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Department of Economic and Social Affairs  
Division for Public Economics and Public Administration

# FINANCIAL MANAGEMENT IN TRANSITIONAL ECONOMIES



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## FOREWORD

The United Nations General Assembly, in its resolutions 48/180 and 48/181 of 21 December 1993, encouraged the relevant bodies of the United Nations system to foster the environment for entrepreneurship, privatization, demonopolization and administrative deregulation, and to provide policy advice and technical assistance to the countries with economies in transition towards their integration in the world economy. Economies in transition include the countries of Central and Eastern Europe and the former Union of Soviet Socialist Republics (comprising the Baltic republics, the Commonwealth of Independent States, and Georgia).

The Department of Economic and Social Affairs of the United Nations has sought to assist economies in transition, particularly in the areas of resource mobilization, public expenditure management and private sector development, by a programme of research and publication. At the heart of the transition process is institutional change, not merely change of formal ownership, but a complex and many-faceted process of transformation. One of the pillars of a market economy is use of the commercial calculus in productive organizations. From their former preoccupation with physical quotas, enterprises are adopting and adapting foreign commercial practices in the appraisal, management, accounting and monitoring of resource allocations, and in the development of new institutional structures and processes in finance, law and taxation. Most of the countries in transition have liberalized trade and prices and privatized small-scale units; much less has been achieved in large-scale privatization, enterprise restructuring and financial sector reform. This publication focuses on the changing role of financial management in these

economies and the factors assisting in or inhibiting its development.

Financial management refers first to the institutional structure and processes of budgeting, accounting, reporting, evaluation and audit at the micro- or organizational level, which subdivides into banks, non-banking enterprises and government agencies. Secondly, financial management refers to macroeconomic issues concerning money supply and demand, interest rates, control of inflation, trade and the balance of payments, and associated fiscal issues concerning the pattern of public expenditure, internal revenues, external resources and debt. The contributors to this publication focus, first, on strategic financial management issues with regard to banking reform, property rights and microeconomic governance, public expenditure and revenue, and external financial relations and, second, on technical and professional financial management issues. A final chapter provides an overview of the main themes.

We are grateful to the consultants who prepared chapters I and II of the publication, Dr. Bimal Prodhon, Dr. Michael Kaser and Professor Maureen Berry respectively. The publication was completed and edited by staff of the Public Finance and Enterprise Management Branch of the Division for Public Economics and Public Administration.

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## NOTES

The designations employed and the presentation of material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries.

The designations “developed” and “developing” economies are intended for statistical convenience and do not necessarily express a judgement about the stage reached by a particular country or area in the development process.

The term “country” as used in the text of this publication also refers, as appropriate, to territories or areas.

The term “dollar” normally refers to the United States dollar (\$).

The views expressed are those of the individual authors and do not imply any expression of opinion on the part of the United Nations.

The abbreviated references which appear throughout the text are listed in full detail under “References” at the end of each chapter. Footnotes are numbered by chapter.

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# I. STRATEGIC FINANCIAL MANAGEMENT ISSUES IN TRANSITIONAL ECONOMIES

## 1. The meaning of transition

### 1.1 Transition

All countries are, in some ways, in transition—from low to more intense economic development, from agricultural to industrial wealth-creation, from white or male dominated societies towards the offer of equal opportunity for all. But the sense in which “transition” is applied in the present paper (which constitutes chapter I of this publication) is the transformation of an economic system from centralized administration to a decentralized market. Neither the starting point nor the expected destination are homogeneous—the command economy embraced a Soviet-type and Chinese, Vietnamese and Yugoslav variants, while the market economy differs in, say, the United States, Japan and Germany. For the reasons discussed below in this section, the starting model is of the Soviet type. Financial management at micro- and macroeconomic levels is crucial to the change because in the Soviet-type system the holding of money or other financial assets did not determine real resource allocation in the manner that it patently does within markets—subject to a governmental and regulatory environment intended to promote the common good).

The transitional economies examined in this paper are those in which until 1989-1991 a single party organization held a political monopoly and the State administration had the power to allocate the majority of economic resources, and in which subsequent developments have been in the direction of political pluralism and of private-sector decision-making within “wellfunctioning” markets. Neither the system, being abandoned nor the future goal can be uniquely defined but the former can be considered of the reasonably homogeneous “Soviet-type”. In the 30 States defined here as “transitional”, half (the 15 Union-Republics) were part of the Union of Soviet Socialist Republics until late 1991, and in all the others the Soviet authorities had been instrumental in establishing economic institutions immediately after the Second World War. Country histories were not, of course, uniform: Mongolian political autocracy was established in the 1920s, two decades before the country adopted a Soviet-type economy; Yugoslavia and the USSR broke

politically in 1948 and Yugoslav enterprise self-management began in 1950 to explicitly differentiate its system from the Soviet type; the Albanian government renounced Soviet suzerainty in 1960 and until 1978 looked to China for economic inspiration; in 1968, Hungary legislated for economic management to be based on allocations at the State-enterprise, rather than the central plan level. From the mid-1960s political diversity erupted and was generally repressed, but economic liberalization increased during the 1980s (notably in Hungary) and it was the free Polish elections of 1989 which turned the political tide.

The “destatization” of both political and economic activity is broadly perceived as permitting democratic and private enterprise forces to assert themselves, but those forces had so long been dormant, distorted or non-existent that positive action had to be taken to establish the institutions of a “civil society” and of a market mechanism. It is obvious that transformation is taking place in those 30 countries and in all other countries which can conventionally be termed politically “communist”; it is less clear whether all the “transitions” are towards the models currently established in industrialized market economies, as Rose (1994) argues. Certainly the pace of change varies widely, as is shown by an attempt to quantify it by the European Bank for Reconstruction and Development (EBRD, 1994b). Twenty-five “countries of operation” are considered on a scale with a maximum value of four, according to six criteria embracing the degree of privatization, liberalization and financial institution-building. Although none achieves the maximum of 4 in each category, five countries merit combinations of 3 and 4 marks: the Czech Republic, Estonia, Hungary, Poland and Slovakia. Eight countries show a range from 2 to 4: Bulgaria, Croatia, FYR Macedonia, Kyrgyzstan, Latvia, Lithuania, Romania and Slovenia. The remaining ten in the EBRD fold are shown to be still close to the starting post, exhibiting at least one score of 1: Albania, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. Outside the EBRD listing, the Eastern *Länder* of Germany (the former German Democratic Republic) would doubtless rank 4 on all counts;



Mongolia is likely to fall in the EBRD's majority category (i.e., 2 to 4) and Bosnia-Herzegovina, Montenegro and Serbia are virtually precluded from purposive institutional change while the present disturbed conditions persist.

This paper draws examples from 29 States and one region (of Germany) for the analysis of strategic financial management in conditions of systemic transition. Examples may also be valid from countries where the previous communist economic model is being altered, sometimes radically, but without fundamental political restructuring. The great enlargement and dynamism of the private sector in China and Vietnam (which began in 1978 and 1986 respectively) require analysis, but similarity with the thirty post-communist transformations is limited. Two other countries adopted a Soviet-type economy together with a monopoly party in the communist mould, Cuba and the Korean DPR: neither has significantly changed the parallel structures, but they have been modified. In the economy, Cuban domestic market liberalization and Korean establishment of a foreign economic zone are measures which have been taken in transitional countries discussed in this paper.

## 1.2 Strategic financial management

The economic system inherited by the transitional States did not require monetary instruments at the macro level and constrained the use of money to flows between the enterprise and household sectors, and between households at the microeconomic level. As a result, almost every step in systemic transition involves some new role for money, and the strategy for introducing those functions virtually embraces transition as a whole. Every transitional government has decontrolled the majority of wholesale and retail prices. However, the maintenance of some price controls (notably in the Russian Federation, Ukraine, Uzbekistan and Turkmenistan) has vitiated the application of other measures. But in all countries, price signals arising from the interaction of demand, supply and expectations thereof are increasingly determining resource allocation.

Strategic financial management at the microeconomic level relates to property rights, entitlements and incentives and at the macroeconomic level to systemic risk in financial intermediation, savings, inflation and exchange-rate stability. It relates also to the conventional differentiation of the "money" economy from the

"real" economy, which may be seen as a crucial factor in the transition, because the Marxist theory to which the rulers of the Soviet-type economy adhered, endowed the difference with a political interpretation. Marx claimed that the capitalist class which operates the market economy obscured its exploitation of the proletariat behind a "veil of money". The circuit of transactions concealed the alienation of labour from their entitlement to the product they generated beyond their subsistence needs. Once a socialist State had taken over the means of production, distribution and exchange, no such "veil" was needed and money could be merely the "passive" accountancy of State decisions. Because State distribution could not be achieved, until "full communism" ("from each according to his ability; to each according to his needs"), under "socialism" ("to each according to his work"), some money had to be "active", that is, for incentives to work and for the choice among consumer goods and services.

The first Soviet government seized the opportunity of the hyperinflation induced by the chaos of the civil war (1917-1920) to disregard altogether the money mechanism for both "passive" use—Lenin saw the nationalized economy as "a single office and a single factory"—and in "active" transactions; as the Chairman of the Comintern, Grigory Zinoviev, declared in 1920: "we have a way out ... the complete abolition of money. We pay wages in kind, we introduce free trams, we have free schooling, free though at present bad-meals, free housing, lighting and so on".

In adopting a simplistic view of economic relationships, Lenin based himself on Engels' model of a socialist society:

"The proletariat seizes State power and begins by turning the means of production into State property... The government of persons is replaced by the administration of things, and by the conduct of the processes of production."

Confronted by worsening hyperinflation and the breakdown of the food supply from a still-uncollectivized peasantry, Lenin partially surrendered to the market in his "New Economic Policy" (NEP) of 1921, reintroducing a money mechanism and some of the property rights abolished under what came to be called "War Communism". But the return was short-lived (Lenin died in January 1924) and the eventual form of the Stalinist economy—from 1930 in the USSR and some two decades later in Central and Eastern Europe and

communist Asia—was closer to War Communism than to NEP. It diverted financial management out of the channels employed in a market economy in three ways:

- Property rights in land, other natural resources and reproducible capital were expropriated by the State and their use was hence allocated by agents (usually, directors of State-owned enterprises) whose principals (typically, planners and ministers) were not motivated by profit;
- The prices which State-owned enterprises paid among themselves and charged to households and collective farms were administered and unchanged for long periods, largely irrespective of changes in relative costs;
- The money which enterprises used for transactions other than wages and trivial supplies was not fungible into the money used by households and collective farms.

Each of these principles was logical enough when applied within a command economy, but their incongruence with those of a market system was already demonstrated in foreign trade (which was one of the reasons why Stalin drew the Soviet economy into autarky). Post-Stalin governments sought greater economic efficiency by dismantling a few of the economic instruments without divesting themselves of a monopoly of political power.

### 1.3 The speed of transition

The necessary political changes have been undertaken in 30 States, the range of whose per capita GDP is wide—from Mongolia at one end to the Czech Republic and the Eastern *Länder* of Germany at the other. Even at the wealthier end, growth has far to go—threefold if Eastern Germany is to catch up with GDP per capita in Western Germany. In most of the countries considered in this paper political change has been so thorough as to permit the levelling of the State's ownership and control down to the norm of the rich market economies. In some, hostilities, or their threat, have perpetuated a high degree of State intervention and postponed decontrol of prices, macroeconomic stabilization and systemic transition. But all have begun to operate financial management in manners previously unused, i.e. the legitimate and efficient exercise of new property rights valued in money terms, which is the focus of this paper. The first stage—the activation of previously “passive”

money—is essentially complete, but many policy and institutional issues remain to be solved for financial management to be profitably exercised by households and enterprises within a governmental and institutional environment conducive to the common good.

The scale of the transition and the period within which it is being accomplished is, however, unprecedented. The territory over which political revolution has already foreshadowed full systemic transformation is home to 425 million people, of whom 190 million are, or were until the recent changes, gainfully occupied. On the eve of those changes the private sector, despite its toleration in farming and some lowering of barriers to it in the 1980s, generated no more than one-tenth of these countries' aggregate GDP. By mid-1994 there were 13 States in which the private sector generated 40 per cent or more of GDP: Albania, Armenia; Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Russian Federation and Slovakia (EBRD, 1994, Table 2.1), to which Mongolia may be added. Part of the change derived from the emergence and expansion of private entrepreneurs and farms, part from the privatization of State enterprises and decollectivization, and part from the entry of foreign firms into production and trade.

The speed of conversion to a market economy varies from rapid to deliberately hesitant, but the average pace is historically quicker than in any but war conditions—a term appropriate also to the transition from a market to a command economy under communist parties in the Russian Federation, Eastern Europe and Asia. The much earlier transitions into capitalist societies were never of a “shock” character. In Western Europe it took a century or more. Only Japan after the Meiji Restoration and the six dynamic Asian economies (Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand) have shown an acceleration of systemic change close to that of the post-communist States.

This paper begins with an overview of the inheritance from the Soviet-type system, and successive sections consider the transformation of the banking mechanism, property rights, the public accounts, and external financial relations.

## 2. The inheritance

### 2.1 The institutional environment

The traditional Soviet-type economic system is best

described as one of centralized planning, implemented administratively through the issue of direct commands and extensive detailed instructions. Subordinates provide information and suggestions that may greatly influence commands, yet in principle they have little autonomy in determining what to do, or even how to do it (Ericson, 1991, p. 12). The size is overwhelming; the State owns all natural resources (land and minerals) and almost all reproducible capital (buildings, machinery, equipment and inventories), and conducts virtually all activity in industry, mining, construction, transportation, wholesale trade, communications, health, research and development, and education. The Soviet State and collective sectors together produced over 88 per cent of the value of final output in agriculture in 1986, controlled 98 per cent of retail trade and owned 75 per cent of urban housing space. Central control and the priorities of the political leadership were maintained through a vast and complex structure of overlapping administrative hierarchies that gathered information, disseminated instructions, coordinated interactions, managed change, and monitored, commanded and enforced performance through agencies and branch ministries.

Commands, generally based on outdated information, became increasingly unrelated to each other in the process of disaggregation and elaboration. Operational units responded to assignments by requesting capital and material resources, thus revealing some information about their capabilities, much of which was again distorted in aggregation back up the hierarchy. All this involved extensive bargaining, as the central authorities strove for maximum performance with threats of punishment, while subordinates sought easier tasks by pleading incapacity.

## 2.2 Financial planning

Alongside the planning of all physical economic activity ran a parallel process of financial planning. The Ministry of Finance drew up the State budget, while the State Bank drew up the credit plan, cash plans, the balance of incomes and outlays of households, etc. As already noted, money had a very limited role, that of facilitating planned economic activity. Within the State sector it was merely an accounting entry in the books of the State bank. Money was only used physically for interaction where the non-State sector was involved—in particular for wage payments and for consumer purchases.

Prices had a limited and passive role—used primarily for measurement, and accounting and control purposes. Prices, wages, and salaries were administratively set and controlled by hierarchies, according to location and subordination of the user and intended use, and remained fixed for a long time. Commodity prices were generally set on a cost-plus basis, and included planned profits, commodity-specific turnover taxes, and handling charges. They were meant to cover average costs of production in each branch of the economy, so that enterprises might be “self-financing”.

The Soviet-type State enterprise had more of a communal focus than a company has in market economies. Health care, training and recreation were often provided for employees, and costs were usually computed so as to cover such services. Part of profits—or of authorized losses—was allocated to a fund which went under various titles (e.g. in the USSR, successively the Director’s Fund, the Enterprise Fund and the Incentive Fund). These funds provided premium payments to managers and staff, funds for small capital works, subsidies for social facilities, and loans and grants to needy workers. The latter provision was needed because social security was predominantly enterprise-based through the trade unions, and loans through the savings banks were only for limited and specified purposes (such as house-building or buying consumer durables).

Under what could be described as the “classic” Soviet-type system, the profits plan of a State enterprise was reviewed every year. Like other constituents of a State enterprise’s overall plan, it derived from a set of targets and allocations mostly designated in physical units. Finance by itself was not a constraint. If investment was authorized during a plan-year, profits not otherwise earmarked were allotted to contribute to such outlay, any shortfall being met by a capital non-reimbursable subsidy. Profits which were earned in excess of authorized outlays had to be returned to the budget. In this way, investment was maintained under central control and aligned with the physical quantities of capital goods required.

Prices were not set to equate supply and demand; the automatic subsidization or taxation of enterprise funding did not allow them such a role. Nor did they faithfully reflect costs for two main reasons: one ideological, the other operational. First, under the influence of Marx’s analysis of value, production costs represented the cumulative expenditure on labour: no charges were made for capital, land or entrepreneurship; moreover,

the central control of employee and management remuneration meant that payrolls did not represent the opportunity cost of labour. Marx asserted that value was created only by “living” labour (i.e. current wage bills) and by the replacement of the “embodied” labour of fixed and working assets (i.e. capital consumption). Based on this argument, no return was payable with respect either to capital (other than as depreciation), or to land. Private owners of capital and land received payment only from the return to labour. Second, the State-determined prices underlying production cost were rarely adjusted as supply conditions changed: the very number of goods and services (24 million individual products were reported in the USSR in the 1970s) and classes of wage (by skill, experience and branch) made such overhauls a major bureaucratic task.

That system was very good at mobilizing scarce resources and concentrating on a few clear, well-defined objectives that could be expressed in measurable, quantitative, and communicable terms, and could yield large observable changes as outcomes. Programmes in which the human and other costs could be ignored, such as the building of major heavy industrial capacities (1930s to 1950s), the collectivization of agriculture (1930s), the postwar reconstruction of industry, the development of an unprecedented military-industrial complex (1960s and 1970s), were all examples of this effectiveness. The system required subordinates to make decisions that had a wide-ranging impact on the capabilities, operations, and costs of other organizations, in ignorance of opportunity costs and in pursuit of (sometimes misunderstood) objectives of superiors. Feedbacks and fine-tunings were blocked by the inflexibility of planning.

### 2.3 Payment systems

The payment systems in the ex-command economies were inherited, being designed to fulfil the requirements of planned economies, had no urgency in executing transactions. A present consequence is that—at least in the former USSR—money transfer between banks can take several weeks, involving huge implicit interest costs, complicating banks’ liquidity management, and weakening overall control over money supply. Due to lack of automation and inadequate telecommunication facilities, payment systems are often manually based. Settlements between the Russian Federation and other CIS countries are reported as taking months.

The credit float is generally maintained on the books of the bank which initiated the payment. However, the near absence of money markets makes it difficult for the banks to take advantage of the float.

### 2.4 The fiscal system

Because, under the Soviet-type system, the government owned all industrial and agricultural property outside the collective and small household sectors, surpluses extracted from enterprises—and also from households, indirectly—required little codification in formal tax law. There was no need for a formal sales tax as prices for all goods could be set as high or as low as the government desired, and all enterprise surpluses simply reverted back to the State. Thus luxuries could be highly priced, and essentials could be priced as low as the government desired. Similarly, there was no need for personal income taxes; the State owned all the capital stock, set the limits for all wages and salaries, and the enterprises, as agents of the State, could withhold any proportion of household income at source. Depreciation of capital stock was unnecessary, and the State simply authorised all new capital investment by recycling funds to enterprises. Uncertainties remained in the system however; these stemmed from variability in the technology, availability of inputs, unknowns in inventory accumulation, and the lack of information in general and the intentional distortion of reported information—all of which made it difficult to predict enterprise cash surpluses. Not being allowed to hold cash or a bank balance from one accounting period to the next, enterprises accumulated what they had control over—physical assets and inventories—and falsely reported inputs and outputs.

### 2.5 Accounting systems

A precondition for capital market efficiency is the existence of a sophisticated accounting infrastructure (Lee, 1987, p. 75). Accounting systems in the centrally-planned economies have been rather unsophisticated, because there was no need for such sophistication.

The Soviet-type accounting system had three subsystems: (a) a financial record keeping dealing with assets, liabilities, revenues and expenses; (b) a statistical record keeping for aggregate economic data, such as volume of production, costs of production, productive capacity etc.; and (c) an operational-technical record, physically monitoring the movements

of materials and products within the plan (Enthoven, 1992).

When the State owned virtually everything, the State was stockholder as well as creditor; hence, financial reporting was geared to the needs of the State, which required information for planning purposes. Accordingly, the notion of profit was meaningless, because profit is a function of property rights—it is the means of dividing the value added between different stakeholders where these are separate from the enterprise (including the government within mixed economies). Uniformity was the order of the day, and inter-organisation transfer was dictated by the needs of the State. Consumer sovereignty was replaced by consumer choice among the goods and services which planners made available; hence, consumers were not among the stakeholders as would have been the case in market economies.

Command-economy accounting systems are similar to government accounting systems in the Western market economies. In making that comparison, it must be borne in mind that such practices are themselves changing. Practices have two stages, one of data collection about resource use and the other setting targets and standards. Stage one consists of resource accounting methods of financial reporting, which acts as a precursor to stage two; the latter is a system of resource budgeting for the annual spending round. Traditionally the cash basis was used in the West for government accounting, as it was in Soviet-type economies. This basis does not use the accruals concept, and recognizes revenues and expenses when received or paid. Calculating profit is a condition precedent to the sharing out of the value added among interest groups. Under the cash basis of accounting, profit cannot be calculated and therefore does not come into question. Accounting and reporting are meant to supply data which can be summarized to provide a condensed view of the aggregate activities of the enterprises region by region and for the entire economy. In order to facilitate this, uniformity is essential, and accounting policies and bookkeeping procedures are laid down in every detail. Enterprises are treated as “branches” of the central administration.

