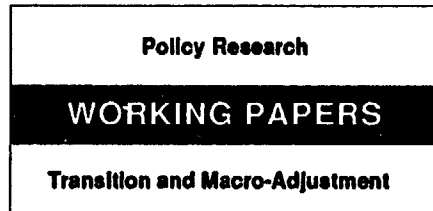


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# Enterprise Reform in Eastern Europe

Sweder van Wijnbergen

**Applying Western textbook solutions to the problems of enterprise reform in Eastern Europe is likely to be counterproductive. Policy design must be imaginative and explicitly incorporate the political constraints and incentive problems specific to the region, leading to new approaches to enterprise and banking reform.**

This paper — a product of the Europe and Central Asia Department — is part of a larger effort in the department to assist the process of enterprise reform in Eastern Europe. Parts of this paper draw on van Wijnbergen (1992), which appeared in the 1992 Marjolin essay competition volume sponsored by American Express Bank. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Bonnie Pacheco, room H11-071, extension 37033 (January 1993, 36 pages).

Enterprise reform is emerging as the core economic problem in Eastern Europe. As privatization has been delayed, a new problem has emerged, largely unanticipated by outside advisers: It is probably possible to run a clear-cut state enterprise efficiently, and it is certainly possible to get efficient performance from a private enterprise. But it is utterly impossible to get anything like efficiency from an enterprise for which the current and future ownership status are in limbo. What has happened in Poland, where reform started earlier than elsewhere, is probably a harbinger of things to come.

Two years after the crumbling of central authority that used to exercise both ownership and control, ownership of state-owned enterprises remains ineffective and control diffuse. Lacking sharply defined control rights, various groups (workers, incumbent managers, and local authorities) often had no other way of demonstrating their clout than by disrupting the enterprise. And with changes in ownership announced but not implemented, managers and workers councils alike have every incentive to decapitalize the enterprise and increase its debts.

Eastern Europe is not well served with straight textbook advice. The common wisdom on privatization fails to address the problems

created by diffuse ownership and conflicts over control that exist before privatization. Regular cash auctions may fail to match managers and capital stock efficiently because of pervasive wealth constraints. Standard advice on enterprise restructuring does not allow for the sheer scale of the problem or the special reasons why, in Eastern Europe, current profits are a poor guide to potential profitability. Simply applying Western bankruptcy procedures based on current data about enterprise profitability introduces a destructive bias toward liquidation and delay.

And, argues van Wijnbergen, introducing Western style unemployment insurance, although it would lower the social costs of unemployment, could also contribute to its indefinite extension.

Van Wijnbergen sketches how these problems can be addressed by incorporating all the incentive problems specific to Eastern Europe into the design of the policies to be implemented. Sometimes the advice that results is novel and as yet untried; sometimes examples exist of its successful implementation. But the alternative is a long period of declining incomes and, presumably, increasing social unrest as the consensus underlying the reform programs begins to erode.

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# ENTERPRISE REFORM IN EASTERN EUROPE

by

Sweder van Wijnbergen  
Senior Advisor, Central Europe Department, World Bank

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## I INTRODUCTION

Price decontrol has eliminated queues in Eastern Europe within a matter of weeks. What it has not done is lead the place much closer to efficient resource use. Moreover, the reforms that most economists agree are necessary to introduce production side efficiency have been surprizingly difficult to introduce. Privatization drives, after initial successes in selling off shops, restaurants and so on, have stalled, with none of the grandiose distribution schemes anywhere near implementation (Czecho-Slovakia's voucher experiment may provide the first exception after almost two years of delays). In the mean time, output in State Owned Enterprises (SOEs) has collapsed across the board, almost independent of sectors and country of location. As a consequence, even the success stories Czecho-Slovakia and Hungary have seen GDP decline by double digit numbers in the first year central planning was abandoned.

The collapse of the SOE sector all over Eastern Europe has also dramatically increased the difficulty of macroeconomic management. Governments relied mostly on SOE profits as a source of revenue; with the decline of SOE profitability the tax base is rapidly eroding. Since introduction of efficient systems of taxation is turning out to be more time consuming than many thought, governments now face the difficult choice between cutting expenditure in line with falling taxes, the deepening recession notwithstanding, or reignite inflation through increasing reliance on the inflation tax. Moreover the widespread fear of massive unemployment once privatization proceeds in earnest is developing as a major deterrent to privatization. This problem is more acute in a recession because fired workers would have difficulty finding alternative employment while the economy is already in a slump.

Thus enterprise reform is emerging as the core economic problem in Eastern Europe. Moreover, as implementation of the privatization plans ran into delays, a new problem emerged, largely unanticipated by outside advisers. It is probably possible to run a clear cut state enterprise efficiently, and it is certainly possible to get efficient performance from a private enterprise. What is turning out to be utterly impossible is to get anything like efficiency from an enterprise whose current and future ownership status are in limbo. The Polish example is likely to prove a harbinger of things to come elsewhere, as Poland's reform program started earlier than those in the rest of Central Europe and the CIS states.

Two years after the crumbling of central authority that used to exercise both ownership and control, ownership of SOEs remains ineffective and control diffuse. In the absence of sharply defined control rights, various groups (workers, incumbent managers, local authorities) often had no other way of demonstrating their clout than disrupting the enterprise. Moreover, with changes in ownership announced but not implemented, managers and workers councils alike have every incentive to decapitalize the enterprise and increase its debts. Thus wage claims have accelerated well beyond productivity increases, and two years after hyperinflation wiped out all nominal debts, 2000 out of Poland's 8000 major enterprises yet to be privatized find themselves once again unable to service their rapidly accumulating debts. There is little doubt that this number would grow if interest capitalization on bank debt would stop.

