informational clearinghouse has been suggested as a way to help match domestic needs to willing donors.



But the main reason for improving coordination is to help governments institute measures that are consistent with the central reform objectives and with each other. Enhanced coordination would help governments achieve stabilization and economic reform more efficiently and rapidly. Moreover, to be sustainable politically, a reform program must be credible. One important factor in establishing such credibility is the internal consistency of a program's various components.

Some governments will establish new formal coordination agencies. Others will designate existing entities as institutional focal points. The CSFR has proposed a "Foreign Investment and Aid Agency" for coordination, evaluation, and approval of foreign capital inflows.<sup>16</sup> It will also receive technical assistance in coordinating aid and as part of its financial system restructuring project. Bulgaria is developing an Aid Coordination Agency, with a broadly representative board but no independent staff, as well as an inter-ministerial aid coordination group. Poland has developed a debt office, the debt management capabilities of which are now being strengthened. In some countries, thought is also being given to consolidating this collection of coordination mechanisms under a single agency responsible for overall coordination of the reforms.

Coordination by external agencies has the advantage of not placing further administrative burdens on the already-overtaxed government bureaucracies of Eastern Europe. However, such a coordinating locus risks being "outside the loop," in terms of input from ministries and intimate knowledge of the system. This might argue for limiting external coordination efforts to an advisory role, such as help from resident World Bank missions in setting priorities.

Several -- perhaps too many -- external organizations are candidates for taking the lead role in coordinating foreign assistance, external debt, and technical assistance. These include among others the IMF, the World Bank, the OECD, the EBRD, and the EC. Of these, the OECD has the unique advantage of not being a lender. Even though the OECD's Centre for Cooperation with European Economies in Transition currently has a staff of only four people, one respondent in the OECD identified it as a locus that could conceivably evolve into a secretariat capable of taking on a coordinating role. Others question the capacity of the OECD to play this role. Alternatively, multilateral agencies might examine the relative merits of turning this task over to one of the few international, non-profit organizations of public administrators which claim to have expertise in this area.

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<sup>16</sup>Czechoslovakia, like Romania, presently has little external debt to be concerned with.

## **CHANGING THE ROLE OF GOVERNMENT IN SOCIETY**

### **(1) Transforming the central government bureaucracy from "governor" of the people to "servant" of its citizens**

Literature on the communist governments in Eastern Europe tends to characterize them as having supplied their citizens' basic needs (via a system of job security, subsidized consumption, and universal access to basic health care and education), while awarding the perquisites and punishments of the system according to ambiguous and changing rules and norms. Country position papers (see footnote 2) indicate that the citizens of post-communist Eastern Europe are now hoping to obtain both the familiar basic securities as well as new freedoms and rights.<sup>17</sup>

Yet many doubt that the day-to-day relationship between society and government has advanced substantially. Burdensome administrative and regulatory procedures persist – evidenced by the numerous steps typically still required to register a small business – failing to reflect changes at the level of macroeconomic policy.

At the same time, newly-emerging interest groups across the region are exercising an active voice concerning the environment, consumer protection, business opportunity, and occupational safety; and the clamor to be heard seems to have grown faster than the governments' capacity to listen. The assessment is that Eastern Europe's transformations will require commensurate governmental change on three fronts: (1) replacing and retraining top managers; (2) developing communication channels between citizens and their governments; and (3) ensuring that civil servants are held accountable for their actions. (The last issue is discussed in "Civil Service Reform.")

All governments have taken action on the first front, having replaced the top-most layer of ministry management (with some exceptions in Romania and Bulgaria). Yet a few more management layers probably need to be replaced to change the culture of a ministry. This will be a major undertaking, however, given the lack of processes to identify qualified incumbent managers, the absence of a functioning labor markets for managers, and the shortage of skilled replacements.

Some respondents suggest that communication channels both to and from the government need to be developed. Part of this effort might be for governments to adopt legal assurances granting citizens

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<sup>17</sup>Some of these demands are inconsistent, and so governments will have to make trade-offs. For example, guaranteed employment continues to be seen largely as an entitlement. Since this conflicts with other restructuring goals, it may have to be replaced by a package of measures: support to the unemployed, retraining, and enhanced labor mobility.

access to any unclassified information about government activities (a "freedom of information" code). Another might be to introduce the institution of parliamentary testimony under oath by government officials. Such measures would help parliaments, the media and interest groups in their role as public watchdogs. Without such guarantees, information can only be obtained haphazardly -- as with the sensationalized news accounts of scandalous spontaneous privatizations.

Governments will also need to institutionalize channels for receiving and responding to citizens' input. Such channels enhance government accountability (both in fact and in appearance) and so help to alleviate potentially explosive political pressures. They also can help protect citizens from arbitrary actions by the government. One such channel might be a citizens' advocate office, as was introduced in Poland in 1988.

(2) Evolving devolution of central government powers and responsibilities

The devolution of significant powers and responsibilities to elected legislatures and subnational governments has already advanced a great distance<sup>18</sup> -- even though their capacities and capabilities are uneven.<sup>19</sup> The development needs of Eastern Europe's elected legislatures are discussed in "Strengthening Elected Legislatures" (page 7), leaving the present section to focus on decentralization from central to subnational governments.

In Eastern Europe, subnational "governments" previously were structured as arms of the central government. The recent devolution of power to regional and local governments is widely viewed as a positive development: decentralization as a means of restoring democratic rights. Yet the rise of subnational governments complicates the reform process in a number of ways.<sup>20</sup>

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<sup>18</sup>Among the governments covered in this study, only Romania's still manifests extreme reservations about the movement away from central government jurisdiction. For example, Romanian government's reform program retains food subsidies, central government administration of social programs, state investment in production, and a massive role for "state orders" from enterprises.

<sup>19</sup>Analogously, central governments are generally already committed to withdrawing from enterprise management, as well as from much of the direct management of the economy.

<sup>20</sup>Consider the example of environmental protection policy. There are three main implications to having subnational governments become responsible: (a) since environmental concerns tend to arise at the local level, those affected will be well-positioned to assess and prioritize them; (b) local governments may have an even lesser capability than national governments to analyze the economic considerations of environmental policy; and (c) many environmental problems extend beyond local jurisdictions. Devolution of power to localities will thus still require national-level environmental coordination among localities, enforcement of clear property rights, and technical assistance from

Most governments have not yet resolved the question of what model of central-regional-local government relations they will adopt. This is necessarily a political process, and so will take time to resolve. Meanwhile, some reforms and projects have been put on hold pending designation of the appropriate authorities. Respondents believe that laws clearly defining the jurisdictions and responsibilities of each level of government could alleviate critical uncertainties.

Decentralization complicates the implementation of reforms, in that measures approved by national legislatures risk derailment if subnational governments are not "on board." And building local government institutions must have high priority across the region, since the domain of local and regional governments will encompass communal services, housing, much of regulatory administration, the delivery of health care and poverty assistance, and parts of the education and transportation systems. Some forms of private sector promotion will also take place at the local level.

Having operated mainly at the national level, the donor community knows relatively little about the structure and shortcomings of subnational governments in Eastern Europe. Still, respondents feel sufficiently informed to identify three broad deficiencies: rudimentary operating systems, insufficient and poorly-trained staff, and an undeveloped capacity to raise revenue. Subnational governments will have to be strengthened to enable them to handle their broad new responsibilities. Otherwise, the good intentions of central governments, evidenced in the flurry of reform legislation, will not reach the implementation stage.