Because the State is the only provider of capital, and the banks are also owned by the State, the commonly recognized distinction between debt and equity in market economies is not prevalent in command economies. Funds flow and cash flow statements are the core, with groups of assets and sources of funding matched in a

balance sheet layout. Thus investment in fixed assets is funded by funds allocated for this specific purpose and made up to the authorized amount with retained earnings. Social funds are formed to provide material incentives for staff and social welfare. Assets related to these funds (usually specific bank accounts) are used exclusively for the purposes for which funds are set up. Land does not appear in the balance sheet, because the enterprises do not own any land. All ownership of land is vested in the State. Valuation in the command economies was influenced by the Marxian labour theory of value.

**2.5.1 Valuation bases.** Because the Soviet-type system did not utilize the market mechanism, market value is not relevant for valuation purposes. Valuation is based initially on historical book value, subject to infrequent nation-wide revaluations of capital assets to replacement value; depreciation is based on the straight line method, and often on asset lives assumed to be very long. Because obsolescence due to changes in demand and in technology were not recognized in earlier Soviet practice, accelerated depreciation was late in coming. Know-how and goodwill went unrecognized, because know-how is a function of private property (of an intellectual type), and goodwill is a function of an addition to market value. Intellectual property in the basic Soviet-type system did not exist as an entitlement, but all countries using the system made provision for rewarding inventors and innovators.

Budgeting and planning were influenced, if only marginally, by local managers; production decisions followed closely from a central plan; wholesale and retail prices were established centrally; reproducible assets and land were not owned by the enterprise; and the generation of profit was largely beyond the control of management. Comparability in accounting was of greater importance than significance to operation. With the exception of the banks—which were owned by the State—the sole user of financial information was the State. It was hence necessary for receipts and payments to be totalled only on an annual basis to determine the amounts to be retained, surrendered or met by subsidy. As countries moved towards Western practice, as in Hungary and Poland, a monthly profit and loss account was compiled, principally to report turnover tax payable.

For imported materials and machinery, the book value was the domestic wholesale price or the foreign price multiplied by the official exchange rate and, in later years, a coefficient which effectively constituted one of

a set of multiple exchange rates (see subsections 6.1 and 6.3), enforceable because of the government's monopoly on foreign trade and payments. Inventories and work in progress are valued at full cost. Provisions for expected losses are uncommon.

Because of differences in accounting methods between the market and the command economies (notably in the field of income recognition, provisions for unpaid accounts and contingencies and valuation methods), joint venture partners had to have special treatment while Soviet-type practices were in use. Other issues were the non-convertibility of local currencies and restrictions on profit and capital repatriation. A frequent procedure was to restrict profit repatriation to a proportion of the joint venture's own foreign currency earnings (OECD, 1991).

## 2.6 Financial data for monitoring performance

Because data were produced as a by-product of the planning process they incorporated a number of qualitatively known biases. Enterprises had an incentive to distort reported outputs either upwards to indicate the achievement of plan targets, or downwards where targets had been overfilled, to restrain any rise in subsequent target outputs. One way of manipulating measured quantity and price changes was to modify the product—or its quality. As prices did not clear markets, the difference in price between the old product and the new was not a reliable basis for measuring quality change. This left the enterprise free to say that the new product was substantially better than the old, thus overstating output growth and understating the price increase. In a certain sense the practice was equivalent to the manipulation of stock prices and earnings per share in capitalist systems, which are motivated and driven not on output targets, but on stock price performance.

The “multiple” artificial exchange rates used introduced an arbitrary element into the combination of figures for domestic output—or absorption—with figures for imports, exports and international factor payments. Indeed, the use of inconsistent crossrates within the Council for Mutual Economic Assistance (CMEA)—which was feasible because the implied arbitrage opportunities could not legally be exploited—made it impossible to establish a consistent trade matrix for the region. These issues are further developed in subsection 6.3.

Opportunities for bias arose at the aggregate level from methodological change, (for instance from the inflation adjustment of inventory appreciation), and from incompletely documented methodological changes (analogous to some Western governments “massaging” unemployment and inflation figures by changing the basis of calculation). For statistical purposes, “list prices” were used that—even more than in a market economy—could deviate from transaction prices, especially on black or grey markets.

Soviet-type economies drew up their national accounts on the Material Product System (MPS), although in the 1980s Hungary and Poland conformed to the System of National Accounts (SNA). The production boundary for Material Product is drawn so as to incorporate only economic activities which give rise to tangible products (hence the term “material”) and services for their physical distribution to consumers (such as freight transport, storage and sale to final users). So-called “non-tangible”—or “non-productive”—services (such as passenger transport, personal services, banking, insurance, health care, education, scientific research and the welfare derived from housing) were perceived as being remunerated from a “redistribution” of Material Product, but not as part of it. The difference between Net and Gross was depreciation under each concept, but in MPS only depreciation of assets generating Material Product; assets generating non-tangible (nonproductive) services, such as schools, hospitals and housing, had their depreciation charged as “redistribution”. The divergence of National from Domestic Product in SNA was paralleled—though not precisely—by that between Material Product Distributed and Material Product Produced. In policy terms, the use of Net Material Product (NMP) to measure growth for planning and reporting purposes, led to a certain neglect of “nonproductive” activities. Introducing the SNA in countries which formerly used the NMP approach is a major undertaking in that it involves changed concepts, and changes in the methods of data collection. In a fully planned economy every enterprise had its targets and had to report their fulfilment—or otherwise—and, given a set of prices, these figures could be summed to obtain national totals. In a market economy, although all large corporations have to file accounts for shareholders, and all enterprises for the revenue authorities, neither is an appropriate form for national accounting. Much reliance is placed on surveys of enterprises and sectors, on the basis of occasional censuses of the relevant populations. Newly emerging private enterprises in

transitional economies are similarly required to register, and the register provides a potential sampling frame for survey-based statistics. In practice, however, there is inadequate compliance with the registration procedure and the machinery for conducting sample surveys is not fully developed, particularly in the case of very small enterprises. The rapid changes in relative prices—as well as in product design and quality—during transition also complicates before and after comparisons of output. For example, a given reduction in military output reduces total output much more if valued when military procurement was large than at the low prices implied by the difficulty in disposing of production, much of which may be accumulated in inventories (EBRD, 1993b, p. 105). This inventory accumulation problem is just as true for civilian output which, after the end of a sellers' market, proved unsaleable following liberalization.

Conventional forecasting in developed market countries depends not only on relatively reliable data but also on relatively stable relationships between economic variables. In this respect transitional countries encounter abundant problems. The behaviour of individuals as consumers, workers and entrepreneurs cannot be foreseen on the basis of past relationships. Adaptation can be a very lengthy process. Private entrepreneurs have incentives to hide private activities, and to avoid paying taxes or social security contributions, meeting legal standards such as minimum wages, or conforming to health and safety standards. In established market economies such practices are associated with the "black economy".

Financial reporting to the State as owner, differs from reporting to private proprietors. In "individualistic" countries such as the United Kingdom and the United States which are stock-market oriented, the maximization of stockholder wealth ranks highly among enterprise objectives; hence, reporting is geared to the needs of primary users such as analysts, current and potential investors, lenders, employees and suppliers. In Germany and Japan, which are not security-market dominated, financial reporting is geared to the needs primarily of banks, creditors, and employees, and secondarily of shareholders among whom banks are major stock holders and lenders at the same time, which is not permitted in either the United Kingdom or the United States.

The financial reporting function is geared to the needs of the major supplier of resources with whom the organization operates. In the UK-US situation, the capital

market provides the finance; hence, the reporting function is geared to the needs of the investing community. In Germany, Japan and Switzerland, for example, the banks are the major suppliers of capital; thus, creditor protection comes before any other function of financial reporting. In command economies, the State provides the finance and all other resources—the needs of the State in the form of uniform information is the predominant function of reporting.

## 2.7 The financial inheritance

The State bank usually had a near monopoly over banking and credit. Yugoslavia, which did not conform to the Soviet-type system, allowed banks to be owned by enterprises. The "monobank" had unlimited capacity to create bank deposits. The State bank and its State-owned affiliates operated the "active" and the "passive" financial circuits already described—the one served the household sector which received personal income in cash, and the other served enterprises which required only book entries showing the credit or debit accumulated. Banks had little incentive to allocate credit on a commercial basis, and penalties for non-payment by enterprises were few. Because of the close links between the enterprises and the banks, the banks were effectively the treasury departments of the enterprises.

The role of the monetary system was to finance the production plan. The physical plan dictated the financial plan—which was broken down into a budget, a credit plan, and a cash plan. Interest rates and exchange rates had no allocative role. Credit was extended to enterprises at low fixed interest rates without any consideration of risk or maturity. Enterprise surpluses earned little or no interest, and balances could not be carried over without higher authorization. As already noted in subsection 2.4, enterprises did not accumulate money balances but real assets, such as inventories, plant and equipment. The old system left no role for profits as a motivating factor. Well-performing enterprises found that most of their surpluses were expropriated or heavily taxed, while chronic loss makers found that their losses were covered by subsidies or credits.

The exchange rate was mainly an accounting device to enable conversions between foreign and domestic prices. Bankruptcy was not a relevant consideration, since the ultimate owner of enterprises as well as the bank was the State. Because all bank credit was deter-

mined by the Ministry of Finance and the increment due to Savings Bank depositors could not be re-lent except by the Ministry's authority, the State budget was the ultimate source of investment funds.

The risk-adjusted return from investment was not the main focus as it would be in a market economy, because the definition of risk in a collective society is not the same as in an individualistic society. The terms "accountability" and "checks-and-balances" have a different meaning in the Soviet-type economy and in the market-based system. In the former they relate to a formally-unified plan, and in the latter they involve multiple owners and multiple stakeholders, and, consequently, multiple mini-objectives.

If transitional economies are to be transformed into well-functioning market systems, choices have to be made as to which form of legal structure is appropriate, since western legal models are not homogeneous. Contemporary developed market economies follow one of two basic legal models: common law, and continental (or Roman) law. Common law is mainly used in the Anglo-Saxon sphere of influence and continental law in the rest. While continental law is codified and therefore rigid, common law is based on precedents, and more readily adaptable to change. As the major capital markets of the world converge through deregulation and instantaneous communication, common law—in use in the United States and the United Kingdom where capital market activities are most intensive—is becoming more prominent. Stock markets are a proxy for capital markets. Following privatization, many transitional economies now have bond markets and markets for the newer types of financial instrument (e.g., the Russian Federation oil firm, Lukoil, in March 1995 sought more than \$300 million in convertible bonds and approached the United States Securities and Exchange Commission for approval for an American Depository receipt issue).

In all systems of law, at all stages, except the primitive, there is a constant conflict between two methods of interpretation: the strict and the equitable. The law of a nation expresses, in the long run, the character of the nation, and similarity of legal method corresponds to similarity in other aspects of social life. The fundamental conceptions upon which Roman law is based are not similar to common law. The Romans had, in principle, no case law; the decision of one court did not make a binding precedent if the point arose again. In Central and Eastern Europe and in the former Soviet Union, the legal system is more akin to structured Roman law.

Moreover, market economies are not homogeneous. At least three forms can be distinguished: (a) the UK-US variety, highly individualistic, where shareholder wealth maximization predominates; (b) the Continental variety of mainland Europe, where societal interests are used as constraint on shareholder wealth maximization; and (c) the Japanese variety, where intercompany holdings and State direction of macroeconomic interests are constraints on enterprises. The UK-US variety is seen as short-term performance-oriented, while the others are perceived as longer-term growth-oriented (Corbett, 1987; Miles, 1993; Prodhon, 1993).

Similarly, the non-market economies of those currently in transition were also not homogeneous. There was market socialism of the Hungarian, Polish and Yugoslav type, where some degree of decentralization had taken place and at the other extreme the USSR, where the system was centralized. As to which model of market economy is applicable in achieving market reform in ex-command economies, this is dependent on the starting point, as well as the kind of market reform desired. In general, an adaptive system, where learning is possible from experience, is likely to be the most relevant system, with adequate checks and balances to which the decision makers are subject. All societies are a mixture of public as well as private sectors. There is no country in the world where everything is in private hands. At the so-called "night watchman" extreme, public finance would be restricted to national defence, the assurance of law and order, and the upkeep of institutions for market regulation and for assuring the continuity and representation of the State. Clearly all modern states undertake more within the public sector, guided by considerations of welfare, wealth and income distribution, "merit" goods and market failure, and the only general requirement is having a system flexible enough to be able to respond to changing circumstances.

While the task is daunting because it reflects a range of economic and institutional issues, the critical question posed in this paper is the degree of decentralization which is appropriate in the transformation process. An example relevant to strategic financial management is the procedure for dealing with the transition from centralized funding of State enterprises to financial autonomy. When enterprises, whether State or privatized, can no longer rely on automatic credit for the settlement of mutual accounts, the bonus for viable existence falls on the individual corporation to cover



outlays by receipts, to raise new capital and to negotiate bank or supplier credit. In the sphere of banking, transition can follow one of two paths:

- In the centralized approach, the government takes over all non-performing loans and replaces them with treasury bonds, guarantees or cash. The enterprise debt is taken over by the banks and is then either cancelled or sold off, as are the physical assets of the enterprises. The government might also form a liquidation/restructuring agency whose role can vary from auctioning off of the debts and assets of the enterprises to a semi-permanent agency entrusted with the restructuring of the enterprises. The government could also declare a moratorium on all indebtedness of certain categories—as many in East Europe did after the financial crisis of 1930; however, no government has so far taken such action in this period of transition. This approach has a limitation, that is, the State agency might not possess the necessary insider information on weaknesses and strengths of indebted enterprises and consequently could be unable to discriminate between potentially viable and non-viable firms;
- In the decentralized approach: the role of the government is minimized, and instead is assigned to the creditor banks in cooperation with the enterprises. This requires the design of a suitable incentive system for the creditor banks to take a lead in restructuring the troubled enterprises. Debt restructuring is nudged toward debt-equity conversion to facilitate privatization and to counter the bias inherent in the thin capital markets which characterize the transitional economies. This is more of a conciliation process than outright liquidation. It has some advantages; for instance, the banks are better prepared to collect and process information on clients than any government agency. Furthermore, since the banks have incentives to recover funds, they are likely to have stronger motivation to find workable solutions than any government agency.

It has to be recognized that sound prudential regulation can not be enforced all at once. Vigorous enforcement will strangle the economy at a stroke. An intermediate step which is a distinct possibility is a two-part banking system. One part of the system would be subject to strict norms and supervision, free of inherited bad loans, and de facto cut off from the ailing, subsidized State enterprise sector; in return, it would receive a seal of approval which would enhance its chances of

attracting commercial and household deposits without offering a large risk premium. The other part of the system would continue to serve the enterprises that depend on building up further arrears for their survival, and would become a State agency responsible for financial relations with ailing enterprises. Stock and flow—solvency and liquidity—are related. New loans extended by the banking system may continue to turn into bad assets. The banks' lack of experience with credit evaluation, the absence of—or inadequacy of—collateral laws, cross-ownership between enterprises and banks (this is also true in Germany and Japan, and is not undesirable, as already pointed out), poorly developed accounting rules, weak enforcement of prudential regulation and the uncertainties raised by the transition process have all contributed to the reluctance of banks to end their "cosy" relationships with enterprises. Corbett and Mayer (1991) have argued that the development of monetary and financial institutions in what were then the "reformed" socialist economies had simply imitated without change a few capitalist institutions which may not have been the most appropriate in view of differences in institutional structures between developed and emerging markets.

## 2.8 Sequencing of reforms

A crucial element in sequencing is the speed of transition from loosened centralized administrative planning and control to the creation of macroeconomic controls suitable for a market environment (Roland, 1994; Van Brabant, 1993). Simply invoking the "invisible hand" of neoclassical economics is not enough. It may be necessary to go beyond a decentralized price system by examining the comparative properties of different economic systems under conditions of bounded rationality (Murrell, 1991, p. 62).

Almost everyone agrees that suitable institutional structure is necessary, but there is no consensus on how to create it. While a stable legal framework may be necessary, the existence of such a framework is dependent on a complex web of social traditions and expectations. Speed may be essential, yet this notion must be tempered; this is because measures such as interest-rate policy for macroeconomic stability and for microeconomic self-regulation, must proceed in parallel while the social effects in either field must be assessed. While there is evidence that, at the aggregate level, a liberalized financial system can result in benefits in the form of mobilization of savings, increased

investment, and faster economic growth, there is also evidence that this widens the dispersion of income and wealth, and may contribute to divisions in society.

Both such economic and social effects need political preconditions and have political consequences, which are crucial in deciding on the pace of transition. Elections in 1994 and early 1995 brought the reshaped communist parties into government in Estonia, Hungary, Lithuania, Poland and Slovakia, while parliaments have resisted more reformist governments in Belarus, Bulgaria, Kazakhstan, Kyrgyzstan and Russia. Public support for a “shock therapy” policy could be mobilized—or could be moulded—at an early stage of political change, as was the case for the “shocks” across the board that Poland and Czechoslovakia were able to apply in 1990 and 1991 and the “price shock” that all former Soviet states introduced in January 1992; in the Eastern *Länder* of Germany, public support was in effect bought by exchanging the GDR currency at a valuation some four times its realistic rate. With the exception of that region and of the Czech Republic, the “shock” has been attenuated by easy bank loans, tolerance of tax arrears and poor financial discipline. Gradual reform provides the screening that facilitates the flow of private savings to good firms yielding high returns: while a high-quality loan portfolio enhances banks’ incentives to apply hard budget constraints and extract greater effort, a low-quality portfolio increases creditor passivity, since a bank that initiates bankruptcy proceedings risks revealing its own financial weakness. Moreover, closing insolvent enterprises may be a mistake, since in a distorted economy, it is difficult to know which enterprises should be closed.

Although optimal sequencing of financial market reform is desirable, in many cases these reforms have to be pursued simultaneously. This is inevitable as there are strong policy and operational linkages between the development of inter-bank markets and the development of market-based instruments. The removal of credit ceilings, liberalization of interest rates, prudential regulations, and development of financial and security markets, all can have substantial impact on the demand for money, the money supply process, and the transmission mechanism between monetary policy and macro-economic aggregates such as prices, output and the balance of payments. To minimize the potentially negative social impacts, the steps necessary include adequate disclosure, improvement of information flow, deposit insurance

and loan guarantees. These issues are the topic of the following section.

### 3. Banking reform

#### 3.1 A two-tier banking system

Financial sector reform is part of broader structural reform of the non-financial sector, which is crucial to macroeconomic stabilization. The first important step in the transition of the financial sector is the transformation of a monobank system into a two-tier banking system. The State or national bank assumes the traditional central banking functions, focusing on regulating overall credit and interest rates, and divesting itself of deposit and loan transactions with households and enterprises, which are transferred to newly established banks, as has happened in China in 1984, Hungary in 1987, the USSR in 1988, Poland in 1989, and Czechoslovakia and Yugoslavia in 1990 (Sundararajan, 1990, p. 4).

The objective of the two-tier system is two-fold. First, it establishes a central banking system by separating the conduct of monetary policy from the allocative objectives that are, supposedly, better served by pursuing profit maximization through sound commercial banking; and second, it introduces competition in the commercial banking sector. There have been difficulties in breaking up the former monobank system inherited from the socialist system in a way that stimulates competition. It was hoped that competition would mobilise savings, improve the quality of financial services and reduce costs of the banking sector. In practice, the monobank system was often broken up hastily and in a fashion that did little to further these objectives. Central banking reform allows monetary policy to play a proper role in macroeconomic regulation, influencing interest rates and exchange rates. All lending and deposit taking are transferred to new commercial banks leaving the central bank to take care of its standard banking functions, including management of the currency. Such transformation evokes a host of legal and structural issues. For central banking such issues include the degree of autonomy over monetary policy and supervisory functions of the central bank, and the range of monetary policy instruments and prudential regulations. The detailed credit plan and cash plan are replaced by various intermediate and operating targets of monetary policy, supported by appropriate monetary management techniques—central bank refinancing quotas, bank

specific credit ceilings, reserve requirements, and managing the issue, servicing and redemption of treasury paper.

For commercial banking the policy issues include what should be permissible banking functions (e.g. universal banks, one-stop banks, banks permitted to own shares in corporations, specialized banks), the permissible types of ownership structure of banks, and rules governing their establishment and approval. Other matters are: the size, number and geographical distribution of banks; the sources, type and level of capital required; permissible capital structures; the distribution of non-performing debts; accounting standards and systems; settlement clearing; payment and electronic transfer mechanisms; and staff training for the radically new conditions. The change from an essentially monobank system to a two-tier banking system implies a significant redistribution of power away from government authorities in direct economic management, strengthening the autonomy of the central banks in macroeconomic management. In the early stages of transition the newly established commercial banks find their ability to compete for deposits and loans circumscribed by the concentration of the banking industry, the limited network of branches, and various structural and regulatory impediments.