The debt overhang problem that has been created in the past two years pretty much prevents straight privatization through auctioning. Outsiders have no way of knowing whether the firm's distress situation is due to inefficient

management, due to very efficient management responding to perverse incentives or due to the fact that the firm has no prospects at its current capital structure even under the best of management practices. This means that enterprise restructuring has become unavoidable in spite of widespread agreement in the profession that this is best left to new private owners.

An additional problem concerns the financial sector's role in all this. Western loan classification practices would show most of the banks recently split off from the central bank to be insolvent, in most cases because of the very debt servicing problems in the SOE sector I just highlighted. But banks are the major creditors of SOEs and claims on SOEs dominate the asset portfolios of the banks. These two facts make separate treatment of enterprise debt and bank recapitalization impossible. Thus a successful restructuring plan needs to address both problems jointly. The current note identifies the main outstanding issues and proposes ways of addressing them within the general framework and the current legal structure concerning privatization and debt restructuring in Eastern Europe.

## II OBJECTIVES OF A SOUND RESTRUCTURING PLAN

The core objective is to restore efficient employment of industrial assets, both capital and labor. The more narrow objective of solving the debt overhang of enterprises and the portfolio quality problem in banks is a prerequisite for the wider objective. However, common sense and experience elsewhere (for example Morocco's public enterprise restructuring in 1987) suggest that that is not enough. The debt problems arose for a reason; if that root cause is not addressed, the problems will most likely reoccur a few years

from now, as they did in Morocco. Thus any sound restructuring plan will have to include safeguards against reoccurrence.

Experience to date in Eastern Europe has shown clearly that it is maybe possible to run a clear-cut state enterprise efficiently and that it is certainly possible for a private enterprise to function efficiently. What is clearly not possible is, to run an enterprise efficiently whose ownership and control structure are in limbo. Thus a clarification of medium term ownership structure should be the starting point of any plan. Similarly, clear assignment of control rights over the corporation, not in the medium term but right now, is essential to stop the destructive fights over control and the decapitalization that are currently plaguing most enterprises.

The first decision necessary to achieve clarification of ownership status is whether the firm is to be privatized or even in the long run should remain in state hands. If state, the company should arguably be transferred to a separate agency that will deal with enterprises that are to remain in state ownership;<sup>1</sup> the state as senior creditor and owner can take separate action and afterwards establish an effective governance scheme. Incentive problems in permanent state enterprises are entirely different from those faced in enterprises about to be privatized; there is no obvious merit in combining their control in one agency.

For those enterprises that are not to remain in the state sector, reestablishing central control on an interim basis is unlikely to be effective. No governance scheme can be effective if privatization will take place "somewhere" in the future, since managers in that case always have

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<sup>1</sup> See Dervis and Condon (1992) for a defense of this approach, which was followed in Hungary.

incentives to decapitalize the firm and buy off worker unrest through excessive wage increases. This suggests that all firms not permanently put under state ownership should be transformed into joint-stock companies immediately, with the intention to transfer these stocks to an effective owner in the near future. The only proper safeguard against reoccurrence of the debt problems is a substantial acceleration of the privatization effort.

For firms that currently succeed in servicing their debts, one of the many proposed privatization schemes can be considered; a positive cash flow after debt service means that a positive price is feasible through auction or possibly bilateral negotiation. Such a sale does not necessarily have to involve cash up front; a strong case can be made to also seriously consider non-cash mechanisms, such as bank funded management buy outs. Otherwise wealth constraints might limit the set of potential bidders too much, leaving out potentially better entrepreneurs because of ineffective capital markets.

However auctioning off enterprises with a heavy debt burden will most likely fail; under present management practice most of them are insolvent, which precludes straight auctioning off since a cash auction, for incentive reasons, will require a positive price. To see this, note what the effect of a negative price at a cash auction would be: a transfer to a "buyer" of a lump sum payment plus a negative net worth company (otherwise the cash payment would not be necessary to begin with). Clearly the optimal thing to do for the buyer is to simply take the money and walk away from the company; this would, with the state or state owned banks being the main creditors, once again mean state ownership. The net result would then be a cash transfer but no privatization.

Problems with auctions are exacerbated if many firms are offered at the



same time. In that case the information problem for potential bidders becomes almost impossible to solve. However, the problems with negative price cash auctions do not mean that heavily indebted firms should not be privatized, but that their debts need to be reduced prior to privatization.

Liquidation, which is often proposed for enterprises that do not generate enough cash flow to service their debts, is both infeasible in practice and likely to be excessively destructive; poor performance in many cases reflects as much distorted management incentives as real insolvency assuming sensible management incentives. A much more efficient way of debt restructuring would use the opportunity to introduce effective ownership into the process. This suggests that conversion of some of the debt into equity should be the main focal point of the restructuring exercise, rather than debt write downs and full collection of what remains. Debt equity conversion offers a more promising way towards efficient use of the assets controlled by the enterprises than liquidation into a thin capital market and a depressed economy does.

Privatization is in fact most efficiently done within the context of the debt restructuring plan. After all, debt restructuring and work outs will involve changes in the modus operandi of the firm; to make such decisions without involving the ultimate owners is likely to be inefficient in that it almost guarantees the need for further reorganizations once new owners take over. Thus there is a high priority to devising ways of bringing privatization into any debt restructuring scheme.

The situation is different for commercial banks. While there is little doubt that they need to be privatized eventually if they are to operate efficiently, the combination of de facto if not de jure deposit insurance and

information asymmetries makes this industry exceptionally vulnerable to fraud. There is now widespread consensus in the economics profession that the fastest way towards a socialized banking system is complete liberalization without effective regulation. Chile's banking collapse in 1982 after a no holds barred liberalization effort is only the best known of many such crises. On these grounds, actual privatization of the commercial banks may be best delayed until an effective regulation framework and mechanisms for enforcement of prudential rules are in place.