Hungary and Poland have taken concrete steps to strengthen the capacity of local governments. In Hungary, the central government consults the "Association of Local Self Governments" on all relevant draft legislation. It has also introduced a sweeping, comprehensive local government reform law, which will transfer substantial authority, assets, and taxing authority. Poland has established a new, high-profile office charged with reforms at the local level, and has stepped-up revenue-sharing and asset transfers for municipalities.

The heavy demands likely to be placed on local governments warrant a study of their capacity, like that already prepared for Hungary (Davey, 1990). Further, respondents tend to argue for beginning to address certain immediate needs for technical assistance and training even before the governments undertake such studies. Hungary has relied for technical assistance and training on local government

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donors.

The first World Bank environmental loan in the region, for a small Environment Management Project in Poland, is a model of careful and complete design. It seeks to help the country evaluate priorities, strengthen operational procedures, coordinate donor activities, and improve communication channels between central and sub-national governments. It also includes components for technical assistance, training, and institutional twinning.

specialists from foreign academies of public administration. And in the CSFR, the government's Institutes for Local Government and for Local Administration assess municipal capacity issues.

Donor governments (national and subnational) also are beginning to participate. For example, USAID has earmarked \$5 million specifically for subnational government development in Eastern Europe. These donors may be called upon to impart their particular expertise in the areas of allocating administrative and political turfs, and of revenue-sharing arrangements. In addition, the World Bank intends to initiate a cross-country study of local government issues in Poland, Hungary, and Romania.

One effect of decentralization is that it increases the need to reform the tax system: without tax reform, decentralization might undermine the tax system and thereby endanger macro-stabilization programs. Subnational government operations in Eastern Europe will initially have to rely primarily on central government financial support, but will presumably have to develop independent revenue sources. Given local resource-mobilization problems, permanent arrangements will still involve central government revenue-sharing. Under such arrangements, objective and transparent norms will replace the current hybrid systems of negotiations, norms and discretion. It has been suggested that OECD governments' methods of local taxation and their inter-regional revenue arrangements might provide models (and technical assistants) for the East. In addition, Hungary implemented local government reforms over the past few years, and may itself be well-positioned to offer advice that is tailored to the conditions of the region.

Another issue involves the tendency in Eastern Europe for autonomous municipalities to be divided into very small units. This tendency raises questions about their capacity to handle public finances properly and to deliver public services. In Poland, the capacity constraints of villages will be addressed by mechanisms to arrange cooperation among villages for certain functions or by contracting out functions to private agents.

World Bank training staff note that, in the OECD countries, central governments and non-governmental organizations offer training seminars and reference materials to newly-elected local policy-makers. In Eastern Europe, nearly all local office-holders are new and relatively untrained, so the need for quick training is far greater. For the near-term, it was suggested that assistance be given immediately to Eastern Europe to translate reference materials and to develop and implement short courses in local public administration. This aid might be channelled through training centers for local government officials, such as those set up across Poland through private non-profit efforts.

A few of those interviewed note that the World Bank lacks a mandate for assisting in the political process of designing subnational government relations. However, the World Bank may wish to commission studies of particular subnational operating systems and their strengths and weaknesses, and

identify the appropriate level of government for the delivery of a particular kind of government service. Donors will also be asked to help finance what are bound to be very expensive training and technical assistance programs.

In most instances, it is assumed that donors will be obliged to initiate assistance to subnational levels of government indirectly via the central government. Central governments will retain the role of approving, coordinating, and managing external assistance. Nonetheless, many would encourage central governments to allow expanded outside contacts with regional and local entities (including contacts with foreign subnational governments), in order to spur development in this neglected area. Of course, care must be taken to ensure that local-level technical assistance be coordinated with national-level policies.

A major implication of the new decentralization is that the central government will no longer automatically receive information about economic agents via administrative channels. As a result, the government is losing some of its access to essential economic data – data it needs from the emerging private sectors for macroeconomic policy-making; external debt management; tax administration; and the protection of the environment, of investors (from fraud), and of workers (from occupational hazards and unfair labor practices). Overcoming this loss of information requires that governments restore their capacity to collect information – either by collecting information itself or by aggregating information collected by subnational governments.

One part of rehabilitating governments' capacity to collect information involves building (or rebuilding) the national apparatus for the collection and evaluation of economic statistics (already discussed on page 4 in "Policy-Making Capacity"). Another distinct component is the introduction of an effective system of mandatory financial disclosure requirements for subnational governments, so as to enhance transparency and therefore government legitimacy. Local government disclosure requirements will improve financial accountability for funds granted from central governments, and help avoid the anticipated corruption problem at the local-level.

It is felt that, as a general principle, information and control can no longer issue hierarchically from the central government. Information flows will necessarily consist of networks among *all* agents, which will develop naturally. Such networks have many components, including access to government information, communication across ministries, information-sharing among governments, and greater inclusion of the government bureaucracy and the private sector in policy formulation.<sup>21</sup>

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<sup>21</sup>The operational significance of these is discussed in the sections "Policy Making Capacity," "Maintaining Political Support," "Coordination," and "Devolution of Central Government."

### **(3) Liquidating obsolete government agencies**

Many of those interviewed are encouraged by the relative ease with which Eastern Europe's reformers have shut down obsolete bureaucratic structures. Throughout the region, central planning ministries died along with the demise of command economies.<sup>22</sup> Nearly all of the region has enacted impressive and rapid price decontrol,<sup>23</sup> allowing governments to eliminate or shrink their price-setting offices.<sup>24</sup> Finally, under the old system, each "branch" (i.e., individual-industry) ministry acted as the head office of its industry, managing enterprises as subsidiaries. With control devolving to the enterprises, the need for branch ministries evaporated. In response, every country in the region consolidated its branch ministries into a single, much smaller Ministry of Industry<sup>25</sup> on the Western European model.

Even though the closing of these agencies had overwhelming popular support, one might have expected greater difficulty in shutting them down. For one thing, the functional vacuum left by the closure of a national-level agency (even one which performs badly) might have caused nationwide economic disruptions. For another, civil servants might have used their clout to prevent job loss, fighting the closing through political channels.

Aside from Poland, which has witnessed substantial layoffs of civil servants, governments deferred the employment issue by limiting layoffs.<sup>26</sup> However, there is a wide diversity of opinion about whether civil servants from liquidated government agencies can be recycled usefully into new government functions. Some governments outside the region have apparently succeeded in turning civil servants that formerly obstructed the market into functionaries that serve a pro-market role. Yet most observers of

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<sup>22</sup>A (much diminished) planning apparatus still exists only in Poland, where it was downgraded from a ministry to an office. The World Bank recommended moving this office to the Ministry of Finance, and charging it with multi-year fiscal planning.

<sup>23</sup>Only in Romania has there been halting progress in and a lack of political commitment to price liberalization.

<sup>24</sup>Civil servants from these offices now tend to serve the relatively minor role of price monitoring.

<sup>25</sup>In Czechoslovakia, branch ministries were consolidated into a single ministry, but the Republics have so far only succeeded in reducing slightly the number of branch ministries.

<sup>26</sup>Many of these countries simply transferred redundant civil servants to other ministries. For example, the former planning staffs typically dispersed to state enterprises, the Ministry of Industry (for sectoral planners), and the Ministry of Finance (for macroeconomic planners); and many retrenched employees of branch ministries went to enterprises in their formerly-subsidiary sector. Nonetheless, large numbers of employees in obsolete agencies found employment in the private sector, or in education and research.