### 3.2 Interdependence in the banking system

While the purpose of establishing a central bank is to create a stable macroeconomic climate of low inflation, controlled money supply, and a supervisory regime to foster an orderly growth of the economy, the purpose of commercial banking reform is to encourage competition and efficiency to help foster growth in the private sector.

The long-term success of any banking system rests on the two pillars of solvency and liquidity. Solvency of the system implies that the realizable value of the assets is significantly larger than the market value of the liabilities, to the extent that the system can at all times meet its obligations to the depositors. This is the “stock” problem. As the major proportion of assets of the Soviet-type commercial banks had been the loans portfolio (fee earning business being very small), the larger the proportion of doubtful debts in the portfolio, the less was the stock of realizable assets; hence, the less solvent was the system. The importance of solvency extends beyond a single bank, because solvency is a

matter of confidence, and insolvency in any individual bank can create a contagious bank run threatening the solvency of the banking system as a whole. Issues in solvency management include strengthening the supervisory power of the central bank and giving it independence to ensure capital adequacy, minimizing the risk of non-performing loans and reducing unfettered subsidies to enterprises.

While solvency is a long-term problem, liquidity is a problem which preoccupies banks in the short run. Liquidity refers to the need to keep the system liquid and ensure efficient clearing and settlement; this is the “flow” problem. In the initial stages of transition, this problem has been generally resolved via generous refinancing facilities and credit directed by the central bank. Such an excessive preoccupation with liquidity can result in unsound lending practices, and pose difficulties for the design of monetary policy. Liquidity management implies the need for an efficient payments and clearing system, the establishment of efficient capital markets where financial instruments can be traded, an efficient transmission mechanism, and the training of personnel in all aspects of banking.

When banks seek to maximize profits, they are exposed to problems of liquidity and safety. Thus an uncontrolled banking system is inherently unstable. To avoid such instability, there is an obvious need for the central bank to act as lender of last resort. Thus, the two levels of banking—central and distributed—are closely linked. For example, realistic management of exchange and interest rates can help both macroeconomic management, for which the central bank is responsible, and commercial banks by making it possible for them to invest short-term surplus funds profitably and thus improve their liquidity management. Similarly, a reliable loans evaluation system can help commercial banks in reducing their non-performing loans portfolio, at the same time reducing the systemic risk of a run on the banks; both instances help the central bank to achieve monetary stability.

### 3.3 Solvency issues

**3.3.1 Capital adequacy.** In a market economy, the banking system has to ensure that the insolvency of one bank does not entail a systemic risk. Therefore, the capital base has to be large enough to withstand reasonable loan losses and yet permit each bank to keep up-to-date on its payments obligations. There is a general agreement in banking circles that financial inter-

mediation requires “a minimum size”. Given the lack of financial markets with which all transitional economies except the Eastern *Länder* of Germany and Hungary started, most governments imposed a minimum size requirement. In an attempt to flush out a proliferation of smaller institutions “just pretending to be banks”, the Russian Federation Central Bank required from January 1995 a twenty-fold increase in banks’ minimum capital requirement. Inflation had rendered trivial the former threshold of 100 million roubles—entrepreneurs could choose between buying a car or starting a bank. This new threshold of 2 billion roubles will be raised in stages to the equivalent of 5 million ECUs by 1999, which is the present minimum requirement—set in 1994—for banks in the European Union.

A global measure of capital adequacy is provided by the solvency ratio, defined by the Basle Committee of the Bank for International Settlement (BIS), which divides risk-weighted assets by capital (with the latter adjusted to include subordinated debt). Classifying borrowers into various categories (for instance government, banks and others) with a corresponding risk-weighting (zero, 20, and 100 per cent respectively, according to BIS guidelines) banks have to back up their risk-weighted assets with a minimum of their own funds. The Basle Committee recommends 8 per cent for this purpose. This requirement, with slightly modified underlying accounting rules, has been adopted by Hungary and other countries. Latvia, for instance, has introduced special risk-weights for loans in non-convertible currencies.

However, caution is necessary in the application of BIS capital adequacy ratios. For instance, the correct identification of “own funds” is problematic so long as loans have not been audited and adequately covered by provisions. Hence, the first element of any attempt to solve the problem is the auditing of bank assets to classify outstanding loans by quality, in order to facilitate provisioning against potential non-performing assets. Further difficulties may arise in applying the Basle Committee’s guidelines to the banking systems of transitional economies because these guidelines were developed for western banking systems, where the nature of risk and information disclosure requirements are very different from that of the former Soviet-type systems (EBRD, 1993a, p. 14). Moreover, such ratios ignore (a) the correlation of returns between assets, (b) the bank’s exposure to interest rate risk and inflation risk, and (c) information

relating to off balance sheet items (Tirole, 1994, p. 133).

**3.3.2 Loan losses.** In relation to capital adequacy, another serious threat to the banking sector comes from banks being owed large sums of money by ailing enterprises which happen to be their shareholders and may for the first time be allowed to go bankrupt. The threat in this case is the domino effect of bank crashes precipitating business collapses across the economy.

There are three possible ways in which loan losses can be treated in the banking system (Fries, 1994):

“Additional funds granted by the government to the enterprise sector. This is what was done in Romania in 1992, but after some initial improvement, non-payments emerged again and inflation accelerated in 1993. The time to deal with the stock problem is when the flow problem has been reduced to manageable proportions.

“State take over of bad loans from the commercial banks at a discount. In Hungary, the government offered to take over most of the bad loans from the commercial banks at a discount of 20 to 50 per cent. But the banks were reluctant to accept the losses because of their very fragile capital position in 1993.

“Financial restructuring combined with conditional recapitalization of banks. This is what was done in 1993 in Poland where special government bonds were issued for refinancing the banks, with the banks enforcing restructuring of State enterprises. In order to tackle the flow problem and prevent bad loans from re-emerging, it is essential to reduce the number of unsound credit decisions. This implies a radical change in the incentive structures facing bank managers. Where privatization is politically difficult, commercialization of State banks combined with the rapid introduction of prudential regulations and the involvement of foreign banks may result in improved efficiency.”

It is important to remember that private banking is not necessarily good banking. Sound banking is also dependent on sound governance. The development of the legal and regulatory framework, as well as corporatization and the establishment of governance structures, such as responsible boards, should accompany recapitalization. The performance of

private banks depends upon the quality of ownership, the quality of supervision of the banking system and the general business environment.

**3.3.3 *Inter-enterprise indebtedness.*** In transitional countries which have made real efforts to rein back the monetary expansion and strengthen the banks' lending criteria, a common side effect has been a surge in interenterprise arrears (see subsection 4.5.3). In many cases, it has been assumed that the State will continue to pick up the bill as in pre-reform days. This has created a close financial interdependence between enterprises—which has short-term advantages for the enterprises concerned—and has made it very difficult for banks to assess or diversify lending risks.

Commercial banks in the early stage of transition inherited a large portfolio of non-performing loans from the enterprise sector. The legacy of non-performing loans stems from the deterioration in the financial condition of most state-owned enterprises, reflecting major shifts in relative prices—especially energy prices—and declines in the domestic demand for capital goods, as well as import liberalization resulting from a breakdown in the trading arrangements under the CMEA, and a reduction in subsidies to these enterprises.

Furthermore, the ownership structure of commercial banks created additional problems in enforcing payments in that most banks in ex-command economies are at least partially owned by the enterprises to whom the banks have loaned monies. Inter-enterprise indebtedness also makes it difficult for banks to assess or diversify lending risks in the absence of analytical expertise and the lack of sophisticated accounting and disclosure systems.

Inter-enterprise indebtedness is a product of the old system in which goods were traded according to a central plan, and money was an insignificant accompaniment. Thousands of Russian enterprises have been producing goods they are unable to sell and taking delivery of goods they cannot pay for. It is estimated by the Russian Federation's federal bankruptcy agency that, in 1994, this indebtedness amounted to 30,000 billion roubles. As subsidies are phased out, and monetary and fiscal policies are tightened to reduce inflation in the Russian Federation, thousands of factory directors have found a way to evade the government's new austerity by not paying their suppliers and employees. It has also been surmised that corruption, in the form of bribes given to factory managers, induces them to ship goods

for which their enterprises are unlikely ever to be paid. Reformers in the Russian Federation Government concede that these indebted enterprises form a powerful lobby which is pushing for an old style solution: lower taxes, easy credits and a freeze on some prices. Bankrupting these enterprises would be an effective market-based solution, but the social consequences in the short run can be rather unpalatable.

One way to avoid the problem conflict-of-interest in ownerships and the threat of non-performing loans, would be the introduction of limits on lending to shareholders to the equivalent of a small proportion of bank capital. Such limits have been implemented in a number of countries, including, for example, Latvia, where the maximum exposure of banks to any individual share holding entity is 25 per cent of capital (and 50 per cent for a non-shareholder). This lowers exposure, improves portfolio diversification and reduces risk.

**3.3.4 *Deposit insurance.*** Deposit insurance and withdrawal of licences are further measures which the central bank can use in reducing the risk of insolvency in the commercial banking sector. The two principal effects of deposit insurance are to eliminate the risk of a run on bank deposits and of undermining depositor discipline. The elimination of the threat of a bank run enhances financial stability; however, the reduction of depositor discipline, depending on the insured depositor's coverage cap, can reduce financial stability because it provides an incentive for banks to take excessive risks and encourages risk indifference among investors, as happened in United States in the Savings-and-Loan crisis of the 1980s.

**3.3.5 *Withdrawal of licences.*** Another possible supervisory mechanism that central banks can apply to the commercial banking sector is the withdrawal of the licence to operate as a bank. In the Russian Federation, 19 banks in 1993 and another 21 in the first half of 1994 lost their licences for non-compliance reasons.

**3.3.6 *Subsidies.*** To maintain stability in the economy, in most countries under the former system, enterprises were granted generous subsidies by the State. The central bank has to balance the objective of reducing inflation with the disruptions to the financial and production systems which radical reform can cause. The regulatory authorities have to balance the need for efficiency (letting market forces play an active part) with that

of safety (which requires appropriate regulation and supervision). For some enterprises, subsidy reduction and import competition make it impossible to earn a surplus on operations, let alone service their liabilities. There are large portfolios of non-performing loans; and recently, subsidies have been reduced substantially in many transitional States. In the Russian Federation, the decision—not yet implemented—to terminate subsidized credits to all enterprises except for agriculture, coal mining and the biggest factories has meant that companies face a real prospect of closure unless they restructure. In 1994, for example, the Russian Federation was scheduled to spend 10 trillion roubles on coal subsidies, representing almost a tenth of budget revenues. Even there, a World Bank report, details of which reached the press in September 1994, proposed the reduction of subsidies to coal mines from the “clearly unsustainable” 1.4 per cent of GDP in 1994 to 1.0 per cent in 1995, and thence by stages to zero in 1998. Related attempts were being made to force companies to repay the 42 trillion rouble debts that Russian State enterprises as a whole had accumulated with each other by June 1994, in an attempt to cushion themselves against the shock of government policies. In a move to make a clear distinction between lending and subsidies, 6 trillion roubles (3 billion dollars) which started off the year as “credits” earmarked for agriculture were soon incorporated into the 1994 budget as straight subsidies.

In Central and Eastern Europe, governments have had occasionally to recapitalize state—owned banks, and banks have remained liquid, drawing on such refinancing and on the confidence of depositors that emanates from explicit or implicit government deposit guarantees. A switch to selective and explicit subsidies to State enterprises through the government budget rather than the banking system would assist in banking reform, but it is politically difficult to achieve.

### **3.3.7 Interest rate and exchange rate management.**

Until realistic exchange and interest rates are achieved (problems discussed in subsections 4.1 and 6.3), bur-

## **3.4 Liquidity issues**

Resolving the problem of existing non-performing assets does not guarantee that the banks will strive to perform their “allocative” function, or that they will do so prudently. Stock and flow, solvency and liquidity are related. In the absence of an efficient liquidity management system, new loans extended by the banking system may continue to turn into bad assets.

geoning foreign liabilities and foreign currency deposits of residents create large solvency risks for banks, which become apparent when a more appropriate exchange rate policy is adopted. To avoid such insolvency risk, local currency deposits have to yield a higher rate than foreign currency rates, to compensate for the depreciation of the local currency. In the Russian Federation, in 1992 and much of 1993, making money was easy for private banks. They could borrow roubles from the country’s Central Bank at interest rates lower than the prevailing rate of inflation. They could swap these roubles for dollars, sit back while the rouble fell and then use some of the dollars to buy back just enough devalued roubles to repay the Central Bank’s loan. The dollars left over were pure profit. Since October 1993, this is no longer possible, as the Central Bank imposed a positive interest rate, charging 13 per cent per month—double the rate of inflation. It was reported that half the 2,300 licensed commercial banks depended for their solvency on that loophole.

Flexible management of interest rates has proved difficult in the absence of market-based instruments of monetary control. In the old regimes, money and securities markets were discouraged due to the fear that such markets would interfere with the central credit plan. Some preliminary attempts have been made to stimulate treasury bills and inter-bank markets. T -bills were introduced in Hungary in 1988 and in Poland in 1989. The inter-bank markets in most transitional economies remain thin, illiquid and highly segmented. There are uncertainties in settlement systems, lack of high quality paper for trading and absence of liquidity management by the central banks. Other aspects of capital markets are described below.

Problems of liquidity in transitional economy banking are accentuated by:

- the lack of an efficient payments and clearing system;
- the lack of an efficient capital market where funds can be profitably invested; and
- the lack of an efficient loans evaluation system.

**3.4.1 Payments system reform.** An efficient payments system permits prompt receipt of payment and promotes liquidity management. Banks and enterprises can be confident that distant business relations can be safely undertaken. Efficient payments systems are good for the conduct of monetary policy because they eliminate wide swings in the banks' reserve balances, which can lead to difficulties in controlling the monetary base and the money supply.

The clearing and settlement systems for payments in most Soviet-type economies were on a gross (item-by-item) basis with no netting or subclearing arrangements, reflecting the importance of checking the legality of each payment. Inordinate delays in transmitting information bestowed large uncertainties in the amount of banks' clearing account balances, distorted monetary statistics and prudential returns. Reliance on cash transactions and the slowness of inter-bank transfer is not only a brake on economic recovery during transition, but facilitates fraud and crime (see below).

**3.4.2 Capital markets.** The surplus funds stemming from an inefficient payments and clearing system could not be invested profitably in the absence of an efficient capital market, including markets for treasury bills. Further, most borrowers do not have track records, and systems and procedures within the banks are poorly developed for loans evaluation, all of which result in accumulation of doubtful debts from newly-granted loans, or in sing out on promising new prospects.

### 3.5 Competition and supervision

The replacement of monobank systems with two-tier systems of banking separated central banking from commercial banking. Such deregulation requires supervision for an orderly functioning of the system.

The growth of the Russian Federation banking since the break-up of the old Soviet Union's State banking monopoly in the late 1980s has been prodigious and virtually unregulated. With 71 per cent return on equity in 1993, banking was probably the most profitable sector of the Russian Federation economy. Benefiting from wild currency fluctuations, high inflation and, until recently, extremely cheap central bank credits, banking in the Russian Federation has been tantamount to "a licence to print money". But the boom days may be over as the Central Bank has begun to charge high positive interest rates on loans to commercial banks intended to support industry,

agriculture and the Russian Federation's northern territories. By the summer of 1994, the Russian Federation interest rates had swung from being sharply negative in real terms to being among the highest real rates in the world. On 1 August 1994 the Central Bank reduced the rate at which it lends to commercial banks from 12.9 to 12.5 per cent per month; inflation in July 1994 was estimated to have been 5.1 per cent.

As the Russian Central Bank comes to grips with banking supervision and responsible monetary policy, the country's 2,300 commercial banks may finally be embarking on a transition from a Wild West free-for-all to competition, consolidation and regulation. Russia was not alone in bank proliferation. The small Baltic States have large numbers of banks for their size: in mid-1993 Estonia had 22, Latvia 57 and Lithuania 23.

The presence of foreign banks can exert a certain financial discipline in the banking sector of transitional economies. In June 1994, President Boris Yeltsin gave up attempts to keep western competition out of the domestic market and reversed restrictions on half a dozen western banks licensed to set up full banking subsidiaries in the Russian Federation. The licences, issued by the Central Bank almost a year previously in an attempt to attract western investment and banking know-how to the Russian Federation, had been effectively frozen under fierce pressure from some powerful Russian Federation banks. But, in addition to bringing in foreign banks to raise standards through increased competition, the Russian Federation Central Bank has begun to turn to the task of restructuring and monitoring the health of domestic commercial banks.

Progress in banking supervision has been slow due to weakness in legislation, the time required to adapt the traditional accounting concepts to the needs of a market-oriented economy, and the scarcity of personnel with adequate training. Apart from the fact that most clients do not have a track record, many standard tools for assessing the credit risk do not apply in the Russian Federation, and violence is unfortunately often used as a method of eliminating indebtedness and exacting payment. The companies which can readily raise bank finance in the Russian Federation are involved in trading the Russian Federation's more lucrative exports. It is easier to start with exporters, with the objective of encouraging manufacturers, because assessing the viability of an export prospect is less time-consuming and less technical than for a manufacturing process. The main hope of harnessing banks to economic growth is for the authorities to persevere in

their new-found financial orthodoxy, while making it easier for banks to lend money to companies—for example, by improving courts' ability to handle commercial disputes. Meanwhile, the Central Bank, whose own irregular practices were revealed in an audit in 1992, faced the prospect of external supervision of its own activities. A supervisory council to monitor the performance of the Central Bank has been proposed in the draft of a new law which will circumscribe the previously erratic behaviour of the Central Bank, with a view to rendering it more responsive to macroeconomic objectives.

### 3.6 Bankruptcy reform

Banking reform requires the existence of a bankruptcy law to ensure that failure to repay loans does not threaten the existence of the banks themselves. Therefore one of the prerequisites of liberalization is the existence of a bankruptcy procedure so that market discipline can be applied in an orderly fashion.

The goals of bankruptcy legislation can be said to be:

- the imposition of market discipline on enterprise managers;
- the specification of the priorities of claimants on the enterprise's assets in case of default, thus allowing property rights to be discharged in an orderly fashion; and
- as a by-product of the preceding two goals, an efficient allocation of societal resources.

In the transition period when many of the enterprises are State-owned, bankruptcy reform is difficult to implement at a stroke; hence it is applied mainly to small-scale enterprises to minimize political disruption in society. Governments of transitional economies are considering some variant or other of the bankruptcy laws in existence in the established market economies. Bankruptcy laws in the market economies are of two types: creditor-oriented and debtor-oriented. Until the last quarter of the twentieth century bankruptcy laws have been primarily creditor-oriented to maintain stability in the credit system. Thus, if the borrowing organization failed to discharge interest or capital payment in time, enterprise assets were sold, and the proceeds distributed among the creditors according to priorities specified in the debt covenant. Variants of this procedure are US and UK receivership laws, and French administrative procedure.

More recently, penalties imposed the systems described above have come to be seen as harsh, especially when a period of respite could allow a defaulting enterprise to be reorganized, whereby all claimants might be better off in the long run. The United States Bankruptcy Reform Act of 1978 (Chapter 11) is the forerunner of this concept, and many of the Western European market economies are adopting variants of this version. In this system, the managers organize structured negotiations between various groups of claimants. However, the bargaining process can become cumbersome and lengthy, and abuses do take place when bankruptcy is seen as benefiting managers and lawyers at the expense of various stakeholders.

The choice of an ideal bankruptcy law in emerging market economies is difficult, yet some form of bankruptcy law enactment is essential if market reform is to take place. A balance has to be maintained between market discipline and societal welfare, especially where large numbers of employees are likely to be made redundant as a consequence.

Developments in Poland and Hungary are two examples of bankruptcy reform attempts. Poland has opted for a softer approach while Hungary has gone for the harsher approach of bankruptcy and liquidation. In Poland, there were about 2,000 troubled companies in 1992, accounting for about 40 per cent of the total loan portfolio of the nine State-owned banks. Each bank was expected to take a lead in restructuring about 200 to 300 of these troubled enterprises (Dhar and Selowsky, 1994). This conciliation process required the banks to solicit reorganization proposals from other creditors—besides investors—and from management. If reorganization was not possible, liquidation was proposed as a final resort. For organizations that were too large, an intervention fund was established to minimize the macroeconomic impact, particularly on employment. Hungary on the other hand, has initiated the use of bankruptcy as the central mechanism for conflict resolution between banks and enterprises. A strict bankruptcy procedure was initiated in 1992 requiring enterprises to file for bankruptcy or liquidation if they were in arrears on any of their debt for more than 90 days. Out-of-court settlements minimize litigation costs. As of September 1993, more than 5,000 bankruptcy and 16,000 liquidation proceedings were outstanding.

A properly functioning bankruptcy code is the ultimate form of sanction against inefficiency and involves minimal government intervention. Except in Hungary;



bankruptcy laws remain weak and unenforced, and have little impact in imposing financial discipline in most transitional States. This has been the case not only because of limited capacities of the courts and the scarcity of skilled personnel, but also because of the concern that unfettered mass bankruptcy would create huge human costs and political unrest in the countries concerned.