This also means that working towards establishing such mechanisms is of the utmost importance; a really efficient banking system cannot be expected to come in operation until that time. In the mean time, half way solutions can be implemented, following the Mexican example in financial sector reform: run the banks, while still state owned, on an "arm's length" basis until regulation is in place, at which time they can be privatized. This makes the provision of proper incentives to bank managers a particularly thorny problem. Since much of what will be proposed below hinges critically on the banks exercising effective control over their assets, such reforms are also critical for the success of the enterprise reforms.

### III PRIVATIZING PROFITABLE INDUSTRIES

There is widespread agreement that privatization is the ultimate answer to Eastern Europe's problems, and that it should be done fast. Nevertheless not a single country has been able to implement privatization at a significant scale beyond simple single establishment service sector firms. Everywhere mass privatization schemes have either been abandoned or are stalled; even Czecho-

Slovakia's vouchers scheme has been delayed by almost two years. So what is it that the initial advice overlooked? Why is privatization so much more difficult than initially thought?

The initial discussions focused mostly on how to promote widespread share ownership without diluting corporate control and on whether the government should also pursue revenue objectives (Tirole (1991)). For small establishments there is only one owner so the effective control issue does not arise. In most mass privatization schemes the effective control objective is pursued through establishment of intermediaries (investment funds). The monitoring of the funds themselves is an unresolved issue. Since most of the private sector emerged from communism completely decapitalized, Mexican or UK style auctioning would have been impossible; a serious stock-flow problem (financing the purchase of the capital stock out of the flow of current savings) precludes prices anywhere near discounted future earnings. Thus both Poland and Czecho-Slovakia settled for give away schemes at nominal fees. Exceptions were made where dominant investors could be found, usually foreigners; in that case firms were to be kept out of the mass privatization schemes.

All this sounds well thought through and workable; so why has n't it worked? With hindsight three major issues were overlooked, each important enough in itself to block serious progress. The first issue derives from the most striking difference between SOEs in Eastern Europe and say Mexico and the UK: in the latter two countries state enterprises, by the time privatization came under consideration, were tightly controlled by an effective central authority. The situation was the same in Eastern Europe until the early eighties; but it was this very central authority that was completely

discredited during the collapse of communism towards the end of the decade. Since then control of SOEs has been diffuse, with several groups vying for a dominant position: workers, incumbent managers and local governments.<sup>2</sup> This situation has led one observer to call for nationalization as a prerequisite for privatization (Hinds (1992)). The battle for enterprize control has not only crippled the current operations of SOEs throughout Eastern Europe, but has also effectively precluded privatization. With nobody exercising effective control, nobody can transfer it either.

Hinds' suggestion to start with reestablishing central control is understandable but clearly not a solution: if central authorities would have been able to implement such a solution, they would not have lost control in the first place. The proper response probably requires buying off those groups powerful enough to block privatization in the absence of such measures. This could be done by transfer of shares as part of the privatization process. Elements of such transfers have been built in the process in Poland, but apparently not enough and not well enough targeted. There are clear political problems with this advice; in most cases the former power brokers (the "Nomenklatura") are among the groups to be bought off. The experience so far suggests however that the costs of locking them out, even if ultimately successful, something that seems anyhow increasingly unlikely, would be prohibitive and in the end would leave everybody worse off.

The second problem stems from the employment effects of privatization. Experience so far suggests that privatization leads to layoffs of about 50% of the work force prior to privatization. This would obviously cause dramatic

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<sup>2</sup> Schleifer and Vishny (1992) give a vivid account of this process in Russia.

problems if privatization would take place rapidly and on a massive scale and explains why workers everywhere have resisted privatization fiercely (this is especially clear in Poland). Western advice to deal with this problem through European style safety net institutions is obviously not going to resolve this problem: to leave workers anywhere near their previous level of income would lead to totally unaffordable schemes which in addition would completely destroy adjustment and labor supply incentives. We return to this issue in section VI.

The third problem is more practical than the previous two, although probably as important. The administrative requirements of the various schemes have clearly been underestimated and are far out of line with most East European governments' administrative capacity. One solution is to focus a great deal of foreign technical assistance on the privatization agency. A more fundamental approach is to design the program in such a way that most of the initiative lies outside the government sector, bypassing its agencies to the extent possible. The countries where privatization does seem to be progressing most rapidly all put most of the initiative with the enterprises or the banks, not with government agencies (Czecho-Slovakia or Croatia are examples).

#### IV ENTERPRISE RESTRUCTURING AND PRIVATIZATION

Straight privatization is not going to succeed for those enterprises who do not generate enough cash flow to service their current debt and leave some income for residual claimants. Those firms may however be salvageable at lower levels of debt; they are thus candidates for restructuring. This section attempts to apply the general principals laid out so far to the design of a

restructuring-cum-privatization program for enterprises. The first section states key guiding principles and the second sketches two proposals that adhere to these guidelines.

#### IV.1 Core Issues in Debt Restructuring

##### A *Avoid Large Scale Liquidation*<sup>3/</sup>

The idea that almost an entire industrial sector would be unsalvageable makes very little sense. After all a large part of GDP (which is a value added concept!) is produced in manufacturing; this means per definition that it is possible to devise a capital structure and set of wage contracts under which most of the sector can operate profitably. Moreover, it is more than likely that most of the problems are related to distorted incentive structures in the past rather than incompetent management; and even in the latter case the right solution would be to replace management, not necessarily to break up the firm.

It is true that in most of Eastern Europe firms are excessively vertically integrated, as this was often the only way secure input supplies could be arranged under central planning. But this problem calls for splitting the firm into smaller firms during privatization<sup>4</sup>, not for asset stripping, which is what liquidation amounts to.

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<sup>3</sup> Liquidation means piece-meal selling off of the firm's assets. In Poland, somewhat confusingly, wholesale leasing out of all the firm's assets, often to incumbent managers for operation in a private shadow company often on the same premises, is also called liquidation. Such a process is better looked at as a particular form of a non-cash management buy out, a class of privatization devices that has much to recommend itself.