Eastern Europe are quite pessimistic, citing a gross mismatch of skills, experience and attitudes. For instance, it was suggested that former planners be used to develop longer-term macro-economic and sectoral strategies. However, many doubt the possibility of converting former central planners from quantity allocators to advisors, promoters, and financial regulators. Similarly, some officials proposed putting pricing offices in charge of price liberalization and fair competition, but doubts that price office staffs can be productively transformed have held sway.

As an example of an alternative strategy, it was suggested that the government encourage former staff of planning and branch ministries to operate trade and service associations or consultancies for their industry (as some sectoral planners have apparently done in Poland). Although the principle has received support from firms, other observers express concern that these might act as mechanisms for rent-seeking, collusion and market monopolization.



## **REDESIGNING FUNDAMENTAL GOVERNMENT SYSTEMS**

The controlling role of government in former command economies is necessarily changing dramatically. A variety of institutional changes will be critical to transforming these institutions, so that they can instead act to promote and regulate the market economy. Where functions cannot be carried out by transforming existing agencies, new institutions will develop.

For Eastern European governments, designing new government systems risks conflicting with the desire to shrink central government. For this reason, particular attention should be paid to initiating programs that minimize central government involvement. A number of observers urge governments and their advisors to consider private provision of services that might otherwise be delivered by government. Many also expect local governments increasingly to provide public goods and services, such as job training and unemployment benefits. One respondent also recommended that governments make explicit which functions are transitional, and the manner in which they will be dismantled.

It is evident that governments are severely constrained in their capacity to implement the required new systems, and so respondents suggested a variety of ways they might economize on implementation. For instance, governments might offer their employees incentive awards for suggesting innovations that enhance technical and managerial efficiency.

As another example, where economic and legal expertise are limited, the wholesale adoption of a foreign country's system may sometimes make sense, rather than using time and resources to invent a new system. This might help countries avoid both mistakes and the disruption caused by ensuing corrections. Of course, the appropriateness of a foreign system depends on many characteristics of the country, and limited adaptations to local conditions will therefore often be necessary.

"Twinning" arrangements, whereby a public or private Eastern European institution is paired with a foreign analogue, have begun on a limited and ad-hoc basis.<sup>27</sup> Such arrangements are used to facilitate many types of technical assistance, exchanges, and training, across a wide array of institutions. Some respondents believe that a major expansion of government institutional twinning would decentralize institutional development assistance and might help speed its implementation.

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<sup>27</sup>Among the many examples, Eastern European securities regulators have been paired up with the U.S. SEC, broadcasters with West European television companies, local governments with municipal governments in the U.S., management institutes with business schools in Europe and the U.S., and social welfare agencies with the U.S. Department of Health and Human Services.

(1) Legal and regulatory reform

Legal and regulatory systems are by their nature extremely detailed, nuanced, and vary dramatically across countries. A generalized summary of legal and regulatory reform runs a high risk of missing critical exceptions and caveats. Since each topic offers the scope for a separate, in-depth paper, the contribution of this section is merely to point out some areas where action is lagging and some particular cautionary observations. Fortunately, it seems that the Socialist Economies division of the World Bank will be undertaking a study of legal reforms in Eastern Europe.

More than in any other area of concern, governments are under pressure to "get it right the first time." It is feared that legal and regulatory uncertainty or vacillations will kill off private investment plans, particularly foreign investment. Therefore, Eastern Europe's governments are asking that donors provide timely technical assistance to design legislation, regulations, and mechanisms for enforcement and dispute resolution. A good deal of technical assistance for legal reforms is already in place.<sup>28</sup> In contrast, foreign regulatory expertise is apparently harder to come by and few advisors are working in this area as yet.

For several reasons, legal and regulatory reforms will take substantial time. As explained, reforms must be carefully crafted and will require extensive external assistance. Some also believe that reforms have been delayed due to financial conflicts of interest among some of those in power. Moreover, there is an enormous volume of legislation to rewrite, and the reforms are subject to parliamentary debate.

In addition, the design of legal and regulatory reforms must take Eastern Europe's severe implementation capacity constraints sufficiently into account. For instance, Poland's three personal income tax rates makes sense; Romania's 66 corporate tax rate increments do not. Similarly, regulations that are relatively self-enforcing are more implementable than ones which require extensive on-site verification.

Local governments will be charged with the actual implementation of legal and regulatory system reforms. As discussed in "Evolving Devolution of Central Government Role" (page 15), foreign advisors know little about local government except that its capacity is typically weak. Thus, donors will have to analyze local government capacities before they can help national governments to design reforms.

Some of those interviewed stress the value of preparing a blueprint for legal and regulatory reform to assist countries in coordinating and packaging these inter-related reforms. Such an exercise would sum up the goals of the reforms, the specific regulatory and other legal changes needed to meet the

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<sup>28</sup>Although Romania and Bulgaria seem to have suffered due to their isolation from legal expertise up until recently.

goals, and the actions taken to date. For example, Bulgaria's reform blueprint (Rahn et al, 1990) was prepared by a collection of government leaders and domestic and foreign advisors, in consultation with business and labor interests. It includes a detailed review of regulatory and legal reforms to promote business activity and foreign investment. Hungary and Romania have also taken stock of the current status of legal reforms and written a roadmap of future needed legislation. In the other countries, the process is much less formal and not organized for the entire economy.

### **Legal issues**

Contract enforcement and dispute resolution remain undeveloped, calling for reforms in commercial and investment codes, and property, administrative, banking, and bankruptcy laws, etc. Yet the introduction of new laws is hampered by a lack of domestic legal expertise.<sup>29</sup> Writing new laws tends to be a haphazard process of cutting-and-pasting bits of Western countries' laws, the outcome often being overly-interventionist and inconsistent reform legislation of quite variable quality.

Romania and Bulgaria are implementing short-term reforms, and included foreign help in drafting new laws as a component of technical assistance and other loans. Poland is tapping into a variety of sources: bilateral grant monies for technical assistance, pro bono work by foreign private law firms; and grants to help civil servants to develop legal skills in specific reform areas. In most respects, national governments and private law firms have a comparative advantage over the multilateral institutions in drafting legislation, although some warn that the process should also include economics expertise, to assure consistency of the programs with the economic goals of the reform.

Another means of economizing on limited legal expertise and time might be for Eastern European countries to adopt legal systems from market economies with which they share ties or history, and preferably ones which are at a similar stage of development. In general, simple laws should be the watchword, in order to avoid either overwhelming the country's implementation capacity or inducing rent-seeking behavior and corruption.

The long-term solution to the shortage of legal expertise will be improved and expanded legal education: one of those interviewed specified that this might include placement of law school professors in foreign law schools, law school educational exchanges, and placement of lawyers into foreign firms and government agencies.

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<sup>29</sup>Hungary is a fortunate exception.

## **Regulatory issues**

There is a strongly-held perception that existing, inflexible regulatory systems may thwart entrepreneurial activity and foreign investment. Yet these laws and methods, as well as their arbitrary enforcement, have not changed much, and there is some dispute as to whether regulatory reform is a matter of primary importance.