### 3.7 Legality and financial governance

Without legality, any shift away from central planning toward market allocation may lead to economic decline, inflationary pressure and a polarization in income distribution, which in turn could unleash political reaction against the reform process. Legality is associated with the rule of law as opposed to the discretion of leaders. Research in economic history has emphasized the importance of the rule of law in explaining economic development. The rapid economic growth of 17th century England, for instance, was brought about through political change that allowed the property-owning bourgeoisie to limit the discretionary power of the sovereign. This process of institutional development is the product of a complex interaction of cultural, political, and economic variables (North, 1990).

Legality is based on a mutually consistent set of laws, an independent judiciary and the people's belief in the stability and enforcement of these laws. Economic legality refers to laws in the economic domain, examples of which are contract, tax, and bankruptcy laws. Enforcement of completely unfamiliar laws can be difficult. Even if formal rules may change as a result of political or judicial decisions, informal constraints embodied in customs, traditions and codes of conduct are much more impervious to deliberate policies.

In command-type systems, the discretionary power of officials over subordinates, enforced by the political dictatorship of the Party, and the reputation effects from personal and often long-run ties were fundamental to decisions and therefore to concepts of legality. The administrative hierarchy was the equivalent of the market system in coordinating economic activity. The administrative allocation of resources revolved around the annual material-balance plan, which emerged through extensive bargaining between various levels of hierarchy. Superiors had the overview, but no detailed knowledge, while subordinates had the detailed knowledge but no overview. Bargaining was conducted

around this asymmetric information base. Marginal adjustments were made on the base of the previous year's plan. Virtually every organization had an individual whose main task was to foster informal links with other organisations in order to help in the bargaining process in obtaining supplies or amending budgets and targets (Litwack, 1991, p. 80). The regime did not consider itself bound by the law; indeed all institutions, courts, enterprises and information media were all subordinate not to the government, but to the highest authority in the Party, its First Secretary. A tenuous although possible example of this attitude is manifest in the event that so far the Russian Federation has been unable to come to any arrangements over the 26 billion dollars it owes foreign commercial banks because of its refusal to accept that a bank should be able to seize State-owned assets in the event of default. The foreign debt has elsewhere generally been settled (see subsection 5.3).

In considering legal reform, one of the largest problems is that of consistency in the face of hundreds of thousands of decrees and regulations of the previous regimes. A psychological difficulty in transforming to a market economy is the inheritance of a belief from Marxist ideology that "property is theft"; indeed (as examples in subsection 4.6 show) it often is. Many of the new rich have acquired their properties through influence or bribery. In countries where until recently most forms of private business were deemed criminal, any successful business person is often deemed to be a crook. Changing people's perceptions takes time. Transformations to market economies will continue to remain fragile until most citizens believe that the market delivers the goods to most people most of the time.

The model of a market economy which is being promoted in transitional States assumes that an efficient equilibrium can be achieved in a competitive environment. But competitive prices are not sufficient when information can be used to further an agent's welfare or where information transmission is ineffective or costly. In a world of product differentiation—achieved in a market economy—consumers gain from increases in variety, but economies of scale limit the number of varieties. The competitive market solution is based on two main concepts: (a) producer efficiency resulting from competition and the good use of factors of production, and (b) consumer sovereignty whereby consumers exercise choice in what they buy and attempt to maximize their consumer surplus. To measure the net welfare gain, a comparison needs to be made between

(a) the bureaucratic costs of organizing the production of many varieties, and (b) the ability of the market economy to produce the correct balance between economies of scale and variety.

While the “invisible hand” paradigm commands a powerful position in competing visions of economic reform, factors ignored in this paradigm include lessons of informational economics (Stiglitz, 1989), the links between ownership systems and the viability of coordinating mechanisms (Kornai, 1990), and an understanding of evolutionary economics.

One of the main thrusts of reform is to construct incentives for and constraints upon enterprise behaviour that will produce better performance than that achieved under a command economy. In the long run these incentives will depend on the nature of capital, product and labour markets external to the individual enterprise, on internal governance and reward structures, and on the interaction between these internal and external forces. In the meantime reformers face management, workers and unions whose attitudes, skills and behaviour have been conditioned by incentives and constraints inherited from the administered economy (Mayhew and Seabright, 1992, pp. 105-106).

In the analysis of transition, enterprise adjustment hinges on the extent to which the incentives of enterprise managers have changed. If incentives have changed decisively in the direction of market-driven ones, then the market tests of profitability and insolvency to judge the progress of the system can be used. Instituting a price system through the market allocation of resources, the deregulation of enterprises and private ownership of enterprises need to be supplemented by an appropriate mechanism to give to owners and creditors some control over enterprises (Carlin and others, 1994). Without such a mechanism for enterprise control, enterprises without owners, operating in a society without effective laws, can easily allow managers to privatize the gains and socialize the losses.

Enterprise control in the former command economies was not uniform. To encapsulate subsection 4.5.2 in a few words, in Hungary managers had control, in Poland the workers’ council, in Czechoslovakia the state, and in the Russian Federation the managers, followed by the workers and then the ministries. Enterprise governance in a market economy requires a measure of external influence, for instance by stock

markets and banks. As stock markets are essentially oriented to short-term results, banks are probably the preferable alternative (Phelps and others, 1993).

A profitable firm is a collection of assets that yield higher earnings when managed together than when managed separately. The question of whether the economy’s overall management of its assets is efficient can be broken down into a series of subsidiary questions:

- the asset bundling question is the choice as to which assets are managed together an efficient choice;
- the management question;
- the ownership question; and
- the social welfare question.

In economic markets, values are attributed to physical and property rights in goods and services or to the performance of agents. Measuring and enforcing agreements in political markets is even more difficult. What is being exchanged—between constituents and legislators in a democracy—is promises for votes. The speed of economic change is a function of the rate of learning, but the direction of that change is a function of the expected payoff’s to acquiring different kinds of knowledge. It is the mixture of formal rules, informal norms and enforcement characteristics that shapes economic performance. While rules may be changed overnight, the informal norms change only gradually, and it is the norms that provide legitimacy to a set of rules. Transferring the formal political and economic rules of successful developed market economies to those in transition is not a sufficient condition for good economic performance. Both institutions and belief systems must change for successful reform, since it is the mental models of the actors that will shape choices.

Issues of strategic financial management merge into those of property rights—to which the following section is devoted. The attitude of the individual towards power and law is an important determinant of such rights. For instance, for a Russian, power has been more authoritative than law.

Over the centuries, the overwhelming majority of Russia’s population had practically no property, and whatever it had could be removed at any time by the arbitrary order of the authorities. Nor could contractual law develop, since the right of property is at its core (Vasilev, 1993, p. 73). It should be no surprise therefore that the financial and industrial groups emerging today are very often based on kinship or

friendship. Amid these vaguely defined patterns of property and contractual relations, bribes seem quite a natural instrument. It is against such a background that the States longest bereft of a market—the successor States of the Soviet Union—are undertaking a vast enlargement of the private sector, of which divestment by the State of most of its assets is the crucial element, as the next chapter describes.

## 4. Property rights and micro-economic governance

### 4.1 The politics of ownership concentration and dispersion.

During modern times in only one socio-economic system—the Soviet-type system—has the government nationalized the ownership of productive assets to protect and implement its political monopoly. Governments of market economies in wartime and totalitarian regimes in their fortunately-truncated tenures of power, have imposed all-embracing controls over the employment of such assets; these governments applied coercion and asset confiscation to enforce such control, but did not arrogate to themselves the entirety of ownership: the facility of private ownership was not withdrawn. In Soviet-type practice, by contrast, a crucial reason for the nationalization of land and of virtually all productive assets was to eliminate all forms of decision-making potentially hostile to the government; the other key factor was, of course, the execution of the Engels' directive cited at the beginning of this paper, "turning the means of production into State property" for "the conduct of the processes of production".

The political argument for extensive divestment by the State rests on three aspects of countervailing power. The first aspect fosters the establishment of civil society,

"that set of diverse non-governmental institutions which is strong enough to counterbalance the State and, while not preventing the State from fulfilling its role of keeper of the peace and arbitrator between major interests, can nevertheless prevent it from dominating and atomizing the rest of society" (Gellner, 1994).

The second aspect holds that

"if the property is in the form of monetary claims, with protection against the actions of

political agents who can effectively destroy capital values through inflating the money issue ... individuals can be made more independent, can be secure in more liberties, in a regime that embodies predictability in the money/goods exchange rate" (Buchanan, 1994, p. 10).

In these two considerations, the degree to which the state is "rolled back" from the model of the command economy to that of the market is to be chosen by the society concerned: the case for a very substantial divestment has been accepted in all transitional economies, even whereas in some successor states of the USSR and of Yugoslavia—the communist political monopoly has been replaced not by parliamentary democracy but by nationalist populism under presidential rule.

The goal of the third aspect is to build a mass constituency of owners whose stake would dissuade them from surrendering it in any systemic reversal. That stake can be obtained in three ways: managers and workers may be given a preference to purchase shares at a rebate; citizens may be given vouchers to acquire ownership rights in companies; or individuals may purchase equity interests. The political element argues for speed and comprehensiveness, i.e. for "shock therapy" rather than for gradualism. Shock therapy attempts to preempt the political backlash engendered by the initial hardships of transition. As a consequence of the widening of wealth differentials within a declining real-income trend, a backlash in some States led to the election of "extremists", including members of the former ruling communist parties. So far, however, no transition to a market economy has been halted, whether or not its parliament or government included advocates of retrogression.

Even before the political revolutions of 1989-1991, a process of transition had begun with the enlargement of the non-State sector and by the introduction of a set of entitlements tantamount to ownership. As a rule of thumb, the larger the non-State sector was, the quicker the early stage of transition was. A non-State sector originated from two sources: some activities remained after the waves of nationalization (around 1918 and around 1930 in the USSR and around 1948 in East and Central Europe and Mongolia), and some arose spontaneously from the mid-1960s in waves of "economic reform" which attempted to establish a "socialist market". Thus land was never nationalized outside the USSR and was farmed, as in the USSR, not only by State enterprises but also by cooperatives and

“dwarfholdings”, while peasant agriculture was never substantially displaced in Poland. The other part of the non-State sector arose from State divestment, of which the most extensive instance found was in Yugoslavia, where, from 1952, state productive assets were vested in the self-managed enterprises in which they were located; in Hungary after 1980 State assets in some small enterprises were ceded to private owners; and in Hungary and Romania from the 1970s, and the 1980s elsewhere, joint ventures participated as minority holders in the equity of State enterprises.

After the 1989-1991 revolutions there remains of course a major role for the State in strategic financial management. More detail is given in section 4.3, but it may be summarized as follows:

“The assurance of a long-term financial perspective for the macroeconomy and of appropriate institutions and instruments (including the budget and a positive real rate of interest) for its implementation;

“Support for industrial restructuring, including for small and medium enterprise and appropriate policies towards international trade and capital transfer;

“A balance between the provision of protection and the promotion of competition in the domestic microeconomy, achieved by means such as taxation and control of bankruptcy, fraud and crime;

“The assurance of adequate research and development in domestic entities, the encouragement of technology transfer from abroad, and the promotion of revenue therefrom;

“The facilitation of resource transfers which support an active social policy, particularly with respect to a desired income distribution and the minimization of involuntary unemployment.”

(Benini, 1994, pp. 10-12)

## 4.2 Entitlements as property rights

Just as the ownership of assets entitles the proprietor to the derivative income flow or utility, the Soviet-type State offered certain entitlements to its employees. Many of the entitlements were the “merit” goods and services distributed by the State in modern market economies, such as free or subsidised education, health care and social security. The Soviet Union itself discriminated in favour of those who were, or had been,

State employees. Thus those who were not State-employed, such as collective farmers, did not have access to free secondary schooling until 1955, social security pensions until 1964 and free health care until 1969. By directing merit goods and services to its employees, the Soviet State both demonstrated its economic priorities (industrial growth, for which agriculture was a supplier of food and labour transfer) and directed benefits (not only social services but, for example, gratis holiday stays) to those who would contribute more effectively to the chosen branches of production by being better educated, healthier and rested on vacation. Such prioritization of production had a serious obverse in that health and safety at work were neglected and the natural environment was badly damaged. Other countries modelled on the Soviet system did not carry the choice of “entitlement” over “merit” that far, but all accorded State employees some preferences over other citizens. Privatization and the “slimming” of government administration (see subsection 5.6) have left gaps in social services which the private sector may come to fill, but not, of course, as merit goods. Thus, in Russia the share of beds in hospitals run by production enterprises dropped from 10 per cent in 1989 to 3 per cent in 1993.

The entitlement to job security, the loss of which is socially disruptive, was formerly regarded as a right. Soviet-type institutions offered a variant of the market-based “wage to effort” bargain. Low work effort and leisure in working time were exchanged for low remuneration. The oft-repeated adage, “We pretend to work and they pretend to pay us”, not only epitomizes such a “social contract”, but the relations of mutual protection whereby workers did not strike and management secured subsidies for wage-bills unjustified by labour productivity and other enterprise losses. The withdrawal of the “right” to job security by involuntary redundancy following privatization can, on these grounds, still be expected to lead to social unrest in the transitional States. So far only Romania and the Russian Federation have significantly experienced that reaction, chiefly among miners.

A corollary to job security was compulsion to remain in a particular post, and all Soviet-type countries experienced some direction of labour, coercion and the use of prisoners for work. At the end of the Soviet-type system all such constraints were quickly eliminated—where they had not already disappeared—but market incentives have not proved adequate to keep staff in what had been low-priority

branches everywhere. Agriculture was one such branch. Many of those who worked on farms left agriculture—particularly because permits were no longer required for urban residence—leaving behind an elderly workforce and farm buildings and machinery unsuitable for agriculture. Consequences have varied; in Albania and Bulgaria many fields remain untilled and buildings and equipment in disuse because of disputes over ownership, whereas in the Russian Federation, collective and State farms have persisted because many of the farmers occupying them believe they cannot obtain the capital and current goods they would need as smallholders. In Romania, so many farmers were the descendants of the original peasant owners that there are now six million proprietors with 20 million parcels of land between them. In all transitional countries the inefficiency of agriculture poses financing problems for governments in the form of low rural tax revenues (narrowing the tax base, as described in subsection 5.1), subsidization (see subsection 5.6) and protection (see subsection 6.1).

As noted in the previous subsection, dissatisfaction with the new uncertainties has led voters in the most recent parliamentary elections in Hungary, Poland, Slovakia, the Russian Federation and Romania to turn in substantial numbers to the successors of the former ruling parties. Unwillingness to be exposed to such uncertainties has been a factor in elections and has resulted in the appointment of presidents in Kazakhstan, Turkmenistan and Uzbekistan who had been leaders of the former republican Communist Parties.

#### 4.3 The economics of ownership dispersion

Diversity of asset ownership allows competitive instead of imperative criteria to be followed in four arenas of microeconomic decision:

- Financial costs and benefits are in principle determined by prices of inputs and outputs;
- Financial resources are allotted between current and capital use by the expectation of return on the latter and the opportunity cost of other uses;
- A loss has to be met out of assets, and, failing this, by bankruptcy;
- Financial resources may be attracted from, or remitted to, foreign entities on the same criteria as for

domestic enterprises adjusted for current and expected exchange rates and foreign government constraints and incentives.

Government may influence foreign participation through fiscal instruments, regulation, treaty, international agreement or association within an economic area. Government influence on the exchange rate needs no rehearsal, but the process of “nostrification”—the compulsory conversion of foreign-held assets into domestic ownership, as practised for example, by the Czechoslovak Government between the two World Wars (Ranki and Tomaszewski, 1986, pp. 7-9)—must be noted as the obverse of the practice in the Soviet-type system of first expropriating foreign assets and then forbidding such property.

Governments and legislatures in the transitional economies are taking measures on five aspects of property rights:

- The establishment of legal forms of ownership and their delineation;
- The protection of—and power to extinguish—property rights with respect to government and business entities, households and non-residents;
- The valuation of assets in two salient cases—mass privatization and market failure;
- The transfer of property rights among proprietors and power over these *pro bono publico*; and
- The control of the use of assets by either local or central authorities and the policing of such use against fraud, crime or illicit monopoly.

Reference is made in the remainder of this subsection only to those features relevant to strategic financial management. As was realised from the start (Kaser, 1990, pp. 600-604), substantial price decontrol was needed before goods and services could begin to be transacted at prices determined by buyers and sellers; its complement was the assurance that the resources so priced be put to their most profitable uses. This process requires a system of institutions that provides a socially desirable internal coordination mechanism, including a complex set of incentives for individuals to respond in a particular way to the information conveyed by the market environment (Frydman and Rapaczynski, 1994, p. 47).

Such a “coordination mechanism” is considered below. Most enterprises have to adapt to receiving and acting

appropriately upon signals received from suppliers and consumers of their products and services, instead of from administrative superiors. The widely-accepted procedure for such a transition is privatization into structures governed by profit-motivated management and incentive-based remuneration for staff: Optionally, the change in ownership can in itself embrace both objectives of governance by providing equity to management and staff, but in all procedures the assets transferred require valuation and financial arrangements for their enhancement or retrenchment. Only one transitional economy—the eastern *Länder* of Germany—has enjoyed sufficient external finance to restructure State enterprises before privatization. The new structure of financial management has to provide for capital funding—essentially asset enhancement or closure—and for current accountancy of costs, revenues and profits; as is noted below, such accounting has been hindered by weak payments discipline and failure to insist on hard budget constraints for newly-privatized and remaining State enterprises.

#### 4.4 Establishment and delineation

As already stated in section 2, a Soviet-type economy commonly vested land and other natural resources in the State and rendered illegal—or subject to punitive taxation—the use of reproducible capital in conjunction with hired labour. There was no uniformity in this field among the countries subject to communist regimes and the transformation of property rights, since the disappearance of those regimes consequentially varies. Nevertheless, three stages can be identified: (a) general legislation authorizing and protecting the establishment and exchange of titles; (b) the recognition and definition of any titles held prior to nationalization; and (c) the procedure for divestment. The more complex the issues of change were, the fewer rights had been left outside State ownership. The extremes were Poland and Yugoslavia, where agriculture (subject to a maximum holding of 50 and 10 hectares respectively) and much small enterprise, remained in private ownership, and Albania, where only personal chattels and rural housing with minuscule plots were allowed.

**4.4.1 The East German property transfer.** The simplest case of transition in this arena is that of the former German Democratic Republic, where Federal German law had only to be applied to the new *Länder*.

The first stage was thus effected virtually at a stroke, with the added advantage that, as valuable as the social entitlements of the GDR had been, those of the Federal Republic were better and funded by the public revenue and borrowing power of that Government. All the legal instruments for proprietorship were thereby put in place as were all the practicalities of transactions, including access to stock exchanges. It is to be noted that since reunification no stock exchange has been established in the Eastern *Länder*—in the light of the likelihood of merging Western *Länder* exchanges, this was to be expected. Furthermore, German membership in the European Union assures a still wider dimension to new owners as part of the single European Market.

The second stage was rendered more complicated by the political decision to recompense landowners in kind (restitution) rather than solely in money or vouchers to buy assets (compensation). Former owners or their legal successors could reclaim property expropriated by the Nazi regime (1933-1945, mostly Jewish), and under the communist government (1949-1989), although within a limit of area. Excluded from restitution were land subjected to an agrarian reform in 1945 and enterprises seized during the Soviet occupation (1945-1949). A law of May 1994 established an 18 billion Deutschemark compensation fund and allowed landowners the repurchase of their property at below market prices. The establishment of title after so long a lapse has meant that judicial decisions on restitution, compensation or rejection are expected to be required for some 15 years, that is to about the year 2005. Claims were registered for 2.8 million property titles; by June 1994, 43 per cent of claims had been settled for business enterprises and 38 per cent for all others. Settlement rates varied, however, by “Land”: Saxony had the highest, with 62 per cent of enterprise claims settled, but Berlin and Saxony-Anhalt resolved 20 and 31 per cent respectively, largely because of the high pre-Nazi concentration of Jews whose descendants have proved difficult to trace. As elsewhere in transitional economies, land registers had been inadequately maintained or lost and many claimants were non-resident.

The third stage was also the simplest among transitional States, for all State property in the GDR was, even before reunification, transferred to a single agency, the *Treuhandanstalt* (in July 1990, on the basis of a holding trust established as early as March 1990).

After reunification (October 1990) all former State-owned enterprises were transformed into joint-stock

companies wholly owned by the Treuhand—the larger into an AG (*Aktiengesellschaft*) and the smaller into GmbH (*Gesellschaft mit beschränkter Haftung*)—or made over to municipalities. Because the subsequent sale of such companies (after restructuring, as described in subsection 4.5.1) was being obstructed by the indecision of “restituted” owners, the Treuhand was authorized by a Law on the Removal of Obstacles to Privatization of Enterprises and for the Promotion of Investment (1991) to sell an enterprise if the former owner did not furnish a business plan equivalent to that offered by another. It was also, by a law on special investments, allowed to make dispositions in important cases without awaiting the outcome of restitution procedures. In both groups, restitution was replaced by compensation. When the Treuhand was terminated, as envisaged, on 30 December 1994, its initial stock of 12,300 privatizable enterprises had been reduced to 67; some 8,600 had been sold and 3,700 liquidated, but the cost was higher than any other transitional economy could have borne by itself (Carlin in Estrin, 1994). The Treuhand had incurred a government debt, held by the Federal Unwelcome Legacy Repayment Fund, of 270 billion Deutschmarks (190 billion dollars), and had imposed 3 million redundancies of an initial workforce of 4.5 million and a total Eastern *Länder* employment of 8 million.