<sup>4</sup> Or even afterwards, by the new owners, if no monopoly problems are created by not doing it during privatization.

**B     *Avoid if possible formal bankruptcy procedures;***

Use of bankruptcy procedures would inevitably overload the system and lead to interminable legal delays, thus prolonging the very limbo on ownership and effective control that is behind much of the current SOE crisis to begin with. This requires more than just a decision not to use bankruptcy courts in the workout scheme. In particular, the next point needs to be resolved if excessive use of bankruptcy courts is to be avoided.

**C     *Resolve conflicts between creditors without triggering unnecessary liquidation;***

Any debt work out has to find a way to reconcile different creditor interests. In particular if a senior creditor imposes a solution seen to be unfair or less favorable than straight liquidation by another creditor, that other creditor will derail the program by triggering bankruptcy procedures. This is a major issue, since the bankruptcy courts clearly cannot handle say 2000 companies within 6 months. Thus the work out scheme needs to incorporate mechanisms of resolving creditor conflicts that will not trigger excessive liquidation proceedings.<sup>5</sup>

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<sup>5</sup> This is one of the objections against the Begg-Portes (1992) proposal to take loans to loss making SOEs off the banks' books and put them back in the Government to auction them off to whomever wishes to collect on them. Their proposal pays no attention to the creditor conflict issue at all and thus is likely to lead to inaction and delays on enterprise restructuring. Another reason to expect that is that in their proposal the initiative for enterprise restructuring is again put back with the Government in a centralized approach. But of course most governments have already demonstrated that they cannot really come to grips with these problems.

D *Maintain incentives to not unload debt to the government;*

Debt write-offs should be just enough to restore solvency, but not more than that. In particular excessive unloading of bank and interenterprise debt onto the government will add to an already extremely difficult macro-management problem. Servicing the debt so created would require additional tax measures while the current system is already strained to the limits to finance current expenditure plans in a non-inflationary manner. Thus debt restructuring should be costly to management and commercial banks.

E *Bias Debt Restructuring towards Debt/Equity Conversion;*

This has been a trend in bankruptcy reform all over the Western world. D/E conversion allows the firm to continue as a going concern and avoids the firesale problems associated with liquidation. A creditor is always better off with a D/E conversion than if it writes the loans off; equity cannot fall below zero so is at worst equivalent to a write off, but if the firm's fortunes improve, the creditor will share in the upswing. It will also simplify turning the debt restructuring into a privatization device.

F *Reserve a Substantial Role for the Commercial Banks in the Process;*

It is arguable that having the government or one of its agencies as the "agent of change" in privatization or restructuring will lead to considerable delays. It is very difficult, if not impossible, to structure incentives in such a way that middle level officials, who will actually have to implement



any scheme, find it in their interest to cooperate. It is possible (and very important!) to provide such incentives to bank managers (cf Section V.3).

An additional argument to rely on banks as the "agents of change" is that through their existing customer relation they are best placed to judge the potential of a firm and thus the merits of a particular restructuring plan. The objection that banks do not have the skills to do this right, even if true, is less compelling than it seems at first sight. The point is not that banks are good at doing this, but that they are likely to be better than anybody else, in particular better than the government.

Concentrating substantial ownership of equity in the commercial banks causes regulatory problems; in particular it is difficult to evaluate the equity for capital adequacy calculations, since it is likely to remain non-traded in most cases. This means that over time equity in bank portfolios may have to be sold off, which could be done through providing only temporary waivers from exposure limits. However converting much bank debt into equity creates concentrated share ownership which has one big plus point: at least one group of shareholders has the ability and incentives to actively monitor managers. The regulatory problem is likely to be minor for some time if banks are recapitalized up front on the basis of a conservative assessment of the status of the loan that is to be converted into equity. And as time goes by and the regulatory problem grows, the banks can be made to sell off the equity gradually. To avoid the firesale problems associated with instantaneous liquidation, a substantial time period should be allowed for this, in the order of say five years.

#### IV.2 Two Practical Proposals

In what follows I outline two proposals for restructuring; both ultimately aim at debt-to-equity conversion, but each takes a different approach to the problems created by the existence of multiple creditors with different seniority. Typically, creditors can be subdivided in three classes: one, and most senior, the government through tax arrears, social security claims and so on. Two, bank credit and secured non-bank creditors; three, interenterprise credits. At the bottom of all this are the ultimate owners, in this case the government or a government-run agency. The two proposals differ in their approach to resolving creditor conflicts. But both aim at privatization of the restructured enterprise, and both rely heavily on the commercial banks to resolve the administrative capacity constraints on privatization agencies. Both also explicitly allow for non-cash bids, an important feature in the presence of pervasive wealth constraints and imperfect capital markets (without which wealth constraints would be a non-issue).

A *An Unfamiliar but Almost Perfect Approach: Taking a Cue from Recent Proposals for Bankruptcy Reform*

Bankruptcy reform throughout the Western world has attempted to remove the liquidation bias from regular bankruptcy proceedings. In most cases, firms, once properly managed, will be worth much more than the resale value of their underlying individual assets. Thus there is an incentive to maintain the firm as a going concern, or at least maintain potentially successful subdivisions as going concerns. The approach sketched below modifies a recent proposal for bankruptcy reform so as to turn it into a method for

restructuring-cum-privatization (cf Aghion, Hart and Moore (1992)).

The proposal is designed to reach three objectives:

- A Achieve fast clarification of ownership and control through privatization;
- B Provide a mechanism for resolving creditor conflicts during the debt work out;
- C Do all this as part of the debt restructuring scheme.

The latter is important to avoid destructive outcomes of the work out scheme.