Two approaches to regulatory reform have been suggested. Some would like to see a massive, item-by-item rewriting of regulations. Many others argue that the existing regulatory system is not salvageable. They would essentially dismantle economic regulations, and then build up a rudimentary replacement system as required by the economy.<sup>30</sup> The design of a comprehensive regulatory reform could then follow.

The World Bank has taken an intermediate position in Czechoslovakia, where it recommended the establishment of a temporary governmental deregulation taskforce<sup>31</sup> to undertake a systematic study of the regulatory system and propose an action plan for reform. Such a study might consider the burdens faced by businesses due to both regulations and administrative procedures. And its recommendations would necessarily be informed by governments' severe regulatory capacity constraints.

The state's role in the region's new regulatory systems will generally be at arm's length. For instance, it is expected that governments will not continue to manage state enterprises directly. Given the misalignment of government and firm incentives, and the lack of qualified civil servants to manage businesses, a government agency will instead likely establish a board of directors for each public company and then supervise its performance from a distance.<sup>32</sup>

Regulatory technical assistance has been offered from many bilateral and multilateral sources. It is well-advanced in Poland in the areas of anti-trust, commercial, and securities policies. Such assistance has also begun more recently in Hungary and Czechoslovakia.

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<sup>30</sup>The economic principle of the new system would no longer be control activity, but to correct for market failures. The guiding legal principle would be "everything not explicitly forbidden is permitted."

<sup>31</sup>One suggested approach would exploit the self-interest of the citizenry, by using business and consumer representatives for such a taskforce. This might involve simply maintaining regular contacts with these representatives, or else opening a small office to receive ideas about regulatory problems from the public.

<sup>32</sup>This is exactly the current approach of Hungary's State Property Agency. Hungary perceives this system as a precursor to near-total privatization over the next few years. Other countries could be expected to perform this same role for many years before a major portion of their state enterprises would be sold off.

## **(2) Public finance reform**

### **Taxation and Revenue**

In the near-term, structural adjustment in Eastern Europe threatens government revenues: macroeconomic changes are transforming existing tax bases, privatization will eliminate governments' direct control over company dividends and prices, and at the same time governments face increased demands for transition-related expenditure. Literature on the subject notes that this threat creates a challenge for governments to maintain and restore existing revenue sources, and to experiment with new sources.

Thanks to IMF and World Bank technical assistance, tax policy reform is currently underway across the region.<sup>33</sup> Nevertheless, the reform of institutions related to taxation has advanced only negligibly. The IMF anticipates conducting country surveys of tax administration capabilities in the near future, and thereafter developing a reform strategy for each. In the meantime, knowledge of this subject is very sparse and commentary on it is rather more speculative than on most other issues covered in this paper.

According to respondents, simplicity and uniformity will rank among the foremost considerations in overhauling the system of taxes and other revenues (in order to assure both equity and ease of administration and enforcement). For example, collecting taxes from individuals may be difficult, and governments will certainly depend to some extent on tax withholding by employers. It has been suggested as well that income taxes might also be collected at source for dividends, interest, and the fringe benefits of managers and employees.

Under the former system, the state enterprise sector served as the main source of government revenue. As a result, governments developed very little capacity to collect revenue or fight tax evasion. Moreover, it appears that the governments of the region do not fully recognize the urgency of initiating active efforts to develop this capacity.

Given the enormous new need for tax administration, respondents express concern that attempts to impose complex Western European taxes may be misguided.<sup>34</sup> Rather, many feel that governments

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<sup>33</sup>A comprehensive tax reform was implemented in Hungary. Bulgaria, Czechoslovakia, and Poland have pending, IMF-approved reform legislation. However, progress in Romania and especially Yugoslavia is much less assured.

<sup>34</sup>However, reforms must also be made with an eye to fiscal compatibility with Western Europe -- particularly regarding the VAT and customs tariffs -- to facilitate increasing integration with the European Community.

should look more to model systems used in countries of a similar level of economic development. Technical assistance in tax administration might therefore be sought from the tax authorities and finance ministries of the newly industrialized economies. These foreign agencies might also serve as sources of training for civil servants to beef up their capacity to design tax policy, to administer tax and other revenue systems, and to audit the private and state-enterprise sectors.

As privatization proceeds, governments' direct information links to the economy weaken further. Yet governments have a vital interest in ensuring their access to certain kinds of corporate financial information.<sup>35</sup> The governments of Eastern Europe intend to impose standard requirements for financial disclosure, reporting, and auditing on corporations that are traded on public stock exchanges. However, the need for public access to information argues for extending these requirements to *all* corporations.<sup>36</sup>

### **Budgeting**

Outside of Hungary and Poland, little is known among donors about the region's systems for budget preparation, approval, and execution. In Hungary and Poland, the IMF recently evaluated the budgeting methods being used at the time, finding them to be entirely incompatible with the modern systems used in capitalist economies. In 1989, the IMF installed systems in Hungary that conform with international budgeting conventions (but has not yet proceeded to do so in Poland). It appears that the IMF will eventually follow the same procedure of diagnosis and reform in the other countries of Eastern Europe.

Once accounting standards are in place and accountants trained (or foreign accounting firms contracted), governments can proceed to establish critical auditing mechanisms for their own finances, and for the finances of state-owned enterprises and subnational governments. They will also need simple systems to audit their own operational effectiveness, so as to remedy program deficiencies and refer cases of malfeasance and non-feasance to the appropriate authorities. For each of these auditing functions, the perception of objectivity and independence is critical.

Rudimentary financial auditing infrastructure exists in some countries. The parliaments of Hungary and Poland have a State Audit Committee and an Inspector General, respectively. However, the objectivity of their budgetary audits has been questioned, and their small staffs and lack of routinized

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<sup>35</sup>Reasons for guaranteeing information flows include the prevention of income tax evasion, fairness in labor relations, and environmental, consumer and investor protection.

<sup>36</sup>See Rice (1990). It has been suggested that universal reporting requirements might be viewed as the price of having limited liability status.

systems limit the quality and scope of their work. Poland's Government Auditor performs functional audits of government operations which elicit both press attention and responsiveness from the rest of the government. And Poland's Attorney General investigates fraud. At least at this point, such offices are highly political, and they should be strengthened both in governments and elected legislatures.

It has been suggested that the decentralization of government administration prior to the imposition of financial controls has added to economic instability in the region. Modern accounting and auditing systems are now being installed in Hungary and Poland, and the rest of the region will soon follow. It is likely that central governments will have to establish financial control over subnational governments and state enterprises, through budgeting and accounting standards and financial disclosure requirements.

The governments of Eastern Europe have made some budgetary reforms independently, but these have been ad hoc. Moreover, these governments possess very limited capacity for making multiple-year projections of current expenditure or investment strategy for government operations and infrastructure. On the whole, budgeting and planning outcomes are quite loose and fluid. For example, the category "Other" comprises nearly 30% of Poland's central government budget. The IMF has naturally taken a leading role in providing technical assistance for budgetary reform, and it can also be expected to do so for training in this area. Specific suggestions from respondents regarding budgetary reform include introducing a formalized system of competitive bidding for procurement,<sup>37</sup> and creating an independent procurement oversight department, perhaps located in a government auditor's office.

With regard to public investment, experts identify a regionwide failure of governments to apply standard rate-of-return criteria, and they question the project assessment capabilities of the governments of Eastern Europe. They fear that the new governments are overly-cautious in borrowing for investment. And they worry that market forces will not act as useful signals, given the region's continuing price distortions, undeveloped capital markets, and foreign exchange shortages. Finally, they point to the poor quality of civil, mechanical and electrical engineering in the region – which may impede governments' capacity to design, assess, operate, and regulate projects – and note that the World Bank's interlocutors fail to appreciate the extent of these shortcomings.