**4.4.2 Restitution and compensation.** Nine other transitional States (Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia) have enacted restitution to resident citizens who were deprived of ownership during the Second World War and in the communist period without—or with inadequate—compensation. Hungary and all members of the Commonwealth of Independent States (CIS) explicitly decided against restitution. Albania accepted partial restitution of land, but only up to one-tenth of the pre-collectivization holding, to preclude the restoration of the extreme inequality that had earlier existed. Restitution to domestic institutions, as distinct from individuals, has been much more limited; however, including in those States opposed to general restitution, most of their buildings have been returned to religious bodies. Restitution to foreigners, including former citizens, has been complicated by bilateral treaties with communist-period governments under which residents in the Western signatory country had already received some compensation; only Latvia explicitly ruled out restitution to foreigners, partly because of the emigrant/immigrant problem with the Russian Federation.

All the “restituting” States, plus Albania, Hungary and Poland, authorize compensation to individuals in one or more of four forms—the allocation of a similar asset or of privatization vouchers, or the payment of money or of a lifetime security (such as an annuity or pension supplement). Compensation has, however, been ruled out by members of the CIS, on the grounds that the nationalizations of 1918-1932 were too remote in time and that assets had been profoundly changed in the interim. Special issues arose in the territories annexed by the USSR in 1945 and now part of Belarus, Moldova and Ukraine, and in two regions of the Russian Federation (Tannu Tuva, incorporated from quasi-independence in 1944) and Kaliningrad (Konigsberg, annexed in 1945), many of which remain unsettled.

**4.4.3 Registration and exchange of title.** The second stage has been completed everywhere or is in process through the revival of officially—held property registers. Cadasters for land and registers for real estate were extant everywhere—though not necessarily up-to-date—including in the former Soviet Union; in Russia the State Property Register was made a “Chief Department” (*Glavnoe upravlenie*) of the State Property Management Committee (*Goskomimushchestvo*). A major problem has, however, arisen for non-tangible assets. Outside the CIS, the establishment of company share registers was fairly expeditiously made joint ventures with foreigners had to be registered in the communist period and registration procedures and offices were generally part of preparations for privatization. Of nationwide stock exchanges on a recognized basis, two have market capitalizations already equal to smaller capital-city exchanges of the European Union; thus, Prague at 14 billion dollars in 1993 just exceeded Athens (13 billion dollars) and Warsaw at 3 billion dollars equalled Lisbon. Budapest was the only other to surpass 1 billion dollars, but these Central European exchanges, including Bratislava, are together likely to reach 28 billion dollars in 1994, about equal to Vienna’s 27 billion dollars in 1993 (London Stock Exchange, 1994, p. 36). A stock exchange will open in Bucharest in mid-1995, the law being already in place. Although legislation to create a Mongolian stock exchange dates from March 1991 (its 1993 capitalization reached 300 million dollars), it was only in mid-1994 that a full Securities Law was enacted, providing formal regulation of the financial market. This followed some extreme mishandling of foreign exchange dealings by Mongolbank (the Central Bank).

The individual republics of the former USSR had enacted legislation (uniformly titled “On Securities”) on the eve of secession. Legislation is in place almost everywhere for stock registrations and transactions, and, although many share dealings take place on bourses set up for commodities, there are now 70 authorized stock exchanges in the Russian Federation alone. Those in Moscow, St Petersburg, Yekaterinburg and Novosibirsk are the most active, and transactions in 1994 were estimated at 3 billion dollars; a unified electronic clearing system is envisaged. Shares in investment funds have been of the bearer type, rather than nominated, but even named shareholders have been fraudulently deleted from company-held share registers. A Federal Commission for Securities and the Stock Market, overseeing a State Property Register, was set up in November 1994. As mentioned in subsection 3.3, the most notable scandal in the Russian Federation to date has been AO-MMM, a pyramid sale based partly on the attraction of naive lenders by sophisticated media advertising—reportedly spending the fantastic amount of 100 million dollars—and partly on its management by the same individual, Sergei Mavrodi, of MMM-Invest, which garnered 3.1 million privatization vouchers from 2.4 million people in exchange for its shares. With these vouchers MMM-Invest bought equity in 28 of the most likely profit-makers among privatized firms and advertised in the *Financial Times*, on 27 June 1994—a mere four weeks before AO-MMM crashed—that it owned between 5 and 25 per cent of shares in eleven major Russian privatized producers. In a further advertisement (*Financial Times*, 10 April 1995) it claimed substantial holdings in 13 companies and small participation in 13 others.

In all Soviet-type economies, retail banking was little developed; as already noted, the takings in State shops and the wages in State enterprises constituted the demand for cash between the State sector and the household sector. The latter made almost all their transactions in cash, with a “girobank” service available through savings banks. West German banks soon took over the GDR Savings Bank and established their own branches (the Dresdner Bank “went home” to Dresden with no little ceremony), and local networks were quickly set up by domestic and foreign banks in Eastern Europe and the Baltic States, and, already in the 1980s, in Hungary).

By contrast in the CIS, households and private firms continue to handle large quantities of banknotes,

resulting in much tax evasion, money laundering—especially for narcotics smuggling and protection exactions—and capital flight. Inflation in all of these countries has led to some “dollarization”. The ratio of dollars—by far the favoured vehicle—to Russian roubles in late 1994 was about the same as dollarization in Peru at the height of its hyperinflation in 1990, although Russian inflation was much more moderate. Furthermore, it is estimated that a quarter of the dollars circulating in the Russian Federation are counterfeit.

In the CIS the problem of a high ratio of money in the form of notes and coin (Mo) to other forms of money is twofold. Distrusting banks—many of which are controlled by criminals—and with scant information on the viability of newly—established private companies, the public has deposited vouchers and cash in investment funds. Such funds are also ready havens for illicit and speculative monies, and the Russian Federation Government, among others, has sought to curb such use by confiscation. Both factors led to the police seizure in August 1994 of billions of roubles from Russki Dom Selenga (the last term a russianization of “selling”), whose slogan, “Others only promise a better future, we guarantee wealth today”, typified the extravagant claims being made. The scheme had attracted 1.5 million depositors before judicial closure. The Georgian militia were less prompt: a find, Achi, had obtained some 10 million dollars in deposits before its chairman fled with the money. Excesses like this brought a Presidential Decree in June 1994 to restrict financial advertising and a draft law in August for regulation by the Ministry of Finance of the burgeoning Russian stock markets (which traded the equivalent of 500 million dollars in July 1994 alone). Since pyramid selling had not been experienced in the communist period, it had not been dealt with by legislation. The Russian experience with AO-MMM was not an isolated case: the Caritas fraud had been as serious the previous year in Romania. Since 1 January 1995 a licence must be obtained to engage in securities intermediation in the Russian Federation.

Many of the title transfers under privatization arrangements were however legally encumbered. A randomized survey of businesses after “small privatization” found restrictions in the transfer contract of 52 per cent in Hungary, 41 per cent in Poland and 28 per cent in the Czech Republic; the duration of the lease on the premises occupied was two years or less in 42 per cent



of small businesses in Poland and 33 per cent in the Czech Republic, but only 6 per cent in Hungary. Reporting these findings, Earle and others (1994, pp. 255-257) believe that these restrictions were due to unjustified government fears of change of use which could lead to “disruptions of supply”. In the short term, rapid resales could lead to speculative real estate markets and pressure to flout zonal planning regulations (as happened in some restituted housing and in municipal sales to tenants in Czechoslovakia), but restriction hinders the restructuring which transformation of the real economy requires.

The same survey found that very few of the encumbrances related to the maintenance of an agreed level of employment (1 per cent in Hungary and Poland, none in the Czech Republic) and none to required investment. Both these injunctions figured prominently in the Treuhand’s privatization in the German Eastern *Länder*—by July 1993 1.48 million jobs and 181 billion Deutschemarks in investment guarantees had been secured. Such obligations are enforced during their contracted period by fines; the same financial sanctions operate on surplus profit arising from early resale and on any undervaluation of land which may arise in a defined future period. At least one Russian buyer of a Treuhand firm regarded the fine as part of the purchase price and made over both in one payment (in Deutschemark banknotes brought over in two suitcases).

Other, more general restrictions exist on land ownership. Most of the postwar agrarian reforms remain in place, foreign purchases are restricted, often to leasing without the right of purchase, and some new limits are established—such as 300 hectares for land purchases in Hungary by a law of April 1994.

**4.4.4 Privatization procedures.** All 30 transitional States have at least institutionally completed the third stage—the installation of a procedure for privatization. In accordance with 1991 legislation before the breakup of the USSR, each of the CIS created a State Committee for the Management of State Property (like the *Goskomimushchestvo* of the Russian Federation to which reference has just been made), charged with all forms of “destatization” (*razgosudarstvlenie*). The German *Treuhandanstalt* model, already described, was followed in Estonia, but in the two other Baltic Soviet successor States, Latvia and Lithuania, the role was filled by existing ministries (ECE 1993, p. 194). Specific Ministries for Privatization were established in Czechoslovakia (the two federated ministries being

inherited by the Czech and the Slovak Republics) and Poland (originally called the Ministry of Ownership Changes) where, however, pre-privatization restructuring is in the hands of the Industrial Development Agency, causing some confusion. In nine States an agency was created with effectively plenipotentiary status: the National Privatization Agency in Albania, the Privatization Commission in Armenia, the Privatization Agency in Bulgaria, the Transformation Agency in Macedonia, the Privatization Commission in Mongolia, the Agency for Economic Restructuring in Montenegro, the National Agency for Privatization in Romania, and the Privatization Agency in both Serbia and Slovenia. Two countries, for a short time, had dual agencies. In March 1990 the State Property Agency was established in Hungary to implement privatization and at the end of 1991 a State Assets Company was established to hold equity in 162 large “corporatized” enterprises. The left-centre coalition Government of 1994 soon merged them (under the presidency of a chairman of the State Bank in the communist period). The Croatian Agency for Restructuring was merged in 1993 with the Fund for Development into the Croatian Fund for Privatization. The “Fund” in those titles relates to the other institutional procedure generally adopted of re-founding State-owned enterprises as joint-stock companies in which all shares are held by the State, a procedure known as “corporatization” or “commercialization”. It was adopted in most European transitional States (Bulgaria, the Czech and Slovak Republics, Hungary, Montenegro, Serbia, Poland, Romania, and Ukraine), but in the Russian Federation corporatized equity was transferred to an entity within the particular branch, e.g. Rosneft for the oil industry, Rosugol for the coal industry. Some governments perceived corporatization as permitting them to retain some direct control over resource allocation or over exports (as with Russian gold and gas), but increasingly State-owned equity is being sold off in the interest of widespread privatization.

All governments have provided for the establishment of investment funds to manage or buy privatization vouchers, where issued, or to buy into privatizations on behalf of depositors. In Poland each fund is to be managed by foreign companies (such as major accountancy firms) to hold a substantial part of the equity of the 450 to 500 enterprises to be privatized (citizens’ privatization vouchers, described in subsection 4.4.5) could buy into the bundle of equities run by a “fund”, not into an individual privatized enterprise. Nearly everywhere

commercial “fiends” were set up by private investors and managers to attract vouchers and money for acquisition in each “large privatization” scheme. In the Czech Republic a small number of fiends quickly attained market dominance, some by offering very attractive promises for the deposit of vouchers with them—and which still have to be demonstrated in dividends. The fulfilment of promises has been slow. From a high of 3,805 in February 1994 the Prague share (HN-Wood) index dropped to 1,836 in the following June. Even so, Standard and Poor raised their investment rating of the Czech Republic at the time from BBB to BBB+. The first wave of privatization took place in a united Czechoslovakia and the distribution of the nearly 1,500 enterprises involved was virtually the same as that of the population—two Czechs for every Slovak. But whereas the Czech Republic went quickly into a second wave, the next Slovak wave began only in September 1994, with the issue, as before, of vouchers to be purchased. In the first Czech wave the 185 “investment privatization funds” received 72 per cent of the vouchers, but in the second wave, 349 such funds attracted only 64 per cent of the vouchers. It could be concluded that more citizens were making their own stock-market choices.

In the Russian Federation a few funds were nationwide: a major one was run by the insurance company ARCO, another by the Alpha Bank and another by the MMMInvest described in subsection 4.4.3; the Bank’s advertising was as moderate as that of the twin MMMs was extravagant. Some funds were run by local entrepreneurs (e.g. the Ekaterinburg Small Business Administration) and others were promoted by the regional authority (mainly for privatizations affecting the local infrastructure). Sensing the that danger funds would buy privatized enterprises for asset-stripping, the Lithuanian Government restricted any fund’s purchase in a particular firm to 50 per cent of the equity; Thomas and Kroll (1993, p. 451) state that two-thirds of fund managements had asset disposal as their objective.

#### 4.5 The finance of privatization and restructuring

**4.5.1 Enterprise valuation and disposal.** Expectations were soon dashed that the sale of the majority of the State’s productive assets would yield large sums which would contribute to reducing budget deficits or providing budget surpluses. However, throughout, there has

been a close link between monetary stabilization and the associated processes of restructuring and privatization. The anticipation of a profit was drawn from the experience of sell-offs of major public corporations in established capitalist economies, notably in the United Kingdom in the 1980s; there had been some restructuring, financial consultancy and advertising costs, but the net proceeds had been substantial and had contributed to a significant deceleration of inflation. It was enshrined in the Unification Treaty of the two Germanies that the net surplus from the sale of GDR State property would be “exclusively and only” (*ausschließlich and allein*) for GDR citizens, *pro rata* to their personal savings at the time of monetary union (Schrettl, 1992, p. 147).

The costs which exceeded receipts were under three headings: the direct expenditure on the privatization process; financial and physical restructuring; and subsidization of current enterprise outlays in a more or less prolonged transition. The first set of costs is straightforward—some are those incurred in similar programmes in Western Europe, but they are mainly for the administration of the agencies listed in subsection 4.4.4. The one controversial feature has been the magnitude of spending on Western consultancy services. Governments of transitional States accepted that the suddenness of the political changes and their lack of experience—Hungary and Poland excepted—in the procedures required for market institutions demanded external advice. But legislatures and voters became concerned at the size of the fees levied and the proportion thereby taken of money set aside by international and Western administrations. In one case, external consultancies were afforded a major role: the Polish Government called for tenders—awarded in late 1993—from financial service firms to manage the score of “funds” which would hold the equity of mixed baskets of privatized enterprises; however, a successor administration was cautious in its implementation.

The second group of costs was and is the subject of much controversy within legislatures, executives and their foreign or international advisers: should the State undertake restructuring before privatization or should it accept a lower price at privatization and leave restructuring to the new owners? Most governments have been prepared to consolidate the outstanding debts of enterprises and to clean up the balance sheet before privatization (“financial” or “passive” restructuring), but few have shown themselves

prepared to undertake “physical” or “active” restructuring. Exceptionally among the transitional economies, the Treuhand has provided the capital for reshaping enterprises as fit for a competitive market, because its statute required it to take account of the social costs of unemployment and retraining arising from redundancy and efficiency cutbacks. Privatization agencies have generally broken up or merged enterprises into appropriate lots—especially where division is in the public interest to preclude monopoly power—but have not invested heavily in restructuring. Some division has been taken at the instance of existing managements, each interested in achieving a feasible span of control—this has been the case, particularly in the Russian Federation. Because many producers in the Soviet-type economy were underfunded against environmental damage, the disposal agencies have had to offer indemnities against rehabilitation costs and future environmental damage to third parties.

The value of an enterprise is the discounted value of future net cash flows. The cost of restructuring and of environmental repair reduces net flows. A minimum is set by the value of the equipment and buildings sold separately after closure. If the enterprise is reopened after a period of closure, suppliers, clients and goodwill may have been lost. But the Soviet-type economies were so isolated from the price relativities prevailing in developed market economies, that neither input prices, nor output prices, nor capital-to-output relationships as inherited, bore consistent relationships to those to be confronted on the world market. This was the case with or without adjustment for import subsidies or duties, or export subsidies or duties (all four of which could be found in transitional trade regimes). Over- or undervaluation of the fixed exchange rate also contributed to the vagaries. All transitional economies liberalized wholesale and retail prices at an early moment in transition (some only partly, with added irrationalities) and allowed the exchange rate to float, sometimes over-, sometimes under-shooting an equilibrium rate. The combination of these actions led to very wide dispersions of national prices as they responded to demand and supply measured against any external norm. Thus a year after the January 1992 price liberalization in the Russian Federation, the price of diesel oil was 35 per cent of the world price at current exchange rates, of aluminum 45 per cent and of sugar 151 per cent (Flemming and Matthews, 1994, p. 68). Prices of equipment were still less amenable to measurement at world prices, not only for the inherent

difficulties of equating models and performances, but particularly because obsolescence, disrepair and rates of depreciation varied widely. The value of mineral deposits proved still less amenable to accurate valuation. The capitalization of Lukoil, the first Russian oil producer to be privatized, implied that its proven oil reserves were valued at much less than Western oil companies valued theirs, but its likely productivity in exploiting them was also of course much lower.

Parallel with the complexity of present valuation of assets and the expected flow of income therefrom (the supply prices of privatization) are the inadequacies of purchasing power to buy them (the demand side). In the very first days, it was thought that the monetary “overhang” that had accumulated under the repressed inflation experienced everywhere, save in Hungary, could be absorbed in privatization buying—with benign effects on domestic inflation. But price liberalization brought rapid inflation to almost all States in transition—hyperinflation in the States of former Yugoslavia, Ukraine and the Caucasian republics—and liquidated the overhang. Other channels of transferring equity out of State hands therefore had to be established. In the one transitional economy (the Eastern *Länder* of Germany) which avoided inflation—in fact prices dropped in the first year of change—normal selling—off could be, and was, undertaken. But there, the plant had to be brought up to the condition demanded by West German buyers: by 1993 only 6 per cent of privatizations had gone to foreigners (albeit responsible for 10 per cent of both investment and employment guarantees) and 19 per cent to management/employee buyouts (with few investment or employment guarantees, as most were of small enterprises, 67 per cent having less than 50 staff. Restructuring and betterment capital, and current subsidy were supplied by Federal sources, i.e. the taxpayers and investors of the Western *Länder*.

Three procedures for transferring property rights have been noted above: restitution, corporatization (commercialization), and closure followed by sale of the assets severally. The other channels which have been employed in transitional States, as exemplified in the Czech Republic (Earle and others, 1994, p. 259) and Poland (Modzelewski, 1991, pp. 4-5), are:

- Commercial sale by contractual negotiation;
- Commercial sale by auction through:
  - ~ open tender;

- ~ closed tender;
- ~ closed non-competitive tender;
- ~ open auction;
- ~ closed auction;
- Gratuitous transfer to current user;
- Issue of vouchers (free or at nominal fee) to a defined group (of citizens, of all adult citizens, of employees) exchangeable against the equity either of an enterprise or of an “investment fiend” holding a mix of equities;
- Open public offering of equity, either of an enterprise or of an “investment fund”; and
- Controlled bankruptcy.

It is general practice to offer some shares on concessional terms to employees (sometimes on a scale which allows larger offers to managers than to others) even if the principal buyer is a foreigner. Thus the procedure termed “capital privatization” (by mid-1994 used for some 100 Polish enterprises) divides equity between such insiders, the Ministry of Finance and a “strategic investor”, usually a foreign corporation. In “controlled bankruptcy”, used for 850 Polish State enterprises by that date, the enterprise is formally liquidated and assets leased or given to staff. Leasing has been widely utilized in the non-farm sector elsewhere, especially for small businesses in which employees are unable to mobilize the necessary capital, or with respect to joint ventures with foreigners; it is especially favoured in the minerals and agricultural branches, where governments are unwilling to yield ownership rights. In agriculture the long dominance of State and cooperative farming—minor in Poland and Yugoslavia, but which oppressed initiative over six decades in the former Soviet Union—was cause for particular difficulty in privatization. In Eastern Germany previous owners could regain land in cooperatives, but the former State farms were divided into leases, which may be purchased outright after 12 years. Restitution from expropriation under the Soviet occupation (1945-1949) was limited to 100 hectares. In Central Europe voluntary cooperatives were often formed when land was returned to owners, whose title had only been pooled, not surrendered. In the Balkans, those who held title, sometimes in conflict among themselves (as noted in subsection 4.2), took advantage of provincial administrative disruption to seize land and have declined to cooperate in production, and often even in distribution, with considerable loss of potential. In the Baltic States, “reprivatization” to

those in current tenure and restitution to those no longer in tenure, quickly resulted in a general return to peasant farming (but with “partnerships” fostered in Lithuania). In the CIS, resistance to private property in land (its socialization had been one of Lenin’s first three decrees in November 1917) left leasing as the main option and most State and collective farms continued to exist.