The proposal consists of two parts, a way of soliciting reorganization proposals and a method of debt and capital restructuring. The method of debt restructuring is best explained by example. Take the case of two creditors: for example tax arrears and a commercial bank, say of 100 \$ and 200 \$ each respectively (a structurally similar approach should be followed in the case of more than two classes of creditors). The debt restructuring scheme implies four steps, to be implemented simultaneously:

- 1 A complete write-off of all debts;
- 2 Creation of equity (in this case 100 shares of 1\$) all of which goes to the senior creditor, i. e. in this case the government.
- 3 The Junior creditor receives a call option on those shares with exercise price of \$1 per share. The bank will exercise this option if the value of the firm without any debt exceeds the value of the government's claims (which the government anyhow could scale back if it so wishes).
- 4 Managers and workers receive call options with exercise price of \$3 per

share, which means exercising them will allow all senior creditors to be paid off. Alternatively, such residual claims could be auctioned off.

Simultaneously with the debt restructuring, the administrator of the overall scheme should solicit reorganization proposals, either from any of the creditors, from workers and/or incumbent management, or from outside investors. The main creditor bank should play a major role at this stage and could expedite the process by threatening to invoke foreclosure on collateralized assets if workers and management refuse to cooperate. The eventual shareholder emerging from the debt restructuring process can vote to accept any of the proposals for reorganization or reject them all, in which case liquidation becomes unavoidable.

Viable reorganization proposals could come from foreigners or outside domestic investors, with cash injection; or from incumbent management without cash injection. In fact this procedure allows for non-cash-management-buy-outs: commercial banks could, instead of exercising their own options, finance management's exercising the lower level options it receives under this scheme.

This particular implementation solves a series of outstanding problems. First of all, seniority of claims is preserved, which facilitates the actual reaching of an agreement; no junior creditor will have an incentive at any stage to derail the whole procedure by triggering formal bankruptcy proceedings. And senior creditors will either get paid, become owners or can install owners of their liking. Wholesale commercialization (conversion of enterprises in joint-stock companies) becomes possible within the context of the current privatization laws, which typically transfer ownership of newly created shares to a government agency. Without a procedure like the one

proposed here with the various layers of call options, such laws preclude debt equity conversion of loans held by commercial banks. This in turn means that D/E conversion of bank claims can be implemented without the need to go back to parliament with all the associated delays. Furthermore the scheme creates a class of equity holders seriously interested in proper management of the companies; and arguably most importantly, it provides a straightforward way of using debt restructuring to accelerate privatization.

Finally, the scheme readily allows non-cash management buy-outs, for example through banks foregoing on the exercise of their own options and choosing instead to finance management exercising its (lower level) options. This is an important feature; incumbent management is typically best informed about the firm's potential but may be wealth-constrained and so unable to compete in a regular all-cash auction. In fact non-cash MBOs have a second advantage: they reintroduce some debt in the new capital structure of the firm. This is important as a disciplining device on management in periods of financial distress (Dewatripont and Tirole (1992)).

**B     *A Simpler but Imperfect Approach: Consolidate debts before Conversion***

A simpler approach would not try to preserve creditor seniority structures but would instead seek to consolidate as much as possible all claims into one of two classes: government claims and claims held by commercial banks. This would require extensive netting out of interenterprise credits, transfer to commercial banks of ownership of claims on receivables pledged as collateral for bank loans extended by those banks, and buy-outs of those interenterprise credits still left after all this.

The government could then decide on a rule for cutting back its own claims; in Poland matching debt reduction has been proposed in such a scheme: if the main commercial creditor writes off say 20%, the government will do likewise. Note that this scheme is advantageous to the commercial creditor, the equal cutback notwithstanding: a junior creditor profits from cut backs by senior creditors but the market value of the senior creditor's claims is not affected by anything the junior creditor does. A modification would offer larger cut backs for work out plans that ultimately lead to outside investors or even incumbent management owning the shares rather than the commercial banks or, worse, the government itself.

The ultimate owner (the government in its capacity as shareholder) then transfers its ownership claims either to foreigners or domestic outside investors if cash offers can be solicited after the debt write downs; or, if no such offers are forthcoming, to management and/or workers in what amounts to a non-cash management buy out. If more than one non-cash offer is received, banks may have to submit the various proposals to outside experts, such as one of the many foreign consulting firms now active in Eastern Europe for an unbiased evaluation.

#### IV.3 Dealing with Large Enterprises

All these various approaches might in the end still leave authorities with companies that nobody wants, even without any of the pre-existing debt attached. If this involves relatively small firms in not too large a number, straight liquidation or just closure is presumably possible. Realism and often simple humanitarian concerns suggests that such drastic actions may not work

for very large enterprises or dominant employers in poor regions. Here a more gradual approach to closure is probably unavoidable.

In fact one way of looking at keeping such loss makers temporarily afloat is as a sort of workfare; since the alternative is unemployment, the government could consider keeping the workers at least productively engaged. As long as they produce enough value added to pay the excess of their own wages over what they would cost the government in unemployment pay,<sup>6</sup> the government comes out ahead from a fiscal point of view.

The argument against such schemes is the same that has been levied against workfare in the US: by providing dead-end jobs only, workers are not really re-integrated in the economy and may in fact be discouraged from trying to be, since their income hinges on not moving away from where they currently are. The latter disincentive is of course singularly strong when a whole region is affected, unfortunately frequently the case in Eastern Europe.

Thus shielding large enterprises or regionally dominant employers from closure may be efficient compared to the alternative, but only temporarily so. But commercial banks may be singularly ill-suited to implement gradual closure. If the enterprise is big enough to effectively blackmail the government in not closing it down now, there is no reason to expect that a commercial bank (or for that matter the government itself) will be any more successful later. Simply imposing cash constraints is unlikely to be a credible threat; once again, if the government can be blackmailed in putting up the cash now, why should the firm not succeed again once the first allotment runs out?