For the near-term, governments will require technical assistance to undertake a careful prioritization of investment projects. Respondents believe that the most urgent priorities can readily be identified. These should be specifically targeted to the identifiable needs of private enterprise. Given the

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<sup>37</sup>See G. Vecchietti (1991), "Steps to Effective Government Contracting with Private Businesses," Institute of Public Administration mimeo.

extent of unutilized capacity of existing public investments, emphasis should be on the rehabilitation of existing assets. An evaluation of specific training needs should also be undertaken now, to assist Eastern Europe's governments to develop independent capabilities in project design, assessment, and management for the medium-term.<sup>38</sup>

Respondents question the fiscal and administrative capacity of Eastern European governments to provide needed investment. Some suggest a study of the possibility of devolving certain projects and functions to the private sector.<sup>39</sup> Liberalization of private investment rules and procedures, as in Poland, would naturally be a prerequisite to such a reform.

### (3) Civil service reform

The governments of Eastern Europe have paid almost no attention to civil service reform, even though it is their civil servants who must implement planned reforms. And in large part, those interviewed admit to being ill-informed about the systems' operating methods and capacities, as well as the skills, knowledge, and attitudes of civil servants. Many issues that concern the civil service are also general labor market issues, and this section does not consider them. Instead it looks only at explicit civil service issues.

Governments have apparently not conceived of their employees as a bureaucracy-wide "civil service." They have yet to develop any comprehensive strategies for re-orienting, retrenching, retraining, and redeploying their staffs, let alone for building an organic and non-ideological civil service system. Currently, these civil services have four broad problem areas: staff and skills shortages, low and compressed salary scales, the residual bureaucratic culture of the former regimes, and job mismatch.

There is unanimous concern about Eastern Europe's civil servants' ability to manage their reform programs. Although the socialized sectors of Eastern Europe's economies are vast, their *central government* civil services are surprisingly small. Staffing levels in government ministries are fairly low in absolute terms, as a fraction of the overall labor force, and in comparison to the share of central government in market economies.<sup>40</sup>

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<sup>38</sup>As in Hungary, "twinning" of Eastern European civil servants with foreign infrastructure and transportation project analogues will likely be a significant component of this training.

<sup>39</sup>In Romanian infrastructure, for example, areas suggested by the World Bank for private investment include roads, communications, public utilities, and agricultural infrastructure.

<sup>40</sup>Sources: Proprietary government and World Bank data, and Heller and Tait (1984).



Moreover, higher wages in the region's emerging private sector (and in local offices of the international donor community) are increasingly draining talent from the core civil services. In addition, the civil service consists of too many engineers, and too few administrators, managers, economists, accountants, and auditors.

Those interviewed indicate that, rather than looking for ways to streamline their core civil services, the countries of Eastern Europe need to consider strategies to expand and improve them. In contrast, many government services are provided by agencies that are situated administratively outside of the civil service, and these agencies may indeed need dramatic staff cuts.

Eastern Europe's secondary schools, universities and institutes have historically offered almost no education or training in economics and finance, public and private management, accounting and auditing, project assessment, or tax administration.<sup>41</sup> About the only civil servants who are trained for these functions are the few who received a foreign education. And while these critical skills and knowledge appear to be virtually missing, governments have been slow in determining their training priorities and expressing their needs to external donors.

A related problem is the strain placed on the limited human resources of domestic bureaucracies by the international community itself. This comes in two forms: excessive and uncoordinated international contacts distract government officials from other matters of state; and the generous salaries of aid agencies act to lure away some of the best domestic government staff.

The problem of missing skills is exacerbated by a tendency for low civil service salaries and salary compression in all of Eastern Europe.<sup>42</sup> As in the past, managers supplement their pay by teaching when they should be working in the ministries, while other civil servants moonlight or use government time and resources for private business sidelines. With the expansion of the private sector in Poland, Czechoslovakia and Hungary, better private sector remuneration has induced a brain-drain of newly-trained managers, financial technicians, and support staff. This same pattern is now developing elsewhere in Eastern Europe. To the extent that the government cannot match salaries in the private sector, even greater numbers of civil servants must be trained to compensate for this brain-drain.

In addition, some of the debilitating *ancien regime* culture of Eastern Europe's civil services still pervades many government bodies. Its implications are a lack of trust and a fear of communication, a

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<sup>41</sup>In addition, Eastern Europe's engineering expertise tends to lag twenty years behind OECD countries, and outside of Hungary there are not enough lawyers to draft reform legislation, nor civil servants with necessary foreign language skills.

<sup>42</sup>For example, the salary range in Romania's civil service appears to have a ratio of 1:3, only a small fraction of the ratio found outside the region (e.g. in the Asian NIEs).

staff that achieved its positions via a highly politicized system of recruitment and promotion, and work attitudes and tightly directed operational methods that are incompatible with a market orientation. One part of the trade-off is well known: nomenklatura often have better training for government positions, but governments question their loyalties and style of operation.

A final staffing problem arises from the governments' typical method of dealing with the civil servants of obsolete ministries: in order to avoid layoffs (or due to personnel shortages), redundant staff are placed in institutions that will perform new economic functions -- even when their skills and attitudes are entirely mismatched. For instance, long-time planning office staff in Romania were transferred to the privatization office. And in Poland and Romania, former price-setters are now being asked to perform as price liberalization watchdogs in the new anti-trust offices; even though both jobs involve prices, many employees may be incapable switching to such a diametrically opposed role. Those interviewed expressed strong opposition to the practice of politically-motivated staff shuffling -- particularly to institutions that are critical for the transition -- since many skills and work attitudes are simply not fungible or would necessitate substantial retraining and reorientation.

One should also keep in mind that, for the most part, there has been too little time to judge whether or not these civil servants will rise to the challenge of implementing the economic reforms. In certain countries and agencies, notably most ministries of finance and the civil services of Hungary and Poland, bureaucrats once operated more-or-less competently given the former system. In large part, mid-level government employees have not received new operating directives and so continue to operate much as before. Their competence in decision-making will not truly be tested until the culture and rules change.

As a first step, those interviewed would have governments establish personnel administration capacity, introducing a formal civil service with a competent, reform-oriented, and high-level directorate. Such a government-wide personnel office would be capable of evaluating its human resource needs on a systemic basis. During the transition, this directorate would be charged with civil service reform: determining training needs and organizing training programs, and instituting structural changes and salary reform. Later, it would become the administrator for the civil service.

Other measures recommended for immediate government action include quickly identifying the greatest needs for salary decompression, and then implementing the most critical pay increases needed to stem the outflow of personnel;<sup>43</sup> the rapid design of short courses for key skills shortages, in order to

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<sup>43</sup>A word of warning: the distributional effect of increased salary dispersion is a delicate social issue, and reform efforts must pay attention to its implications.

help alleviate bottlenecks; and the establishment of training institutes, since they take time to yield results.<sup>44</sup>

It has been suggested that the multilateral institutions finance the preparation of a comprehensive medium- and long-term national action plan for Eastern European civil service development, for which the greatest expertise probably resides with managers and systems analysts within the civil service directorates of the Newly Industrialized Economies and the OECD countries. Three broad types of systemic reform to overhaul the civil services have been identified: transforming the bureaucratic culture and organizational structure, introducing mechanisms to assure accountability, and a major expansion of training capacity.