**4.5.2 Enterprise governance.** Eastern Europe’s five clashes with Soviet dominance marked a path for workers’ roles in present privatization. Tito, seeking to differentiate Yugoslav socialism from Stali’s after the break in 1948, chose enterprise self-management; the leadership of the Hungarian revolt came from the self-styled “workers’ councils” in 1957, and that of the Polish uprisings of 1970 and 1980 from the Solidarity trade union. The culmination of the “Prague Spring” on the eve of the Soviet invasion of 1968 was legislation to vest State firms in “enterprise boards” with a majority of votes allocated to management and workers. With important exceptions (the Eastern *Länder* and the Czech Republic) there has been a trend towards “insider” (management and employee) control in the first four years of change. The growth of capital markets, a rise in household savings and the penetration of foreign investors will modify this trend, but, for the present, consideration of financial strategies must take account of a microeconomy differing in certain respects from that of a developed Western counterpart.

Among small State-owned enterprises, privatization has usually been biased towards the employees of the particular enterprise. At one extreme, in Eastern Germany buy-outs were encouraged by the Treuhand through the offer to staff of loans or leasebacks with a deferred purchase option, and in Slovenia the more favourable the buy-out terms were, the greater the proportion of employees who subscribed their vouchers to their own firm were. On the other hand, in the Czech and Slovak Republics and in Hungary, auctions made all potential purchasers equal, however, as it turned out, two-fifths of small enterprises in the Czech Republic went to insiders, but only 8 per cent in Hungary (Earle and others, 1994, p. 249). “Small” privatization is largely complete in those countries and in Albania, Belarus, Bulgaria, Croatia, Estonia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Mongolia, Romania and the Russian Federation.

In the European Union only 7 per cent of the 14 million existing businesses have more than nine employees, and those with fewer, generate a quarter of total annual turnover. By contrast, in the former Soviet Union 14 per cent of a total of 43,300 enterprises had more than 1,000 employees (1 per cent had over 10,000 each). A feature of Soviet-type industrial organization was the existence of proportionately more large enterprises than in a market economy and proportionately fewer medium ones, typified in a network of contractors and subcontractors supplying big firms. The “shortage economy” favoured vertical integration. Post-communist regimes have partly countered this structure by splitting off subsidiaries for separate privatization, but, as the tendency has been to privatize before restructuring, it is “large” privatization that forms the decisive stage in transition to market-oriented institutions.

“Insider” privatization of the relatively large enterprises has been fostered by various means, such as the reservation or price discount of a bloc of shares for management and workers, or by the deliberate action of staff in applying their vouchers to their own firm. Twenty two States have used vouchers or plan to use them; Albania and Georgia are the most recent examples, having issued them in November and September 1994 respectively. Although most voucher distributions were gratis—either to all citizens or to adult citizens—some money was required in some procedures (see below).

Of the States in which “large” privatization had substantially been accomplished by mid-1994, the most extensive insider predominance when the process was virtually complete was found in Mongolia, where two-thirds of all privatized enterprises were so controlled. In the Russian Federation, when the first wave of large privatization was concluded in July 1994, 103,000 State enterprises had been privatized and 13,000 more privatizations were in process. There were 40 million shareholders, that is, more than in either the United States or the United Kingdom, and the State sector had become smaller than in Italy. Of the 148 million vouchers issued, 97 per cent had been redeemed either directly for share purchase or used for buying through some 600 investment funds (Kaser, 1995; and Lieberman and Nellis, 1995). A second stage then began, in which all shares would be sold for money and the money made over to the firm. However, almost four out of five enterprises in the first stage had chosen, among the three procedures offered, that which

assured management and staff a 51 per cent shareholding-insider equity was the predominant choice. Although concern about job security led many staff to place their vouchers in their own place of employment, the role of the enterprise director in the Soviet system played a large part. He or she had been vested with full authority under the principle of *edinonachalie* (single-person headship) and weight within the troika (three-person group) of the director, the Party secretary and the trade union chairman.

Usually that power persists in the privatized firm and subsequent mergers and expansions can be attributed to the enterprise of such individuals. Thus, the gathering of three Siberian oil producers into Lukoil is reported to be wholly the work of its Director; his firm, with the Russian Federation Government backing, has become transnational by an equity entry of its subsidiary, Lukoil-Baku, into partnership with the State Oil Company of Azerbaijan for exploiting the Giuneshli deposit in the Caspian Sea. Azerbaijan and the Central Asian republics were moving in the same direction. The virtual monopolist of Russian gas production, Gasprom, has diversified through the purchase of shares in more than a hundred privatized enterprises.

All managers of large firms in the CIS were coopted—if they had not already been—into the local political elite, which, as noted in subsection 4.6, was also open to penetration by criminal elements. This set of forces made for imperfect competition—particularly by limiting new entry and checking any downward tendency in prices—and consequently for an upward pressure on prices in conditions of serious inflation. In countries subject to hostilities (the Caucasus and former Yugoslavia), local military dictates added to ad hoc managerial control.

In more ordered countries (Hungary, Poland and Slovenia) insider control was also important. Phelps (in a foreword to Frydman and Rapaczynski, 1994, p. xiv, and drawing on their analysis, pp. 158-163), suggests that this could be due to the management-worker devolution that weakening communist governments allowed under their styles of “market socialism” before the collapse:

“It is a paradox... that it is in a country where relatively slow and belated reforms of this type took place, namely the former Czechoslovakia, where the class of newly empowered groups was not created, that a transition to ownership of enterprises largely by outside interests could go swiftly and smoothly.”

**4.5.3 Enterprise finance.** Because insider-controlled enterprises rank job security highly, they have taken advantage of imperfect markets under inflation to protect employment and wage bills: governments have been slow to foster new entry or to act against monopolistic positions. Because governments are unwilling to countenance unemployment, they have shown themselves willing to subsidize “loss-making” enterprises while still State-owned (“corporatized” or with part equity), and after privatization to tolerate tax arrears (Flemming and Matthews, 1994, p. 75) or pay above-market prices for procurement (hidden subsidies). The impact of enterprise indebtedness from the point of view of the solvency of the banking system has been considered in subsection 3.3.3. Among themselves, enterprises have accumulated debt and neither they nor the authorities have pushed firms into bankruptcy in any significant number. Fan and Schaffer (1994, p. 161) suggest that the low number of bankruptcies may not be due to “creditor passivity” but to the practical difficulties of pursuing a debtor through the courts—indeed some States do not yet have a bankruptcy procedure—and to the low value of remaining assets when liquidated. On the positive side, and as far as the Polish evidence goes (Gomulka, 1994, p. 197), nine out of ten enterprises are debt-free and inter-enterprise and bank debt is concentrated on a mere one-tenth, but these are the “very bad” firms for which a government cancellation of debt and the issue of its securities to creditors in lieu—as some propose—would only postpone “therapy”, for the debt would re-appear. Data as of the end of 1993 for the Czech Republic, Hungary and Poland show that government bail-outs to banks to cover bad debts totalled 6 billion dollars. The situation in the Russian Federation is similar, though several magnitudes greater. Of inter-enterprise debt of 42 trillion roubles (24 billion dollars at the current exchange rate) on 1 June 1994, the bulk was owed by a mere 200 enterprises; debts to the government, including tax arrears, were a small share, totalling 9 trillion roubles. So far as Central European data showed as of 1991, enterprises responded to market forces by reducing inventory ratios (Fan and Schaffer, 1994, p. 155); however, this could be attributed to the discovery of “just-in-time” techniques and to the relaxing of the “shortage economy” rather than to the “bite” of a positive interest rate or better financial management. The inherited lack of a procedure for bankruptcy has now been corrected in most countries, but very few proceedings have as yet been instituted. The

International Monetary Fund and the World Bank made the enactment of approved bankruptcy legislation and the acceleration of privatization a condition of further loans to Romania; the two corresponding laws were passed in March 1995, under which 3,000 State enterprises will be sold off by mid-1996.

Privatization by gratis voucher self-evidently brought in no “new money”, and was defended on political grounds or on the basis of lack of household savings. Some schemes for nationwide shareholding did involve payment. The purchase price (equal to 34 dollars) of a book of vouchers in the Czech Republic, when assets with a book value of 2.2 billion dollars were distributed, proved by mid-1994 to be a bargain at less than one-twentieth of the average share value obtained. In Bulgaria a fee of 500 leva was required for a voucher worth 25,000 leva. A Hungarian scheme begun in 1994 offers interest-free loans (to which any citizen is entitled on payment of a 2,000 forint fee) up to 100,000 forints each (i.e. nearly 1,000 dollars); repayment can be spread over five years, but the shares, which constitute the security, cannot be sold until the debt is cleared; the only gratis vouchers distributed have been given in lieu of restitution. Under the Lithuanian scheme the value of the voucher, deposited in bank accounts of adult citizens, rises with age, and is indexed for inflation; vouchers may be used for housing, land, small or large privatization but must be matched by cash (mostly 5 per cent, but 20 per cent to buy housing). Many CIS States (Armenia, Belarus, Kazakhstan, Kyrgyzstan and Moldova) made similar differentiations among citizens in the value of vouchers, either designated in money or points. But other (Azerbaijan, Tajikistan and Uzbekistan) did not issue vouchers. The second stage of the Russian large-scale privatization, unlike the first, offered no vouchers, but the Government feared that the domestic capital markets and household saving balances would be unable to mobilize the funds to buy the firms offered at realistic prices. Unwilling to sell off at lower prices or envisage widespread foreign purchases, it negotiated with a consortium of eight domestic banks for a loan which would give those banks control of the management and profits of the companies concerned for a period of five years. Because some of the firms most interesting to foreign buyers would be covered (Gasprom, Norilsk Nickel, Rostelcom, and the electricity monopoly) Western multinational corporations were disconcerted, and by early April 1995 the final decision had not been made.

The inadequacy of “new money” under voucher privatization and of financial discipline in insider-controlled enterprises would imply the need for substantial recourse to capital markets. But, for reasons discussed in section 6, foreign investment—direct or portfolio—has been generally slow to participate, and domestic capital markets are only beginning to do so. Again to cite Phelps (in Frydman and Rapaczynski, 1994, p. xiv):

“The need to go back to financial markets to raise capital in the future... is substantially diminished when the enterprises are given soft budget constraints by the government and hence do not have to go to the capital market. Thus a hitherto unrecognized connection between macroeconomic stability and genuine property rights is brought to light.”

#### 4.6 The insidious spread of crime

The weakness of governments towards enterprise financial discipline has led to the call for a “visible boot” to complement Smith’s “invisible hand”. In the accepted sense, the “boot” is government regulatory authority as well as sound finance, but in current post-communist circumstances it must also mean the assurance of security against crime.

The communist-period inheritance of political monopoly and a “shortage economy” was of corruption because so much was determined by officialdom and by illicit dealing, since the State made no provision for—or actually persecuted as “speculation”—a private economic sector. Opposition to “the State apparatus” and defrauding it were, in effect, virtues. In the Soviet republics other than Russia acts against the State could be perceived as “anti-Russian”.

The inadequacy of legislation and the weakness of official investigative forces allowed financial crime to grow in both financial and property markets. Examples of the former have been cited in section 4.4.3; the Schneider real estate fraud, uncovered in 1994 in the Eastern *Länder* of Germany, centred on Leipzig, was a very large instance of the latter.

The range of criminal activity in the Russian Federation goes from the equivalent of billions of dollars in the AO-MMM pyramid down to protection rackets in small trade. The kiosks which sprang up on urban pavements after price liberalization in January

1992—the Ministry of Internal Trade or municipalities held on to shop premises (which, in any case, were too few for retail demand)—are systematically visited by gangsters who dictate the price at which goods shall be sold and levy dues of some 20 per cent of turnover. The same practice rules in services, such as those provided by taxis and cafes. The Moscow Centre for Political Technology reports that 70 per cent of respondents in the State sector and 76 per cent in the private sector admitted that bribery was habitual and that they accepted taking part in it. Even Western joint ventures in the consumer sector are targeted. Penetration by the “mafia”—as popular Russian usage has it—into the large enterprise sector may be virtually complete. On the one hand, a paper of January 1994 by the Centre for Analytical Studies, Moscow (reported in *Izvestia*, 17 January 1994) estimated that four out of five private banks were under “mafia” control; on the other, the chairman of the Security Committee of the Duma, Viktor Ilyukhin, claimed that criminals control 81 per cent of the voting shares of privatized enterprises, and warned that “the Russian Federation could become the biggest criminal State ever to exist” (reported in *The Economist*, 9 July 1994). Certainly, the managerial class, dominant in industry after insider privatization, is integrated with the local political elite, which either rivals the “mafia” for power, or shares it in a local “kleptocracy”.

Army demobilization and the collapse of conscription have allowed small arms to become widely available and, at the other end of the munitions scale, theft of weapons-grade plutonium could not only destabilize world relationships, but bring further funding to the illegal sector. Criminality is as rife in Ukraine as in the Russian Federation, and emissaries of their “mafias” and local criminals affect economic activity in Central and Eastern Europe. The Moscow State Prosecutor’s Office reported a 12 per cent rise in premeditated murder in the first half of 1994 over the same period of 1993, and that the going rate for murdering an entrepreneur was 800 dollars. The break-away Russian territory of Chechnya is reputedly a seat of gangsterism, and hostilities there and in the neighbouring Caucasus have allowed the proliferation of organised crime. In Central Asia, the cultivation and transit of narcotics—a good proportion of which exits through the Baltic States and generates crime there—constitutes another, and major, element in illicit activity. All these activities contribute to “money laundering” and the heavy capital flight from the CIS (see subsections 6.1.2 and 6.4); there can be no doubt

that many purchases of assets in the West—especially property within the EU, though not necessarily the purchase from the Treuhand mentioned in section 4.4.3—are the fruit of crime.

Both the Russian Federation and Ukraine introduced rigorous anti-“mafia” legislation in mid-1994, including checks on bank accounts, and the United States Federal Bureau of Investigation (FBI) set up a unit in Moscow to assist the Russian authorities. All, save the criminals themselves, agree that crime should be repressed, but its cost to the economy is not readily quantifiable. In considering its impact, Flemming and Matthews (1994, p. 80) cite an estimate by Denison (1985, p. 25) that in the United States the rise in crime reduced GDP growth during 1929-1982 by barely 0.1 per cent annually, but they point out that he does not allow for “losses that fear of crime brings about by preventing certain activities from being carried out at all”, which are thus a brake on entrepreneurship as well as on competition. Another consideration is that the levy of “protection money” on sales precludes both the ploughing back of profits—for the recipient “mafiosi” consume their takings or salt them away abroad—and the payment of due taxes, for a tax collector is not as life-threatening as a hoodlum. The shortfall in tax revenue to which crime contributes is taken up in the next section.

## 5. Public expenditure and revenue

### 5.1 Transforming the tax base

Systemic transition involves three changes in the tax base:

- a. From a specified number of State enterprises known at the start of each tax year (updated for any in-year changes), the revenue and expenditure of which are reported to the Finance Ministry—to a much larger and fluctuating number of private businesses in many of which a responsible “fiscal culture” may be lacking;
- b. From predominantly direct taxation of State enterprises—to a new combination of personal taxation and indirect enterprise taxation based on value added;
- c. From components of income and outlay determined mostly by the central government (e.g. prices of inputs, outputs and capital assets and wages)—to variables which cannot be readily predicted by the

tax authorities in order to verify enterprise and personal tax returns.

The fundamental requirement for change with respect to taxation is that the Soviet-type economy, as already explained, required “finance to follow the plan”, i.e. that certain “plan indicators” be fulfilled by the agent and that money be assured in accordance with fulfilment. Any “maximand” in money terms was for convenience—they were “crypto-physical units” (Grossman, 1968, p. 8)—and the money itself was not “a bearer of options” (ibid., p. 3). The aggregates upon which enterprise taxes were levied had operational significance only in relation to the plan, and the tax receipts themselves served only to articulate the money components of the plan. Thus, at the microeconomic level, “deductions from profits” formed part of the enterprise’s investment plan, being negative if authorized investment exceeded profit; the “turnover tax” was the margin between the pre-set wholesale and retail prices, being negative if the latter was lower than the former; the *Preisausgleich* (see subsection 6.1) was the difference between the wholesale price and the export/import price converted at the pre-set exchange rate, being negative as might be required by their relationship. At the macroeconomic level, at least conceptually if not in practice, such taxes/subsidies ensured that agents (government, domestic and foreign-trade enterprises and households) had sufficient funds to make the planned volume of purchases from all other agents. In the sectors using “passive money”, if errors in planning or implementation left a shortfall in a government or enterprise agent, a subsidy was provided; if a surplus resulted, it was demonetized. In the household and collective-farm sectors, in which money was “active”, a surplus above voluntary saving resulted in a monetary (or inflationary) “overhang”, occasionally reduced by a currency reform. The USSR experienced a successful confiscation in 1947 and an unsuccessful one in 1991, and confiscations were undertaken in Central Europe in the early 1950s.

Transition to market-based profit-seeking changes tax, in the enterprise perspective, from a virtually meaningless indicator reported to higher authority into a meaningful impost on earnings. Evasion through understatement of the taxable sum—or its complete concealment—or by bribing tax collectors to accept lower or zero payment is readily undertaken, especially where such practices were normal in communist times with respect to plan fulfilment or the gaining of monetary or bureaucratic advantage. As just noted (see subsection



4.6), the penalties for bribing or evading the tax official in countries where law and order are weak are minor compared with the bodily injury or murder that can be the price of defying criminal exactors. Moreover, readiness to accept bribes on the official's part is enhanced by the decline in his or her real salary (consequent on keeping public expenditure low under macroeconomic stabilization programmes), the widening of income differentials and the loss of access to "closed distributors"-shops selling goods and services in short or zero supply, only to ranking officials.

An accurate record of the tax base is proving very hard to achieve. It is a major administrative effort merely to keep track of the new businesses opening, closing and reopening as the private sector develops and as State enterprises are privatized, let alone to secure accounts upon which tax may be assessed. A network of tax offices must be opened throughout the country, powers of investigation and inspection need to be defined, and accountancy practices established. Powers to examine bank and enterprise accounts should be aligned with best usage in established market economies. So far only one country (Kazakhstan) permits anonymous bank accounts—for accounts denominated in foreign currency. In the former Soviet Union, dealings in "active" money were in notes and coin, and inter-enterprise transactions in "passive" money were under no time pressure. As section 3 observes, the inherited Soviet banking system was primitive—Estonia in 1994 became the first of the successor States to introduce electronic bank transfer and plastic card access to money—and, in Central and Eastern Europe, only in Hungary did the system approach Western standards. Although bank transfers, and hence records of payments, are becoming more general, the frequency of cash transactions and the inadequacy of accountancy practice continue to favour under-reporting of the tax base.

## 5.2 The magnitude of taxation

Faced with a transformation of the tax base and its under-assessment, transitional governments have taxed more heavily those bases from which it can effectively collect. However, by placing excessive burdens on those taxpayers who are accessible to the collector, they are tempted to resort to evasion or under-reporting. Joint ventures and foreign-owned enterprises and resident foreigners—subject to the sanction of expulsion

or confiscation for fiscal offenses—are generally among the full payers, but can suffer commercially in competition with domestic firms and residents who pay less or no tax. Moreover, in the circumstances of "loss-making" and inter-enterprise debt, the government permits the accumulation of tax arrears from enterprises still under State ownership or recently privatized. The wide extent of insider privatization and the previous "cosy" relationship—Kornai's (1990) term—between enterprise and supervising Ministry encourage tax remission or arrears as a substitute for outright subsidy-giving. The Russian Minister of Finance, Sergei Dubinin, estimated that in the first seven months of 1994 only half of the budgeted revenue was collected, and for the year as a whole the share may prove to be as low as 45 per cent. He attributed the shortfall to a greater reduction in industrial activity than forecast, to tax evasion and to the many *ad hoc* tax remissions and tolerances of arrears. The first of these instances highlights the problem of the discoverable tax base; in 1994, the signs were that private activity was at last increasing faster than it was falling in State and large privatized enterprises. An inspection service capable of monitoring the myriad of small private businesses is not yet in place in the two biggest successor States, the Russian Federation and Ukraine.

Because taxes are set high to allow for at least some likely non-payment, Russian budget revenue is in its main proportions similar to that of the United States: they happen to coincide in each country—18 per cent of GDP as federal revenue and 33 per cent of GDP for the consolidated budget (returns for 1992 in the United States and for 1993 in the Russian Federation). On data from the United Nations (ECE, 1994, p. 119) in Central and Eastern Europe the share of central government revenue in GDP was generally below levels in developed market economies: in 1993 the percentages were 14 in Ukraine, 16 in Slovakia, 18 in Estonia and Romania, 21 in Bulgaria, 26 in the Czech Republic, 29 in Hungary and Poland, and 30 in Latvia; it was, however, 50 per cent in Slovenia. Rather higher shares are shown, on data from the EBRD (1994, p. 287), for consolidated general government accounts: again as percentage of GDP, 1993 revenue in Bulgaria was 27, in Romania 38, in Slovakia 43, in Poland 44, in the Czech Republic 46, and in Hungary 52. A private Hungarian research body (CIPE, 1994, p. 17) considers tax levels to be excessive:

“The tax system contains many clearly anti-enterprise elements. In addition to the internal structural contradictions of the tax system, the efficacy of taxes as an economic policy tool is also in doubt. Through international comparison it may be seen that in Hungary the ratio of tax revenues to GDP is at the same level as in developed countries having the highest central re-allocation system.”