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<sup>6</sup> Inclusive of the administrative costs of unemployment insurance, which are considerable!

The special nature of the problem first of all suggests that management of these "workfare firms" should be transferred to an agency that is keenly aware of budget constraints, such as the finance ministry; and second that part of the winding down of the firms should be a major effort to retrain the work force and assist it in finding alternative employment, housing and so on so as to reduce incentives to block closure in the future. Absent such a job search and retraining assistance program, claims of support being only temporary are simply not credible and will almost certainly be broken.

Even if the intertemporal problems (how to make the temporariness credible?) are solved, there are still incentive problems left in setting the total amount available in any given year. Since workfare firms receive public money, there are strong incentives to qualify for that status as a means to escape painful adjustment that other creditors might impose. One approach would be to simply preselect the enterprises, after which this option is closed off. This is very much the German approach to restructuring.

But in countries with less of a civil service tradition (and lower government salaries..), all the incentive problems highlighted before in discussing the government's role would come up again. The political pressure and corruption incentives surrounding the selection process may in many countries argue for an approach where the government has more of a residual role. In such a set up, other creditors would be required to attempt a restructuring, along lines suggested above; the government would then pick from the enterprises where this effort failed and liquidation has become unavoidable, which ones would get workfare status.

But it is crucial, if quantities are not regulated, to stem the



potential influx through the price. Unless admission to "workfar status"<sup>7</sup>/ is made singularly unattractive, the Fund will be oversubscribed and other creditors will not be willing or even able to strike prior restructuring deals even where that would have been possible in the absence of an intervention fund. The point is that if senior creditors hold out the possibility of new money, junior creditors lose the incentives to reduce their claims, particularly if new money is tied to financing needs inclusive of debt service.

The solution is straightforward: access to workfare status (or into the intervention fund) should be made conditional on:

A/ all junior creditors relinquishing their claims;

B/ harsh adjustment measures for both workers and managers, such as

mandatory lay-offs, wage freezes, and replacement of top management.

Condition A maintains the incentive for banks to reach a restructuring package that will keep the enterprise out of the intervention fund; and condition B maintains the incentive for workers and managers to cooperate in this attempt. If either one is not imposed before any money is handed out, the creation of an intervention fund will destroy any chance of success of reaching restructuring agreements through the banks or even management buy-outs. Budgetary control over the process will then become impossible to maintain and the privatization objective will be lost.

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<sup>7</sup> or into an "intervention fund" as it is called in Poland where a restructuring approach along lines suggested here is about to be tried.

## V COMMERCIAL BANK REGULATION AND INCENTIVES

One important caveat attaches to both proposals outlined above: the schemes rely heavily on proper functioning of the commercial banks. It cannot be stressed enough that fast and substantial progress on the implementation of effective mechanisms of bank supervision is going to be absolutely essential for the success of the scheme.<sup>8</sup> The chaos among the recently created private banks in Poland demonstrates that point dramatically.

Proper functioning of commercial banks in turn requires at least three things, each discussed in turn.

### V.1 Regulation

It is difficult to overestimate the importance of prudential regulation. Any business that starts with taking the customers' money up front instead of after delivered services is potentially prone to fraud. Such problems may range from direct fraud (insider lending) to excessive risk taking by managers, especially if their down side risk is partially covered by de facto deposit insurance. Experience in Chile with unregulated privatization clearly indicates that a major crisis is the unavoidable outcome of an unregulated privatized banking system. Thus privatization of commercial banks should proceed cautiously if at all as long as effective regulatory mechanisms are not in place.

An effective regulatory framework requires first of all implementation of a loan classification and general portfolio assessment system to provide

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<sup>8</sup> This point is also made strongly by Frydman et alii (1992).

regulators with the necessary warning signals. Such a reporting system needs to be backed up by occasional in depth on site audits to check on compliance and provide a more in depth assessment than mechanical indicators can yield. Such audits are also necessary to safeguard against fraudulent practices such as lending to insiders while disregarding normal standards of prudence. The latter danger is particularly acute if banks can be owned by industrial groups; for that reason many countries explicitly forbid any industrial enterprise to own a bank.

Second, rules and institutions need to be set up, and the people necessary to operate them recruited and trained. Who collects information, implements rules, sets capital adequacy guidelines, rules in ambiguous cases and so on? In many cases these tasks fall to the central bank which anyhow has to deal with the banks because of its conduct of monetary policy.

## V.2 Enforcement of Prudential Regulation

A regulatory framework is of little use if compliance is not enforced. This raises two issues. First, what is the proper medium term framework for enforcement. Second, since both state owned and private banks are right now far out of compliance with almost any reasonable set of prudential rules, how to deal with the current situation?

### A *Issues in the design of enforcement mechanisms*

The main problem with enforcement mechanisms is how to make it as insensitive as possible against political intervention and direct attempts at

fraudulent manipulation. Many countries feel that leaving enforcement in the hands of one institution leaves that institution too vulnerable to such pressures. This is especially the case if that institution also is responsible for implementing the prudential regulation, since that actually gives it the tools to circumvent the rules if pressured to do so. Moreover, supervision authorities may very well be tempted to cover up past supervision failures in the hope that a reversal of the problem bank's fortunes will get the bank and the supervision authorities off the hook.

Therefore many countries vest enforcement decisions in a Banking Commission consisting of the finance minister, the Governor of the Central Bank and often securities regulators (in practice, in all but the most important meetings, only their deputies would attend). For example in Mexico financial indicators are reviewed monthly for all banks by the technical staff of the Banking Commission; if particular thresholds are exceeded, the commission has to take various measures; in the most serious cases it seizes control of the bank and transfers it to a restructuring agency (which may but does not have to remove management).