Although the challenge of changing the communist bureaucratic culture and organizational structure is unprecedented, governments elsewhere have dealt with analogous transformations in rehabilitating demoralized civil services and in moving from authoritarian to democratic political structures. Eastern Europe can learn from these similar experiences and can obtain technical assistance from those involved. Suggested means of transforming the bureaucracy include: a study of the functional structure and priorities of the government bureaucracy; a survey of civil servants' attitudes in order to understand the kind of changes needed; replacement of the top few layers of bureaucracy; development of a professional, merit-based civil service corps; video and seminar presentations aimed at staff and system re-orientation; new hirings of (unindoctrinated) recent graduates; and reorganization to assure improved horizontal and vertical communication.

Efficient government depends in part on the ability to give proper signals and incentives to civil servants – a difficult problem with which governments continue to wrestle even in industrialized countries. To this end, respondents recommend that civil service reform include mechanisms to ensure that bureaucrats be held accountable for their actions. A first step would be to reassert clear lines of responsibility, based on the study of the government's functional structure. This would enable one to trace and evaluate policy implementation.

The introduction of needed incentives could then follow via a formalized and transparent civil service review and promotion system – perhaps including merit testing for advancement, awards for meritorious service, rewards for innovative ideas that lead to efficiency improvements, and financial incentives for state enterprise managers. The civil service reform would also contain methods for

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<sup>44</sup>This is being done to a very limited degree for managers, public administrators, accountants, bankers, and economists in various parts of the region.

identifying and punishing malfeasance and non-feasance. In this, Poland has taken the lead, using its Inspector General to audit government operations, and its Attorney General to prosecute fraud.

As suggested above, Eastern Europe faces an overwhelming need to train its civil servants.<sup>45</sup> However, it appears that leaders in government do not appreciate the magnitude of this need. Fortunately, government employees are hungry for training, and the opportunity to enhance one's professional skills is seen as an enviable job perquisite. Moreover, local schools and institutes are now rushing to respond to the new demand for certain occupational skills. Of particular note are new programs in business and public administration in the CSFR, Hungary, Poland, and most recently in Romania. Respondents urge governments to expand these efforts by initiating teaching seminars by foreign instructors in the areas of economics and management teaching, and teacher-training.

For the medium-term, donors could help quantify skills shortages and specific training needs (i.e., their urgency, and the amount and level of training necessary), on a government-wide basis (not ministry-by-ministry). Such an effort would probably use interviews or tests of civil servants in several ministries and agencies, and managers in a range of state enterprises. Preferably, such tests would serve two purposes: to diagnose systemic needs and to root out untrainable employees.<sup>46</sup>

The governments of Eastern Europe will have to rely in large part on existing training facilities. Yet foreign experts appear to have little information about the capacity and capabilities of these facilities. Immediate studies of domestic facilities and their faculties are essential, if they are to be used for training and teaching in business, economics, public administration.

Foreign private and not-for-profit institutions are already playing a part in expanding training capacity, and will certainly continue to do so. These include traditional educational institutions, as well as less conventional sources of training — like officials seconded from government ministries in

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<sup>45</sup>The paper does not address the reforms of Eastern Europe's educational systems. These systems generally function on a par with other countries at their level of economic development, particularly at the primary and secondary levels, and are primarily an area for medium-term institutional reform. Until local expertise can develop, Eastern Europe will need to rely on imported foreign teachers in key subject areas at all educational levels. It appears that, in general, such assistance would be particularly helpful at the level of training local teachers to give courses in business and economics.

To some extent, foreign educational institutions are already setting up operations to teach economics, business, accounting, both independently and in collaboration with Eastern European institutions. It seems that, in the absence of government impediments, these schools would be prepared to expand their capacity.

<sup>46</sup>One example is the current testing of East Germany's judges. If it is politically impossible to select out civil servants based on a test, governments may still wish to conduct anonymous tests that will serve only to diagnose systemic needs.

industrialized and newly industrialized economies, foreign chambers of commerce, bar and other professional associations, and labor unions. Some also suggest exploiting the talents of resident foreign accountants, management consultants, lawyers, etc. – perhaps even on a pro bono basis. However, it is widely believed that the scale of training activity by domestic and foreign-based private institutions will be insufficient, and that their lead times will be too great.

Technical assistance and regional information-sharing might assist Eastern European countries in linking up with potential external sources of training. In addition, the World Bank and IMF are also already directly involved in training, and there is a broad consensus for stepping-up this commitment. Bilateral organizations have also begun limited programs of job training and of twinning<sup>47</sup> of civil servants with their analogues in donor government ministries.

The enormous scale of the required training effort demands innovative delivery methods. For instance, Eastern Europe's civil servants are relatively computer literate, and so some types of computer-assisted courses might be economical. In addition, public broadcasters in the U.S. report that Western European and American public broadcasters are already heavily involved in planning educational programming for the region. They envision several areas in which mass media training can help meet the heavy training demand: television and radio programming can be used to educate civil servants (and the population-at-large) about the nature of a market economy and of capitalist society;<sup>48</sup> "telecourses" (including written materials) can be used for more technical training, in order to reach large groups of civil servants nationwide, while economizing on scarce financing, classrooms and teachers; where a professional course or training is needed for smaller groups or at different times, delivery can be made on-the-jobsite by video tape or closed-circuit television.

These few innovative examples illustrate how governments might expand their training capacity. Multilateral and bilateral aid organizations might evaluate the cost-effectiveness of such methods, and based thereon consider financing the cost of course development.

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<sup>47</sup>Training via "twinning" has the advantage of immersing the trainee in the foreign institutional culture at the same time as he or she receives training. In the U.S., for example, counterpart civil servants have been placed in the Department of Justice, Environmental Protection Agency, Federal Reserve Board, Federal Trade Commission, as well as in municipal governments. However, some of those interviewed expressed reservations about overseas training: that it is not cost-effective and is itself a vehicle for international brain-drain. And although it has the administrative advantage of being decentralized, it must be particularly well-structured to have an impact.

<sup>48</sup>For example, Czechoslovak radio broadcast a series on entrepreneurship last year.

## NEW GOVERNMENT SERVICES

### (1) Private Investment Promotion and Regulation

The overwhelming public role in industrial investment is quickly being abandoned throughout Eastern Europe. Yet in most countries, foreign and domestic investors either are subject to micro- and macro- economic uncertainties, or they must wend their way through a cumbersome approval process.<sup>49</sup> This may help explain Eastern Europe's disappointing response from would-be foreign direct investors, and why the privatization process is bogging down.

Governments are quickly learning the new role of investment promotion and regulation. For foreign investment, Poland's reforms have advanced farthest: streamlining of foreign investment approvals (based on a negative list of prohibited investments), creation of the Agency for Foreign Investment to promote and screen investment and to guide investors through the bureaucracy and the economy, and recent legislation to lift important remaining restrictions. Hungary is considering establishing a similar investment promotion agency, but with inter-ministerial participation. Another role for such agencies might be to inform governments of impediments to investment, and to lobby for their removal.