### 5.3 External standards for taxation

International standards are relevant not only to the aggregate level of the government “take” from national income flow but also to the form that those withdrawals acquire. Policy attention is chiefly focused on the aggregate of government revenue, the structure of government expenditure, and the budget deficit, surplus or public borrowing requirement. The ratio of the deficit to GDP is a crucial criterion of “convergence” for membership in the European Union as defined by the Treaty of Maastricht. Ten transitional States in Europe have justifiable expectations of eventual admission: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. The comparative levels of budget deficit and national debt constitute a single criterion; of the four criteria of convergence this is the only one which is not related to actual values in existing member States—the other three can only be determined at the time of intended admission to the Union. The Treaty of Maastricht defines the deficit required as “not more than 3 per cent of GDP and a public debt of not more than 60 per cent of GDP”. It is evident that established European market economies (EU members and others) have recently been diverging from this criterion rather than converging on it, for the average deficit as per cent of GDP was 4.3 in 1991, 5.2 in 1992 and 6.9 in 1993 (ECE, 1994, p. 14); the trend appeared to be reversing in 1994.

The target is important for the Central and East European candidates for EU membership. Data from EBRD (1994, pp. 281-287) show that on 1993 outturn compared to 1991 the indicator changed in the Czech Republic from a deficit of 2 per cent of GDP to a surplus of 1 per cent; the deficit declined in Poland (6.5 to 2.9 per cent); was the same in Bulgaria (15.1 per cent in both years) and Romania (1.9 and 1.8 per cent); but increased in Hungary (2.5 to 7 per cent) and Slovakia (2 to 6.8 per cent). The Russian Federation, a candidate

for only a free-trade area, has shown remarkable improvement, cutting its deficit from 16.0 to 5.7 per cent.

Data from the IMF (1993, p. 86) are available for a wider range of countries, but as budgets rather than actual “outturn”. The grouping of transitional countries in similar fashion for deficits as percentage of GDP in 1991 and 1993 shows declines for Albania, but still at a very high level, from 43.7 to 20.6; for Kazakhstan from 7.9 to 6; for Poland from 5.6 to 4.8; and for the Russian Federation from 16 to 10. Seven countries show a switch from a surplus in 1991 to a deficit in 1993: Azerbaijan from 2.6 to -7 per cent (in the wake of war with Armenia); Belarus from 3.6 to -7 per cent; Estonia from 4.6 to -0.6 per cent; Kyrgyzstan from 4.5 to -4.7 per cent; Latvia from 6.3 to -1.5 per cent; Lithuania from 2.8 to -0.5 per cent; and Romania from 0.6 to -6.2 per cent. Stability was exhibited in Bulgaria (a deficit of 8.4 per cent in both years) and Turkmenistan ran a surplus throughout (3.5 and 4.5 per cent in those years). The budget deficit rose as a percentage of GDP in Armenia from 1.9 to 47.1 (in consequence of hostilities with Azerbaijan), Hungary from 2.5 to 5.4; Mongolia from 10.5 to 17.2; Ukraine from 15 in 1991 to a range of 15 to 20 budgeted for 1993; Uzbekistan from 4.8 to 5.2; and in both the Czech Republic and Slovakia if the comparison is with the combined Czechoslovakia of 1991 (0.2 to 1.1 and 7.2 respectively in 1993 budget terms).

The budget surplus in 1991 in three Central Asian members of the CIS was attributable to the inflow of funds assured by the Union Ministry of Finance until the collapse of the USSR at the end of that year. From the calendar/fiscal year 1992 each newly-independent republic had to find its own resources, although until mid-1993 the Russian Central Bank assisted with substantial credits. Kaser and Mehrotra (1992, p. 39), who were on mission to the four Governments concerned that year, report budget surpluses in 1991 as 4.6 per cent of GDP in Kyrgyzstan, 3.4 per cent in Tajikistan and 3.2 per cent in Turkmenistan—but, as shown also above, a deficit of over 5 per cent in Uzbekistan. In addition to Tajikistan, two other former Soviet republics, Georgia and Moldova, were disturbed by civil war in 1992, when their budget deficits peaked at 35 and 22 per cent of GDP respectively. Military quiescence in all three, as well as between Armenia and Azerbaijan, began a move towards fiscal normality in 1994, but the reactivation of the tax base in national economic activity and the reestablishment of channels

for collection take time. The IMF did not cover the successor States of former Yugoslavia, but EBRD (1993a, pp. 145-170) shows Croatia as cutting its budget deficit from 4.9 to 1.6 per cent, and Slovenia changing from a surplus of 2.6 to a deficit of -1.8 per cent. Patently hostilities in the other Yugoslav successor States created massive deficits from which came hyperinflation, leading to a total destruction of the currency in Bosnia-Herzegovina and the Yugoslav federal state of Montenegro and Serbia—in one case, the Deutschmark completely replaced the dinar and, in another, after spiralling to a million-fold monthly inflation, a peg to the Deutschmark in 1994 began a period of stability. Although no GDP ratio is available for the former Yugoslav republic of Macedonia, the floating of the denar after hyperinflation in 1992-1993 brought a degree of stability and a better budget balance, but—as in those States actually experiencing hostilities—tax evasion and the cost of such extraordinary expenditures as refugee care and the armed forces precluded any normal equilibrium.

A caveat must be entered on use of the deficit/GDP ratio: GDP declined everywhere at least for two years after the end of communist political monopolies and is still falling in some economies. Even keeping a deficit constant shows a rise in the ratio if GDP falls. The narrowing of the tax base—let alone shifts in its composition—was accompanied by certain unavoidable increases in expenditure (see subsection 5.6), such as on social security, for all transitional States inherited a fairly comprehensive welfare system. Where hostilities were involved, mass displacements of people, the prosecution of the war and the repair of the consequent damage made extraordinary calls on spending.

In the peaceful and more successful European transitional States, the deficit is taken as a public sector borrowing requirement, but in the less advanced it is largely monetized. No recent comparable data appear to be readily available on the second element in the Maastricht criterion—the ratio of public debt to GDP—but two general issues are posed. One is the division of government debt when countries are split, and the other is the degree of debt reduction—by writedown, by long moratoria with interest capitalized or by debt-equity swap. The controversy about federal breakup was acute within the CIS during 1992-1993, with proposal after proposal being negotiated and then withdrawn. In the event, the Russian Federation undertook to shoulder most of the former Soviet debt in exchange for assets carried over. The division of Western bank

loans to the former Yugoslavia took three years to its resolution in the two States capable of servicing debt, Croatia and Slovenia. Poland reached settlement of its debt to Western banks at the same time as Slovenia, in September 1994 (both having previously reached agreement on official debt), and on more favourable terms, the Polish write-down was from 14 billion dollars to 7 billion dollars and the Slovene from 7 billion dollars to 4.2 billion dollars. Foreign debt negotiations by transitional countries are prominently, but by no means entirely, with creditors in developed market economies—governments being associated with the “Paris Club” (first convened in that city in 1981 to deal with Polish non-performance) and banks associated with the “London Club”. All countries except Hungary and Mongolia have directly or indirectly (by country break-up) been involved in such debt moratoria. Hungary has serviced its heavy debt throughout both periods of crisis (early 1980s and early 1990s) and Mongolia’s creditors have been the CMEA countries, with which it concluded moratoria arrangements. The Russian Federation was left at the collapse of the USSR with debts owing to it by CMEA and less-developed countries, still largely unsettled, as well as its own substantial debt. Creditors agree to write-downs (or selloffs at severe discount in the secondary market) because “something is better than nothing” and debtors are keen to reach agreement so as to obtain “new money”, either from the market or from international sources. However, a bad example is thus set for domestic debtors in transitional States which encourages arrears, write-downs and write-offs as well as government recapitalization.

The achievement of macroeconomic stability by constraining the government deficit within acceptable bounds and by financing any such deficit by borrowing rather than by money issue is significant also for foreign investment. International country-risk assessors incorporate fiscal magnitudes into their judgements and influence corporate investors; decisions to transfer production facilities or technology are made with prospects in mind for inflation and the tax burden; and portfolio investors seek to envisage trends in equity values and interest rates. At the extreme, uncontrolled deficit finance leading to hyperinflation can bring political instability, or reflect such instability, which adds the dimension of political-risk analysis to the investor’s perspective.

Finally, adherence to well-tried tax practices of established market economies—those of EU countries being

most recommended-encourages foreign investors, because of their familiarity and predictability. The transitional economies were so long out of world capital markets and direct investment flows-although all, save Mongolia and the Central Asian States, had had capital inflow prior to the communist period-that entry has been, or will be, a novelty to most Western "actors". The need for foreign capital is discussed in the following subsection, but the more assurance Western investors have on the appropriateness to them of the market environment in transitional States, the better.

#### 5.4 The tax regime for foreigners

To offer an investor-friendly tax regime-both as to the macroeconomic impact of revenue collection and to the microeconomic effect of individual taxes-is not to pre-judge the issue of tax concessions for foreigners. It is a simple one: concessions attract useful capital inflow and can introduce competition into imperfectly competitive markets even if some tariff protection is maintained or erected. But the gain therefrom may be more than offset by stultifying domestic enterprise-new private firms or privatized State entities-as they are burdened with higher taxes. Moreover, just as tax evasion places a larger burden on honest taxpayers, the domestic firm pays more if foreign competitors are excused.

Four countries have chosen a "level playing field" for foreign and domestic entities alike: Hungary, Mongolia, the Russian Federation and Slovenia. Hungary began its transition with the offer of exemption from profits tax for firms with an initial capital of 50 million forints (then some 625,000 dollars) at least 30 per cent foreign-owned-total exemption for the first five years and 60 per cent for the next five years. But the concessions were withdrawn for firms registered after 31 December 1993. Mongolia's requirement that foreign investment be approved by the Ministry of Trade and Industry is seen by a few as something of a deterrent, but against this view there are no impediments on the transfer abroad of profits or of the proceeds of asset sales. Buckberg (1994, p. 125) cites the Government's recognition "that increased foreign investment is essential for further economic development... To attract larger foreign investment flows, Mongolia is stressing the achievement of political stability and its strong commitment to reform". Certain advantages are available in the Russian Federation within designated "special

enterprise zones", but regulations restricting foreign banking in that country operate in the contrary direction. To the extent that criminal penetration has not affected some big foreign firms, the latter are perhaps somewhat better placed than those which are under the shadow of the "mafia". Slovenia treats all firms alike, but tax reliefs are provided for newly-established companies and in certain underdeveloped districts from which entrants from abroad can of course benefit. Lithuania is in an intermediate position, in that concessions are available to any newly-registered domestic firm and to all foreign investors, but only until 31 December 1995.

Many of the tax concessions where they are offered, are restricted to specified branches or regions and may be seen as part of the government's industrial restructuring policy; those available in any activity or location provide a competitive edge over domestic firms, but are all limited in time-"tax holidays", as they are termed, are often 100 per cent in the first year, or more, and are then scaled down during ensuing periods. Turkmenistan has a variant time limit-a tax holiday until the investment is paid off from its profit. Conditions may be imposed to the effect that the profits exempted be reinvested within the country, or better tax treatment may be offered on those profits so reinvested.

Tax holidays on corporation or profits tax are provided in Albania, Belarus, Bulgaria, the Czech Republic, Estonia, Kazakhstan, Kyrgyzstan, Latvia, Moldova, Poland, Romania, Slovakia, Turkmenistan, Ukraine and Uzbekistan. Foreign investors do not pay import duties on equipment used for their specific investment in Croatia, Kazakhstan, Moldova, Romania and Uzbekistan.

#### 5.5 The reform of individual taxes

The review of individual taxes undertaken by governments of transitional economies would of course be based on consideration of the objectives and effects of taxation and of forms of tax not already employed in their country. The aims to be achieved include-within the prime objectives of paying for government expenditure and macroeconomic demand management—the redistribution of income and wealth among households and between generations; incentives for the creation of new wealth both for individuals and as a return on capital and for altering the ratio of saving to consumption (in either direction), optimizing tax incidence between

producers, consumers and suppliers of factors and international parity—because corporate taxes under fiscal treaties accrue to countries of origin. The objectives to be minimized relate chiefly to the cost of collection and to the distortion of economic behaviour—especially under the risk and uncertainty particularly acute in conditions of transition. In post-communist economies the aggregate transfer of income through the public accounts—including the balance of taxes and subsidies—is of particular importance because of the past overwhelming role of the State towards the productive sector. Governments, both national and local, should be seen to have renounced the assumption that centralization and reallocation through the budget is the norm.

**5.5.1 Personal income taxation.** Direct taxation—and its negative form in cash allowances—as an instrument of income redistribution or of incentives was not theoretically necessary for wage-remuneration in a Soviet-type economy. Centralized wage bargaining between the planning authorities and the compliant trade unions and the obligation of State entities to implement the wage structure so determined could effect at source the desired relationships. Albania and Poland were the only two countries to go to this extreme by abolishing direct tax on income derived from a State entity. All others implicitly accepted that income objectives were to be obtained through the “wage plan” by setting the personal tax-free allowance high in relation to the average wage and the progression gradient low or zero. Income derived from non-State sources was on the other hand quite heavily taxed, sometimes with a steep progression or discrimination against certain sources, such as income from abroad or the income of ministers of religion. Income assessed as derived from “speculation” could be confiscated.

All such ideological presumptions have been swept away with the command economy—in Hungary, even before the fall of the communist political monopoly, by introducing Western-style personal taxation in 1988. In introducing forms of income tax appropriate to a market economy governments have to take decisions in the fields indicated below.

Keeping in view the ratio of revenue to cost of collection, a procedure for assessing and collecting taxes due must be established. For income tax, a “pay-as-you-earn” scheme may be appropriate; as private enterprises proliferate and while accountancy is poor,

the cost of verification and collection is high and tax evasion significant.

Sanctions against non-payment or excessive arrears must be seen to be enforced; the prevalence of crime and the intimidation or bribery of tax officials is common in some post-communist States.

A balance must be struck between the cost of collection from those with the lowest incomes and the tax yield; the non-taxable personal allowance can be set at the statutory minimum wage—which many countries establish—and/or the standard retirement pension, but it may be politically difficult to lower the limit from that which previously prevailed.

Because all transitional States were and (except for the Eastern *Länder* of Germany and the Czech Republic) remain inflationary, the personal allowance is indexed, but may not be adjusted with sufficient speed. Thus in Hungary, the average income doubled between 1988 and 1992, but the personal income tax payable tripled. CIPE (1994, p. 19) attributes this largely to insufficient indexation, but also to the withdrawal of the exemptions in which the prior tax regime abounded. In the Soviet-type economy interest on government bonds was tax-exempt; its retention (as in Hungary) is perhaps “crowding out” investment in the private sector.

The number of bands for taxable income within which the progressive gradient is applied should be relatively small; some governments have multiplied the number of bands to render tax highly sensitive to income differentials, but the taxpayer may better understand his or her liability with fewer rates—say, three or four—especially while accountancy standards are poor and cash transactions predominate.

In the crucial phase of transition when entrepreneurship and workforce incentives must particularly be fostered, the adverse effects of high tax rates for the top bands are to be set against popular calls to moderate the considerable widening of income distribution.

Governments have differing views, under the influence of electorates, on the desirable average incidence. Thus, the tax rates proposed to the Russian Duma for the 1995 budget were from 5 to 40 per cent, but the desirable average perceived by CIPE (*ibid.*) for Hungary is 28 to 32 per cent.

A basic withholding tax rate on interest and share income assists collection—and makes payment earlier, which under inflation is of course to the government’s advantage—but, while banking and the capital market

are little used by households, it could deter the spread of such intermediation, necessary for a developed market economy.

A capital gains tax should be a usual feature to supplement income tax as property ownership broadens.

Because non-cash income was a considerable proportion of income derived from private sources in the Soviet-type period—and still is—a decision has to be made whether to tax some or any of it.

As with all taxes under high inflation, the government is put at a disadvantage because the real value of tax when received is lower than when the relevant income is earned.

**5.5.2 Property taxation.** In developed market economies, the purpose of property taxation is frequently local revenue raising. In the transitional economies the same can apply, but it may also be appropriate to “cream off” rent-seeking activities, especially under imperfect competition. A taxable base of assets is more predictable and easier to verify than a taxable base of income. Land surveys are either satisfactory or have very recently been updated as a consequence of decollectivization and privatization. Productive assets and housing have in the main been valued in the course of privatization. It can be argued that a move to the more certain tax base of property would be effective. But against this, such taxes encourage capital flight and under-recording of values and sales, and constitute a disincentive to invest. The Russian Federation has such a property tax; the rate proposed in the Russian budget for 1995 increases it from 2 to 3 per cent.

**5.5.3 Corporate taxation.** More sophisticated accountancy rules and practice are still needed; the accuracy with which profits are assessed remains poor in many States. Problems arise in the type and value of allowances to set against tax; capital investment is generally allowed, but it has been suggested that allowances be graduated according to the degree of advanced technology incorporated. Special allowances to foreign enterprises for their imports are noted in subsection 5.4.

Corporate—or profits—tax rates seem to have been set high at the start of transition in the interest of raising revenue when other taxes were more difficult to collect. In the interest of reinvesting profits, some countries are reducing rates—in the Russian Federation from 38 to 34 per cent and in Hungary from 40 to 34 per

cent—but insider privatization, whether or not manager-dominated, has an inbuilt preference for dividends and for the finance of any investment—especially while real interest rates are negative—by borrowing. No clear picture seems yet available on the extent to which borrowing may displace the use of retained earnings, hence increasing “gearing”. A reversal of the decline in fixed capital formation is urgently needed; the decline has been continuous during 1990 to 1993 in Albania, Bulgaria, Croatia, Hungary, Romania, Slovenia and the Yugoslav Federation (Montenegro and Serbia), and discontinuous in Belarus, the Czech Republic, Latvia, Poland, the Russian Federation, Slovakia and Ukraine. Savings were only 1.3 per cent of GDP in Mongolia in 1992 and, even in Hungary, it had fallen to 12 per cent.

Corporate taxes do not yet conform in detailed application to the practice of developed market economies. Departures in many countries include the non-allowance of loss carry forward, of depreciation—at least in full—and of interest on long-term loans. The effect of writing off non-performing bank loans and of inter-enterprise debt is, of course, to reduce profits subject to taxation and hence the revenue to the budget.

Kouri (1993, p. 50) has calculated the effective marginal tax rates on income from capital as the proportion of the pre-tax return on capital going to tax instead of to the investor. In only seven States was the proportion less than 90 per cent—Estonia being the lowest at 75 per cent and Albania the highest of these at 88 per cent, with Latvia, Hungary, Poland, the Czech Republic and Slovakia in ascending rank in between. Under 95 per cent were Macedonia, Slovenia, Georgia, Bulgaria, Romania and Lithuania, and between 96.5 and 99.8 per cent were Turkmenistan, Kyrgyzstan, Armenia, Moldova, the Russian Federation, Tajikistan, Uzbekistan, Kazakhstan, Belarus, Ukraine, Azerbaijan and Croatia. In comparison—and of course benefiting from much lower inflation—the United States rate is 63 per cent.

**5.5.4 Value-added tax.** The Soviet-system turnover tax was deliberately designed to conceal competitive cost differentials. Its replacement by Western indirect taxes is necessary to complement price liberalization, so that price signals can be correctly received by producers and consumers.

States seeking membership in the European Union have introduced VAT as a necessary preliminary to

their candidature, but, in fact, all except Albania and Mongolia have already applied it in replacement of the former turnover tax; Mongolia introduced a 10 per cent sales tax in 1993. All the CIS members applied VAT from January 1992, then at the uniform rate of 28 per cent; however, from January 1993 most chose a rate of 20 per cent, while others retained 28 per cent and some allowed a lower preferential rate. There is however a statement of intent to reharmonize. Standard rates in Central and Eastern Europe in January 1994 were at scales rising from 18 per cent in Lithuania and Romania to 20 per cent in Hungary, 22 per cent in Bulgaria and Poland, 23 per cent in the Czech Republic and 25 per cent in Slovakia.

VAT is preferable to a general sales tax in that only final (not intermediate) goods and services are taxed, but accountancy requirements are high, especially as parallel accounts are needed on an accrual and a cash basis. To simplify recording, the CIS members operate VAT on a cash basis only and traders are assessed on the gross margin of sales less bought-in items. A more sophisticated procedure, which measures value added at each stage of processing or movement, is to allow each reporting entity to deduct the VAT it has paid. Because most East European VAT rates are high (in comparison, say, with rates within the European Union), sales are often made without receipt to avoid tax; in Hungary CIPE (1994, p. 20) proposes a narrowing of the margin between standard and preferential rates.

**5.5.5 Payroll tax.** Under the Soviet-type system, social security was financed by a payroll tax, but no actuarial base was calculated; payments were met from current premiums, with the State as guarantor in case of deficit and absorbing the margin in the case of surplus. The "pay-as-you-go" principle is followed in the United States and the United Kingdom, instead of one in which premiums are calculated actuarially. In the longer term many governments are planning a transformation of the bulk of social security into autonomous insurance schemes, but currently rates of payroll tax (social security contributions) are high to cover the needs of the social safety net during recession. Between 1982 and 1992 the Hungarian rate has risen from 25 to 44 per cent. In the Russian Federation the payroll tax is 39 per cent.