A banking commission usually establish supervision work programs and make enforcement decisions, but relies on Central Bank staff to carry out technical work. There is little doubt that such a commission, on which several agencies are represented, is more difficult to manipulate than an institution where authority in the end rests with one person.

#### B *Recapitalizing banks*

Bank managers cannot be made responsive to capital value of the bank if

there is no capital to begin with. Thus an essential element of banking reform is recapitalization of the banks with enough income earning assets to leave a prudential capital base in place after provisioning for bad loans.

Recapitalization through a prolonged period of high spreads between lending and borrowing rates is inefficient; it takes too long and, more importantly, works by taxing successful firms to fund the losses of the unsuccessful enterprises. This procedure could well abort private sector growth before it even starts. An once-off capital infusion based on public debt issue would allow a less destructive way of financing the resulting liabilities.

If bank recapitalization is part of an overall banking reform-cum-enterprise-restructuring plan, as proposed in Poland, it is crucial to do the recapitalization up front, on an ex ante basis, even if it then has to be based on an imperfect assessment of the true value of the loan portfolio.<sup>9</sup> If not, all incentives for the commercial banks to collect anything at all on their claims will be destroyed: with recapitalization ex post, every dollar written off will be replaced by the government with an interest earning asset, so the banks have no incentive at all to try to collect or even to take equity stakes.

Objections to such a recapitalization because of the funding requirements and associated fiscal costs are always misplaced. The crucial

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<sup>9</sup> Because of the difficulty of assessing loan status, Begg and Portes (1992) propose to simply remove all loans to SOEs from the banks' books. Because of the predominance of such loans in bank portfolios, this approach basically restores the old communist practice of direct government lending to the industrial sector, bypassing intermediaries. It would also vastly overcapitalise banks; e.g. in Poland external, Western auditors after three consecutive audits place the percentage of bad loans at at most 30% in aggregate. Note that under the approach proposed here, it only matters to get the aggregate loan quality roughly right, not every individual loan; given the incentive to exaggerate losses and the resulting conservative bias in standard audit procedures, that does not seem impossible.

point is that such a recapitalization is nothing but a recognition of debts that have already been incurred in the past and thus requires no budgetary allocation (the interest on the debt instruments created of course does). The argument against keeping such debts off-the-books, which is what a failure to recapitalize sufficiently would do, is that doing so unavoidably leads to unpredictable but highly inefficient ways of servicing the implicit debt. In fact in most cases undercapitalized banks end up being funded through the inflation tax as losses are picked up by the Central Bank. At least when the debts are recognized and their interest costs brought in the budget, an efficient tax structure can be set up to finance those costs.

A more interesting objection is raised by Frydman et alii (1992). They argue that any injection of capital should go to new banks rather than the old ones. They propose to transfer liabilities of the old banks to offset the book value of the bad loans to be removed from their balance sheets, and use any issue of new debt to capitalise the new banks. They base this view on the claim that even privatization of the old banks will not provide enough of an incentive to bank managers to change their ways. This is in the end a judgment issue; but it is hard to see why, if proper incentives are important enough to completely restructure the economy, it is nevertheless reasonable to assume that that applies to everybody except managers of existing banks. Certainly the experience in Mexico with banking reform strongly supports the approach taken in this paper.<sup>10</sup>

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<sup>10</sup> A more important objection to Frydman e.a. (1992), and a similar plan proposed in Coricelli and Thorn (1992), is that they too transfer responsibility for disciplining state enterprises back to the Government. Like Begg and Portes (1992), they propose simple auctioning off of those claims as a disciplining device. For reasons explained before, this is likely to be ineffective (cf FN 5).

### V.3 Establish a Proper Incentive Structure for Commercial Banks

Establishing effective bank governance ultimately requires privatization. If quick privatization is not advisable because of the absence of effective supervision and regulation of private banks, a difficult situation is created as was argued before in the discussion of enterprise reform. Any workable solution probably requires at least two elements. First, commercialization with the creation of strong supervisory boards will be necessary so as to allow close monitoring of management. Second, since monitoring unavoidably is going to be imperfect, managers should arguably given a strong stake in eventual successful privatization by providing them with the equivalent of stock options: shares in the privatization receipts as part of their annual pay.

## VI EMPLOYMENT CONSEQUENCES: WHICH POLICIES CAN HELP?

### VI.1 Diagnosis

Labor market problems are the most visible and politically most sensitive of all transition problems. They are particularly costly in Eastern Europe because of the absence of institutions to provide a fallback to those becoming unemployed; at the same time, the experience in Western Europe quite strongly suggests that simply providing such institutions could, while lowering the social costs of unemployment, also contribute to its almost indefinite extension. Western Europe is rich enough to afford such inefficient largesse, but the East clearly is not. The core problem is to provide such

assistance without destroying adjustment incentives.

A starting point is the observation that one-off large sectoral shocks create different problems than the regular fluctuations associated with Western style business cycles. Western safety nets are designed to provide income support during periods of temporary unemployment after which the worker is expected to go back to the same or a similar job. They do not deal at all with the special problems created by permanent sectoral and regional shocks, and accordingly have been singularly unsuccessful in dealing with them.

At the core of transitional problems are informational problems and skill mismatches. Workers losing their job in the textile industry in Massachusetts might be willing to take up jobs in electronics in California, but simply do not know about them and cannot afford the job search. Clearly such problems are greatly exacerbated if there is a regional aspect to them. Regional unemployment not only raises the difficulty of obtaining adequate information about job opportunities (and about worker skills for potential employers), but also adds the often substantial costs of relocation and housing provision if a job match is found.

Even if there is adequate provision of information, transition problems could still arise because of skill mismatches. A lifelong experience in building tanks does not help when starting on the assembly of computer memories. What this really means is that built up human capital suddenly loses much of its value when patterns of labor demand shift. The social costs may be quite high and resistance to the subsequent decline in living standards may threaten the sustainability of the reforms that trigger the problem.