Although rules on private domestic investment are relatively liberal, observers call for government efforts to promote domestic investment as well. In some respects, the need is greater, since a lack of experience renders local entrepreneurs relatively unsophisticated. It may therefore be useful to establish a private or quasi-public business development agency (see "Assuring Fair Competition" below). A few references also note one particular problem area that has received very little attention: remaining restrictions and arbitrariness in private access to real estate for commercial use.

It is nearly impossible for a government independently to identify the impediments confronted by investors — only investors can realistically be expected to do so. Therefore, some of those interviewed believe that governments should commission a survey of business attitude should be undertaken to evaluate existing investment impediments<sup>50</sup> (and the usefulness of existing promotion efforts).

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<sup>49</sup>Romania has not yet established its criteria for foreign investment. It seems that a small amount of foreign investment is taking place there even without any transparent set of rules.

<sup>50</sup>Appendix 3 of Government of Czech and Slovak Republics (1990) contains a list of some issue areas that would be relevant in all Eastern European countries (and in most Western European countries).

## **(2) Assuring Fair Competition**

Monopolies are the natural order for a socialist economy, evidenced most dramatically in the institutions of central planning and pricing, and production in the region continues to be dominated by inefficient state monopolies. In response, governments have recently enacted policies to promote commercial competition in three ways: (1) anti-trust activity and regulation of anti-competitive practices,<sup>51</sup> (2) lowering barriers to foreign import competition,<sup>52</sup> and (3) breaking up state monopolies into smaller enterprises.

Respondents endorse additional actions intended to ease market entry for business start-ups. Across Eastern Europe, small businesses are disadvantaged in comparison to large state enterprises in terms of their access to credit, inputs, and office and production space; procurement contracts; and import and export licenses. In an attempt to "level the playing field," governments are looking for ways to ease market entry by small businesses. This will necessitate a range of new activities or new public agencies.

Poland has already taken several concrete steps in this direction: it incorporated financing provisions for small firms in its financial and banking reforms, it is developing a data base for small businesses, its new Anti-Monopoly Office is working to thwart attempts at predatory pricing by state enterprises, and it has established a new department within the Ministry of Industry to consider the needs of small enterprises. Elsewhere in the region, Hungary included technical assistance and lending components for small business in a recent World Bank industrial restructuring loan; Bulgaria has asked

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<sup>51</sup>Every country of Eastern Europe has adopted such legislation. In addition, the governments of Czechoslovakia, Hungary, and Poland have gone farther: each opened an "Anti-Monopoly Office", charged with enforcing new anti-trust laws and fighting unfair competition; and Poland has an active program of bilateral technical assistance in competition policy, which are being emulated in Hungary and Czechoslovakia. However, many observers question whether these countries are capable of implementing anti-trust legislation.

<sup>52</sup>Lipton and Sachs (1990) argue that import liberalization should suffice to introduce lively competition into the small, open economies of Eastern Europe. However, there are two criticisms of this liberal approach: first, foreign exchange shortages and foreign debt will restrict the ability of Eastern Europeans to buy foreign imports; and second, foreigners cannot compete in non-tradable goods and services. The first point is indisputable, although its magnitude cannot be estimated. As for the second argument, one should maintain a healthy skepticism about the true range of so-called "non-tradables." Although some specific industries may fall into this category, international competition elsewhere has entered many fields long considered non-tradables, such as domestic transportation, certain public utilities, and wholesale and retail trade. Since one cannot judge the importance of these two points, one should be cautious about the near-term ability of international trade to eliminate monopoly market power.

for technical assistance in this area as well; and Romania intends to give priority to the investment needs of its emerging sector of small, private farms.

One area that observers feel needs immediate attention is in the reform of existing legal and administrative procedures for business entry and operation. These now clearly favor large, established, monopolistic enterprises over new entrepreneurs. The governments of the CSFR, Hungary, and Poland are already acting to reduce these barriers. One respondent suggested that officials charged with writing new legislation and regulations in this area might establish channels to receive input from nationwide and regionwide associations of small businesspeople.

For the medium-term, it is necessary to learn more about the impediments facing small and start-up enterprises, and then to develop an action plan. Research is warranted in the areas of (1) small enterprise promotion, perhaps to be modelled after the private sector development agencies in Korea, Taiwan or Japan, all of which have impressive track records; and (2) competition policy, perhaps supported by the OECD's competition unit. An action plan might include: technical assistance and other support from OECD countries through their Chambers of Commerce (this has already begun), national agencies for small business promotion, and trade and professional associations; introducing mechanisms to identify and counteract unfair competition; and establishing a private or quasi-public support agency for small business.<sup>39</sup>

### (3) Social safety net

The governments of Eastern Europe are obliged to care for the losers in the process of restructuring, via welfare payments to compensate the poor for their income loss, and benefits and retraining for job losers. Yet the region faces dire limitations on the resources available for social programs. These governments seem aware of the need to design programs that deliver support in a cost-effective and easily implementable manner, and which contain appropriate incentives to recipients.

As a matter of social philosophy, unemployment was deliberately kept extremely low in the socialist economies of Eastern Europe. Two implications of this legacy are that (1) open unemployment is likely to be particularly difficult and disturbing for job losers, and (2) these countries lack institutional structures to deal with the needs of large numbers of unemployed. One implicit trade-off of the economic

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<sup>39</sup>Such an agency could act as an informational clearinghouse for businesses, help new enterprises set up shop, provide counseling services, and run practical seminars on such issues as management, accounting, finance, marketing, investment, bidding for government contracts, and exporting. Respondents stress that such an agency should be decentralized and self-supporting (via user fees).



reforms will therefore be the introduction of unemployment benefits to compensate for the elimination of guaranteed employment.

Together, these considerations point to the need for a rapid and concerted drive to develop creative responses to the anticipated large-scale unemployment. Short-term measures will necessarily consist of ad hoc emergency policies and procedures, while in the long-run attention may turn to a more comprehensive delivery system.

The crushing burden of administering unemployment-related programs first manifested itself in Poland. Although the country responded quickly by introducing appropriate norms and criteria for benefits, its capacity to finance and deliver these services remains limited. Other countries in the region are learning some important lessons from Poland's pioneering experience: that they cannot afford overly-generous benefits (as currently are granted in Czechoslovakia and Yugoslavia); and that programs must be tailored to a country's limited capacity to deliver services (unlike Romania, which has a well-designed system of benefits, but lacks much administrative capacity). Given the region's fiscal constraints and its need for infrastructure, benefits programs that require recipients to work on public infrastructure projects may be of particular interest.<sup>54</sup>

In most of the region, the current fragile financial condition of state enterprises renders them unreliable sources of financing for unemployment benefits. In the near-term, government budgets will therefore have to shoulder this burden, and financing reforms will have to wait until later in the transition. Eventually, government unemployment benefits systems should convert to insurance programs that are self-financed through employer contributions, as will occur in Hungary this year.

Income support for unemployed workers is not intended to reduce unemployment. The liberalization of labor markets will go a long way toward opening opportunities for the unemployed. Most respondents also believe that more active programs will be required to help reintegrate the unemployed into the workforce (see Vodopivec, 1990). Abundant lessons were learned in Western Europe from the nagging unemployment problems of the 1980s, suggesting that Eastern Europe can benefit from the technical assistance of innovative Western European labor ministries, particularly through advice on short-term mechanisms to increase labor market flexibility and help designing a medium-term plan.

Governments can also enact a variety of immediate measures that would seek to spread the burden of unemployment more widely across the whole society. Current experiments of this sort in

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<sup>54</sup>The 1990 World Development Report discusses programs in which recipients of social welfare payments are required to participate in public works projects. These are seen to have had success in increasing incentives to find alternative employment, decreasing incentives to claim benefits, and restoring neglected physical infrastructure.

Czechoslovakia include one-year extensions of periods for vocational training, and elementary and university education; longer vacations and more holidays; limits on the employment of pensioners; and the introduction of part-time employment (which was virtually non-existent under socialist governments).<sup>35</sup> Other innovations include profit-sharing bonuses -- which curtail unemployment in bad times by allowing wages to fluctuate -- and fixed-term employment or a lower training wage -- which makes it less risky and expensive to hire new labor, and gives new job market entrants a better chance to be hired.

Respondents foresee a medium-term plan that would set forth a comprehensive program to train and retrain workers, and align public education systems more closely with the occupational needs of the economy. It would also address two kinds of constraints on labor mobility: a lack of information on vacancies, which might call for establishing a job information clearinghouse (either for government employment or all vacancies);<sup>36</sup> and price distortions in the housing sector that impede residential turnover. Such a plan might be expected to evaluate possible assistance to small businesses for job creation and training.

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<sup>35</sup>Governments may also choose to limit the generosity of current fringe benefits, such as pension coverage, child care, sick and maternity leave, and subsidies for housing, vacations, and family education.

<sup>36</sup>In the former regime, "job exchanges" operated as local employment offices, with economy-wide vacancy listings. In some countries, perhaps parts of these offices are salvageable.

## **CONCLUSION: AN AGENDA FOR EXTERNAL ASSISTANCE**

The interviews and written references are unanimous in at least one observation: market forces alone cannot restore Eastern European capitalism. For the past forty years, the markets of Eastern Europe have been systematically sidestepped and eliminated. Of course, market forces never ceased to exist, manifesting themselves in the parallel economy. But the existing markets are distorted and rudimentary. Therefore, Eastern European governments will require dramatic institutional reform in order to achieve their ambitions to become market economies.

The governments of Eastern Europe, with astonishing speed, have introduced vast numbers of legal changes that are consistent with democracy and a market economy. In addition, they have reorganized some parts of the government bureaucracy and have plans to do much more. But it is apparent that structural forms can be changed on paper much faster than can actual functions and capabilities down the line.

Some observers express concerns regarding the absence of government institutional development, as well as an apparent lack of a private sector development response to an impressive array of good, new legislation. Yet not enough time has elapsed to draw conclusions, either about whether the economy is responding well nor whether any failure to respond results from governments' lack of implementation capacity.

It appears that much of Eastern Europe's reform process must necessarily take place independently of outside organizations and assistance. Reform will be an intensely political process, with interest coalitions emerging from time-consuming public debate. In all this, foreigners can play a useful role as advisors, investors and creditors, providing a menu of policy options and innovations to be debated via internal political mechanisms.

External assistance for government institutional development will have five components: policy advice, technical assistance, training of civil servants, diagnostic research, and medium-term action plans. Across the countries of the region, however, priorities will vary substantially among the specific proposed actions. For this reason, measures are listed below but not prioritized.

**(1) Policy Advice, to encourage governments to pay attention to the following areas:**

The inter-relatedness of policy measures, and the need for simple and transparent laws and regulations (pages 4 and 8).

**Exploiting the unused potential of extra-governmental sources of advice and public management in the local and expatriate communities (page 6).**

**Participating more actively (especially for Bulgaria, Romania, and Yugoslavia) in exchanging views and experience among Eastern European governments (page 6).**

**Enhancing perceptions of government legitimacy by expanding participation in policy-making (page 9).**

**Expanding twinning arrangements between public and private institutions in Eastern Europe and their foreign analogues (page 21), including parliaments (page 7) and subnational governments (page 15).**

**(2) Technical Assistance**

**Introducing a locus for macroeconomic policy strategy and coordination (page 4), and mechanisms for coordinated management of foreign assistance and debt, and technical assistance (page 12).**

**Expanding capacity to formulate macroeconomic projections and policy strategies (page 4).**

**Designing a new statistical system and collecting new statistical series (page 6).**

**Introducing measures to strengthen legislatures (page 7).**

**Introducing a program to preempt and fight corruption (page 9).**

**Drafting a comprehensive economic reform program, and introducing public information efforts to articulate the program to the public (page 11).**

**Institutionalizing channels for the government to receive and respond to citizens' input (page 14).**

**Enacting laws to define clearly the jurisdictions and responsibilities of each level of government (page 15), and developing local revenue systems and cooperative mechanisms among villages (page 17).**

**Systems analysis to economize in the implementation of new functions (page 22).**

**Drafting legislation, and designing mechanisms for enforcement and dispute resolution (page 23).**

**Redesigning regulatory systems (page 24).**

**Overhauling tax administration (page 25), and budgeting, public expenditure, self-auditing and procurement systems (page 26).**

**Establishing requirements for independent financial auditing, disclosure and reporting by corporations (page 26) and subnational governments (page 27).**

**Prioritizing public investments (page 27).**

**Introducing a formal civil service with a competent, reform-oriented, and high-level directorate (page 28). Alleviating the most critical cases of civil service salary compression (page 28). Establishing systems and criteria for selecting government managers from among former regimes (pages 14 and 29).**

**Establishing training institutes (page 32) and a job information clearinghouse (page 37).**

**Liberalizing legal and administrative procedures for business entry and operation, promoting and screening foreign investment, and designing a business development agency for foreign and domestic investors (page 34).**

**Design of unemployment assistance programs and programs to speed job market re-entry (page 37).**

**Introducing measures that enable the burden of unemployment to be shared more widely across the whole society (page 37).**

**(3) Targeted Training:**

**Of local government officials (page 16).**

**In tax policy-making and administration (page 25).**

**In public investment project design, assessment, and management (page 27).**

**In economics, finance, public and private management, and accounting and auditing (page 28).**

**Short courses for key skills shortages (page 29).**

**(4) Diagnostic Research:<sup>57</sup>**

**Nature and causes of the corruption problem (page 9).**

**Relationship of labor unions to the reforms (page 10).**

**Relationships between central and subnational governments, including their actual and desired structures and capabilities (page 16).**

**How much can be salvaged of the existing legal and regulatory systems; reform of the system of legal education; and judicial development (page 22).**

**The possibility of devolving infrastructure projects and functions to the private sector (page 27).**

**Civil service salary compression (page 28).**

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<sup>57</sup>Additionally, the World Bank is currently undertaking a study of "best practices" in Western European public administration; the results of this study can be incorporated in a number of fields.

**Functional structure of the government bureaucracy as a whole, and of individual agencies, including their priorities and implementation capacity (page 29).**

**Training needs and capacity of the public and private sectors (pages 28 and 36), and innovative methods of delivery (page 33).**

**Business promotion, including (i) existing institutional impediments to investment and efficient commercial operation (based on a national survey of private and state-owned businesses); (ii) small enterprise promotion; and (iii) competition policy (page 34).**

**(5) Design Medium-term Action Plans, once the relevant issues and capacities are clarified:**

**Statistical development (page 6)**

**Legal and structural changes in the relationships between central and subnational governments and for local government training (page 15)**

**Legal and regulatory institutional reform (page 22)**

**Civil service development (page 31).**

**Economy-wide training (pages 32 and 38).**

**Business promotion and competition policy (page 34).**

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