## VI.2 What Can the Government do?

### A *Training programs*

Successful adjustment programs, like the one in Japan in the seventies, put a heavy emphasis on training. Setting up successful training programs is fraught with problems however, as Western Europe's experience indicates. The key question for mandatory training programs is: train people for what? Unless some private sector involvement can be solicited, placing trainees can become a serious problem.

Efforts to solve this problem through tax incentives (subsidizing firms that hire graduates of training programs) have tended to produce only short term relief; Belgian experience with this approach is that trainees get fired once the tax benefits run out. An alternative approach is tried in Mexico, where companies organize the training with government subsidies and technical assistance; in this set up, jobs are assured since the firm, which has to share in the costs by paying the worker a wage while on training, presumably would not make this investment unless it intends to reap the benefits in the future. Paying workers while on training also builds an element of income support into the program.

Making firms share in the costs increases the chance that the training will be properly directed, but raises the informational problems mentioned before. After all, such cost sharing comes from new employers, not from the old, so the match between worker and firm still needs to be made. This is in particular a problem if regional location of old and new firms are different. Plans in Mexico to deal with this issue call for integration of data bases of

regional employment offices, and national advertizing of vacancies (put in practice mostly by larger firms).

Japan follows a different approach to this issue. In large diversified industrial groups the match can be made internally, and the companies own training facilities are typically used. The government itself has set up hundreds of training centers for use of smaller and less diversified firms. Moreover, contrary to practice elsewhere, Japanese firms have to pay a large share of the wages of laid off workers, and therefore have a strong incentive to assist laid off workers in finding jobs elsewhere. It is not uncommon for firms to actually contact target firms and make arrangements for salary transfers on condition that the new firm takes over some of the redundant workers of the old one.

#### **B**     *Capital Market Interventions*

Any move into new industries or different lines of work by either firms or workers will likely start out with a period of low or negative cash flows. This could be because of retraining expenses or job search by workers, need for relocation, retooling or investment outlays by firms. This implies that access to credit is particularly important. Unfortunately, reorientation both means a decline in value of current assets and therefore diminished collateralization possibilities, and at the same time higher uncertainty about future earnings. Thus access to credit markets is likely to be impaired at the very time it is most needed. This problem is most severe for individual workers or self employed, and for small and medium firms.

For this reason successful restructuring programs often include a credit

component conditional on submittal of restructuring plans. This was the case in Australia after agriculture support prices were phased out in the seventies and in the Japanese "Smaller Enterprise Business Switchover Act". Similar schemes are under study in Mexico to deal with potential labor market effects of the Free Trade Agreement currently under negotiation with the US (van Wijnbergen (1992)).

C *Public Investment Programs and Regional Targeting*

There is now increasing evidence of complementarity between public investment in infrastructure and private investment. Roads towards a village increase the chances that somebody will build a plant in that village. Thus private investment response could well be stronger if public investment in infrastructure is to some extent shielded from the budget cutting that fiscal sustainability usually requires. Public sector investment projects geared towards private sector productivity improvement (by better roads, access to electricity, investment in training facilities etc.) can play a very useful role in industrial policy packages; during implementation labor is absorbed, while a positive impact on private productivity means that private demand for labor increases once the projects are finished, typically in the same area.

Key to Mexico's relative ease of adjustment (in terms of broad based support) has been an imaginative public works program administered through local authorities. This program, by design, allows fine regional targeting and has incentives built in towards reducing bureaucracy and increasing local participation. The program, labeled PRONASOL, a Spanish acronym for program for national solidarity, consists of block grants from the center to municipal

authorities. They can use this money as they see fit under the following rules. First, it can only be spent on materials; labor has to be provided for free by the community. This makes sure that only projects the community expects to profit from are chosen; otherwise they would not donate their labor.<sup>11/</sup> Second, projects have to be approved in open municipal meetings, so as to eliminate corruption and diversion of funds to local authorities' own pockets.

Introduction of programs like this in Eastern Europe would introduce an employment support program that does not involve open ended budget commitments, since it is block grant based; it would self select only those out of work by offering below market wages; it would allow a cheap way of building up infrastructure and thus is likely to encourage matching private investment; and finally it allows regional targeting, an important plus point given the regional structure of unemployment in most East European countries. A particularly useful focal point would be to finance housing construction through such a program, since this would address one of the most serious barriers to mobility currently holding back labor market adjustment.

## VII CONCLUSIONS

The guiding theme of this paper is that Eastern Europe is not well served with straight textbook advice. The common wisdom on privatization fails to address the problems created by the diffuse ownership and conflicts over control that exist prior to privatization. Regular cash auctions may fail to

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<sup>11</sup> Wage payments below the going rate would still preserve this "screening aspect" to some extent, while introducing an element of income support.

lead to the efficient matching of managers and capital stock because of pervasive wealth constraints. Standard advice on enterprise restructuring fails to incorporate the consequences of the sheer scale of the problem, and of the special reasons why, in Eastern Europe, current profits are a very poor guide to future profit opportunity. Simply applying Western bankruptcy procedures based on current data of enterprise profitability introduces a destructive bias towards liquidation and delay. Finally we argued that introduction of Western style unemployment insurance, while lowering the social costs of unemployment, would almost certainly also contribute to its indefinite extension.

We have sketched how these problems can be addressed by incorporating all the incentive problems specific to Eastern Europe into the design of the policies to be implemented. In some cases the advice that comes out is novel and as yet untried; in some cases successful examples of its implementation exist. This means that a modicum of imagination and experimentation is unavoidable. The alternative, however, is a long period of declining incomes and, presumably, increasing social unrest as the consensus underlying the reform programs starts to erode. Thus the pay off to imaginative policy design and explicit attention to the political constraints and incentive problems specific to the region are difficult to overestimate.

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