Because a payroll tax increases the cost of labour to the employer, wage bills are under-reported or staff are required to work as self-employed. Calculating the increment in labour income implied by the imposition

of a payroll tax mark-up, the EBRD (1993b, p. 49) has applied to the gross income the rates of income tax and an estimated incidence of VAT to show the effective marginal tax rate in most transitional economies. Compared to 65 per cent in the United Kingdom, 63 per cent in Japan and 62 per cent in Germany and below 50 per cent in the United States (because tax in this country is less for social security, and insurance pays for more, its corresponding rate is lower), the range is vast, from 10 per cent in Macedonia to 85 per cent in Croatia. Rates under 50 per cent are shown (in ascending order) for Turkmenistan, Albania, Moldova, Tajikistan, Uzbekistan, Estonia and Azerbaijan; below the 65 per cent rate are Lithuania, Latvia, Armenia, Bulgaria, Romania, Kyrgyzstan, the Russian Federation, Poland, Slovenia and Ukraine; rates are still higher in Slovakia, the Czech Republic, Belarus and Hungary.

The tendency for enterprises to supplement the social safety net by keeping more employees on the payroll than efficient operation required has already been much moderated, except in the CIS economies, and it shows up in high rates of registered and unregistered unemployment. Nor do enterprises maintain nursery, education and health care facilities—the outlay on which, by adding to selling prices, was in effect a supplementary tax burden.

**5.5.6 Customs and excise duties.** Customs duties were levied in the Soviet-type system only on the few imports made by other than State enterprises. Excise duties had been merged into the turnover tax. Privatization and non-discrimination among enterprises required a universally-applicable tariff, and the abolition of turnover tax required that any tax supplementary to VAT be specified as excise (or other designated form). Due to this change in the import tax base, duties have become an important factor in revenue raising, but their function is fundamentally the same as in market economies; this is also true with respect to license and other fee income. Except for contraband—the volume of which is intolerable in the CIS and Balkan States—goods crossing a frontier are identifiable and can be valued by government inspectors. Most developing countries rely on import/export duties for a considerable part of their revenue because they are cheaper and more comprehensive in relation to the tax base than income or enterprise taxes. All, however, particularly in the CIS, are subject to considerable evasion.

## 5.6 Government expenditure

The other channel for reduction of budget deficits is, of course, the trimming of expenditure. Because the recession which has accompanied transition brings unavoidable increases in social security payments—especially in unemployment benefits (which under the Soviet-type system was paid only in the GDR) and pensions (since more workers choose retirement). In an effort to moderate the rise in pensions payments, the Polish scheme will index them to the retail price index from 1996 (originally planned from 1995), rather than to the average wage. Recession and the exposure of non-competitive enterprises to the market evoke pressures on government to continue previous policies of subsidization, and, in the new conditions, to tolerate tax arrears as a substitute for subsidies. Generally, however, the financial management of government expenditure requires no more than the prudent control of expenditure and the avoidance of abuse, which go under the name of “good housekeeping”.

Certain expenditures which were substantial in the communist period have been moderated. Defense expenditures are a major element, but combined with the decrease in armaments exports—to members of the now defunct Warsaw Pact and to certain developing, non-aligned States—have caused unemployment and factory closure or restructuring in the military industries. The administrative apparatus has been slimmed by the abolition of many controls and the privatization of State enterprises. Governments have cut down their own investment programmes, but this—particularly in infrastructure—may evoke higher capital expenditure in the future, not only to make up for repairs and replacement not undertaken but to bring quantities and quality to the levels required for a modern, competitive economy. In the Russian Federation, for example, the EBRD estimates that an investment of 4.5 billion dollars is required to bring roads up to European standards. A shorter-term deferral of expenditure has been effected in the Russian Federation—of wage payments to civil servants in particular—in order to show a lower budget deficit than underlying commitments justify.

Many governments are moving expenditures off budget, either via units with autonomy of expenditure supported by a fee-for-service basis, or by privatization; thus, a small part of the Russian road investment mentioned above could be recouped by tolls. More far-reaching is a draft Russian Law on Privatization of Health Facilities, Pharmacies, Medical Supplies and Pharmaceutical Industries whereby the out-patient ser-

vices (“factory polyclinics”) of State or privatized enterprises and many public-access health-care facilities will be offered three choices of conversion: not-for-profit agencies, limited partnerships (on the lines of the United Kingdom National Health Service Trusts) or joint-stock companies. Users of the new entities would reimburse the cost of health-care provision through their insurance or by government subsidy. In certain cases where governments have retained all shares in corporatized enterprises, demands for recapitalization (as in the case of Hungarian banks) or for investment funding may arise (e.g. for oil, but not gas pipelines in the Russian Federation, where Transneft remains in State ownership).

Of all the changes in government expenditure, the most crucial in strategic financial management has been the withdrawal of subsidies to production enterprises in the State sector (see subsection 3.3.3). A review of the evidence from pre-privatization enterprises in Czechoslovakia, Germany, Hungary and Poland (Aghion, Blanchard and Burgess, 1994, p. 1341) shows that incentives for firm-level restructuring were generally strengthened when firms stopped receiving State subsidies (i.e. were put on strict budget constraints). This factor was strengthened by strong declines in demand for the output of State enterprises in Eastern Europe.

Measures taken included divestment of non-production activities (such as health care, leisure services and education). To the extent that these activities are neither discontinued nor taken over by private operators or insurance companies, the effect is to transfer the government’s expenditure from a subsidy for production (in the Soviet budget “expenditure on the national economy”) to social expenditure (“social and cultural measures” in former Soviet practice). But more importantly, firms were shown to have “unbundled” non-core and non-performing activities, as enterprises would be expected to do in order to maximize the value of their firm—or to demonstrate managerial skill to sell elsewhere. Simplifying their argument, these firms found that they could either defeat others who saw themselves as stakeholders (workers and local officials) or co-opt the majority to change by the assurance of equity after privatization. Governments assisted in the expectation of a positive equity value—where its money had been made over as loans rather than grants—by writing off enterprise debt pre-privatization. In Germany, however, the Treuhand wrote off only 70 per cent of



historical debt, the remaining 30 per cent remaining as an incentive to efficient financial performance.

The tapering off of subsidies as State-owned enterprises are privatized does not end the demand for government expenditure on the production sector. As in most developed market economies—including those taking part in the Common Agricultural Policy of the EU—agriculture is likely long to remain a net recipient of funds from government. Outlays are required for restructuring in advance of privatization, on the privatization process itself (see subsection 4.5.1) and on infrastructure, while income is forgone by tolerating tax arrears or paying above-market prices for procurement (see subsection 4.5.3). The demonstration of uncompetitiveness in foreign trade as the economy becomes more open evokes subsidies even after privatization, a matter which is discussed below.

## 6. External financial relations

### 6.1 Trade, tariffs and subsidies

Comprehensive price determination by the State, without any requirement for those prices to clear the market at either wholesale or retail level ineluctably led to the divergence of domestic price relativities from those prevailing in world markets, however accurately the exchange rate—also solely determined by the government—might have equated the aggregate value of domestic currency and that of foreign currency involved in external transactions. In fact, as official exchange rates were almost always over-valued in Soviet-type economies, a domestic-currency subsidy was required for exports and a levy needed on imports. The magnitude of those subsidies and levies was nearly always modified by the application of official multiple exchange rates (see subsection 6.3) and by black-market transactions in banknotes, the discount on which was greater than the difference between the official rate and that indicated by purchasing power parity. Because all currencies were strictly non-convertible, there was much “switch” trading in undisbursed balances under bilateral clearing arrangements. The United Nations Economic Commission for Europe appointed an agent to negotiate use of such switch balances, some of which required many buyers and sellers to complete a “circuit”. The rates at which deals were eventually concluded constituted yet another set of implicit exchange rates at variance with the official rate.

The product-specific differentials between wholesale and retail prices were absorbed by the turnover tax, in such a way that there were as many tax rates as there were domestic products; subsidies were, however, made on an industrial-branch basis requiring inter-enterprise transfers. Similarly, the product-specific differentials between domestic and foreign prices were met by subsidy or levy, the set of which became known by the term used in the GDR, the *Preisausgleich*, which implied that there were as many exchange rates as there were traded goods and services. Under the “shock therapy” form of transition—a combination of liberalizing domestic prices, floating the currency and decontrolling current payments (“internal convertibility”)—domestic prices would, under the ideal scenario, clear the market. Trade would take place as comparative advantage indicated, and the exchange rate would tend to equilibrium. Where current account convertibility was allowed but price decontrol was only partial, as in the Russian Federation after 1992, some domestic prices were kept below the approximations to world prices which other decontrolled prices were attaining. Export duties were imposed to absorb the extraordinary profit which would otherwise accrue to domestic sellers of pricecontrolled products. The Russian Government reinforced such duties by the application of export quotas in the case of oil, a product for price control kept domestic prices far below the world level. The issue was one of sequencing (see subsection 3.8); these and other imperfect applications of market-oriented instruments dogged even the most rapid of transitions and many governments chose “gradualism” or inertia rather than “shock”. Nor could domestic enterprises, previously protected by the State monopoly of exports and “monopsony” of imports, quickly reach competitive levels permitting them to operate under a regime of free trade and open economy. Indeed, so inefficient were some industries that if their inputs and outputs were revalued at world prices they were value-subtracting, rather than value-adding. Some industries were close to world competitiveness, as Hughes and Hare (1992) were the first to show, but in Poland, for example, they suggested that a quarter of all industrial enterprises should be closed and two thirds of them restructured to reach a profitability compatible with the new market environment. Agricultural produce is a claimant for protection, as it in most developed economies (see Government expenditure above).

At the same time as institutions and regulations were rapidly changing, so was the composition and direction of trade. To the very eve of the political changes of

1989-1991 trade in the countries concerned was severely distorted from that which would have been generated by a market environment. The situations in which States found themselves at the start of transition fall into five groups. Ranked roughly in their approximation to the European Union, the first group comprises all the ex-Soviet republics, Mongolia and Albania (with the caveat that the Baltic States stand out from that group in likely candidature for EU membership); the second is the Russian Federation by itself (the world's largest State by territory with a Federation of 88 components); the third is the ex-Yugoslav States; the fourth those with "Europe Treaties"; and the fifth the Eastern *Länder* of Germany (already within the EU). Three countries, Kazakhstan Turkmenistan and Tajikistan, have not dismantled the State-trading apparatus taken over from the Soviet system, and their neighbours, Kyrgyzstan and Uzbekistan, have gone to the other extreme of virtually complete liberalization; the other transitional States employ some or all of the following means: import duties, export taxes, quantitative restrictions (QRs) on imports or exports and subsidies—in the last paragraph of subsections 6.1.1 to 6.1.5 each country's tariff and QR regime (EBRD, 1993b, pp.33-38) is noted.

**6.1.1 States remotest from developed market economies.** In the most extreme difficulty were Albania and Mongolia. They had largely cut themselves off from market economies, both by preference for fellowcommunist donor States, but whereas the former had lost China as protector in 1978 and then retreated into isolation with investment declining throughout the 1980s, in the latter Soviet capital inflow was so important that in the 1980s Mongolia registered the highest investment rate in the world. Mongolia exemplifies the two-gap, "crowding-out" theory, having both a foreign exchange gap and a savings gap to fill. To fill the first gap it took so much external aid—30 per cent of its GDP in the late 1980s (Buckberg, 1994, p.123)—that it closed the second gap and "crowded out" domestic saving—as shown by the subsequent rate of government savings of 1.3 per cent of GDP (Mongolian Government, 1993, p.5). When Albania opened up and Mongolia transferred as much as it could of its trade to market economies—following the collapse of the Soviet economy—the foreign exchange gap was enormous and external aid was supplied, with Italy in the lead for Albania and Japan for Mongolia. In 1992, 25 per cent of government revenue was foreign aid in Albania and 36 per cent in Mongolia. Mongolia achieved a balance of payments

surplus in 1993, but with a current account deficit still at 7 per cent of GDP. In 1992 Albania had a current account deficit of a staggering 69 per cent of GDP.

In the same group, the Soviet successor States other than the Russian Federation may be counted. As noted in subsection 5.3, the Union Ministry of Finance made grants to Union-Republics where revenue fell short of expenditure. For six such Republics, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan, this permitted an inflow of capital which offset the low—and declining—rates of saving, unfortunately the capital productivity demonstrated was much below the Soviet average (Easterly and Fischer, 1994). When the USSR broke up, these Republics lost their capital inflow and had an inheritance of poor assets in low output economies. The other republics in the group were at higher per capita GDP levels—the three Baltic States and perhaps Georgia were better off than the Russian Federation—but also faced serious balance-of-payments disequilibrium when the USSR was dismantled. None had significant hydrocarbon deposits and they depended on the Russian Federation for oil and gas—and to a smaller degree on Azerbaijan, Kazakhstan and Turkmenistan. Because Russian production of both products has been declining, and both are readily saleable in Western markets, the Russian Federation demanded payment for its deliveries in convertible currency and at prices rising over time towards the world price. Subsection 4.5.1 has noted how the Russian domestic price of oil was kept artificially low after the January 1992 price decontrol of most other goods; the other CIS economies sought to make payment at that price and in roubles. The Russian Federation made some concessions to CIS members, but withdrew rouble financing via bank credit gradually, and completely by mid-1993. It made no concessions to the Baltic States, which had not joined that Commonwealth, but they were able to gain balance-of-payments support from the West and benefited from the return of gold deposited in London before their annexation by the USSR in 1940. In addition, all eight ex-Soviet republics inherited negative trade balances both on the intra-USSR account and with foreign countries—the exception was Belarus, which was in equilibrium with other Soviet republics. In 1987, revalued at world market prices and into US dollars, the sum of intra-Soviet and foreign visible deficits as a share of GDP in each republic were around one-fifth and a quarter in the Baltic States, Georgia and Moldova, 13 per cent in Armenia, 5 per

cent in Belarus and 2 per cent in Ukraine (Smith, 1994, p.54). Severe and generalized recession as transition began—as well as hostilities in the Caucasus and Moldova—reduced export capacity by more than import demand, whether or not “internal convertibility” made those imports legal or illegal. Capital flight rendered the external accounts of these countries still more precarious.

After the Russian Federation terminated the “rouble zone” (as subsection 6.2 describes) trade with the rest of the CIS shrank—by 16 per cent for imports and by 36 per cent for exports in 1993 compared to 1992 and their trade—the Russian Federation included—with non-members by 26 per cent for imports and 3 per cent for exports (ECE, 1994, pp.102-104). Some of this shrinkage was attributable to payments difficulty, but some was also due to the establishment of customs boundaries around them where none previously existed and to the imposition of quotas on either imports or exports. The relationship was abruptly changed by the creation in September 1994 of an Interstate Economic Committee with executive authority by the CIS, with Azerbaijan and Turkmenistan abstaining. It promises a virtual economic union, in which the Russian Federation, with 50 per cent of the vote, holds a veto, but cannot impose its sole will, for major decisions require 80 per cent of the votes. The decision by Azerbaijan and Turkmenistan to remain apart may be attributable to their export potential in oil and gas, the involvement of Western firms in such development, their opposition to Russian intrusion into overall control of the Caspian Sea and their separate foreign policy towards Iran and Turkey (partly to assure the transit of their hydrocarbons otherwise than via the Russian Federation). The cooperation may lead to the CIS acting as one in their external relations, including relations with the EU; indeed, the Russian Deputy Prime Minister in charge of the economy, Aleksandr Shokhin, spoke of the agreement as “roughly equivalent to the European Union”. The immediate prospect was difficult, one element of which was that the non-Russian members of the CIS were in structural deficit with outside countries (another element being exchange control, discussed in subsection 6.3); in 1993 their aggregate exports fell by 16 per cent, more sharply than in 1992, despite increments by four of them, Moldova, Kyrgyzstan, Tajikistan and Turkmenistan (in the latter’s case due to oil and cotton exports), and they failed to restrain imports, which were 12 per cent greater. The largest economy of the group, Ukraine, suffers from capital flight, which

might be described as “capital hover”, because some at least could be attracted back once the currency is stabilized, and as large privatization begins (see subsection 6.4). In the latter case, the “stalled” break-up of collective and State farms could reintroduce agro-business, for it was in Ukraine that largescale commercial farming began in Tsarist times. Belarus is seeking an economic union with the Russian Federation, but the latter’s Government is cautious, for fear of disrupting the disinflationary trend evident in early 1995.

The three Baltic States signed the Baltic Free Trade Agreement in September 1993, which should foster intra-group trade from its currently low levels; it excludes agriculture and allows the maintenance of export duties on certain key raw materials (e.g. metals from Lithuania, timber from Latvia and quartz sand from Estonia). Their principal partners are the Scandinavian members of EFTA and agreement has been reached with it and the EU that their free trade agreements with EFTA will be respected on partners’ adherence to the EU. While their biggest recent increments have been among themselves and with the developed market economies (38 per cent increase in exports and 76 per cent in imports in 1993), they have raised turnover with all other partner groups; Latvia and Lithuania have assured an overall trade surplus, but Estonia was in deficit in 1993.

The Black Sea Economic Cooperation group, formed in June 1992, serves information and trade promotion objectives; a protocol of 1993 envisages the establishment of conditions which could lead to free trade areas. Members are Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, the Russian Federation, Turkey and Ukraine. The Economic Cooperation Organization, limited to contiguous States with Islamic majorities, includes the five Central Asian members of the CIS and Azerbaijan; in March 1995 it established four agencies for member services, a trade and development bank, an airline, and shipping and reinsurance companies.

Summarizing tariff and quota restrictions regulations, in Albania customs duties range from 10 to 25 per cent and quotas are imposed for the import of certain consumer goods and for the export of primary commodities. Armenia has neither tariffs nor QRs on imports, but requires licences for some exports. Azerbaijan has a limited number of QRs on both imports and exports. Belarus has a tariff with rates from 3 to 40 per cent, and no QRs on imports but some

on exports. Estonia has no tariffs, having abolished its export tax in July 1993, and sets quotas for only three classes of imports (alcohol, motor vehicles and tobacco). Georgia has a tariff in the range of 5 to 40 per cent but removed its QRs in March 1992. Kazakhstan has retained the Soviet-type foreign trade monopoly/monopsony, but allows open general licence to about 30 per cent of turnover. Kyrgyzstan has neither tariffs nor import quotas, but has some QRs on exports; there are free economic zones on its and the Chinese side of the frontier. Latvia has both import tariffs (15 to 20 per cent) and export taxes, but no QRs. Lithuania similarly has no quotas, but has duties on imports up to 25 per cent and on exports up to 50 per cent. Moldova has duties on both imports and exports, and quotas on exports. Mongolia has abolished export taxes and quotas, but retains them on imports. With civil war restricting the Tajik government's scope for manoeuvre, trade is still administered by the authorities as in Soviet-times, but smuggling is rife. Turkmenistan, though wholly peaceful, is not dissimilar; some liberalization began in 1992, but has little affected QRs and duties on exports, largely because cotton and oil are its dominant products. In Ukraine, the tariff on imports runs from 5 to 25 per cent, but on exports up to 100 per cent. Uzbek import tariffs were abolished on 1 January 1994, but QRs on exports remain.

**6.1.2 The Russian Federation.** Because the Russian Federation has been increasing its visible trade balance—from 5 billion dollars in 1992 and 16 billion dollars in 1993 to 20 billion dollars in 1994 (ECE, 1995b)—it differed from the rest of the CIS, in which it accounted for 80 per cent of turnover. This was, however, an inadequate guarantee for the future, first because almost four-fifths of its exports were of oil and gas (both of which suffer from inadequate past investment), and, second, because the surplus was achieved mainly by reducing imports (by a huge 27 per cent in 1993). Its underlying foreign-trade problem is nevertheless that of the CIS members just described, but looming larger are trade with its former partners in the CMEA and trade with the rest of the world. The improvement of its terms of trade with the rest of the CIS has, of course, been at the expense of the deterioration of theirs; Ukraine in particular has been willing to grant its firms credit to assure the maintenance of sales from under-capacity plants to the Russian Federation.

Like States elsewhere in the CIS, the Russian Federation is not a member of GATT, but is accorded most favoured nation treatment by most partners. In the Russian Federation and in other CIS countries, the government has a free hand in setting tariffs, subject only to retaliation, and in subsidization, subject only to anti-dumping action by partners. In the short time since independence from the USSR, the Russian Federation has briefly given subsidies to imports—to offset the precipitous decline in the exchange rate while the cost-of-living index was soaring and real wages rapidly declining—and continues to subsidize exports. In the case of its major export, oil, the margin between the controlled domestic price and the foreign price at what has come to be an overvalued exchange rate (see subsection 6.2) is so large as to require the imposition of both export quotas and a high export duty (5.5 dollars per barrel, between 30 and 40 per cent of 1993-1994 prices). Such, however, is the corruption among administering officials that quotas are bought and sold, and the duty evaded. Foreign oil companies engaged in production-sharing joint ventures are reported as complaining that they are at a disadvantage, being virtually the only exporters to pay the duty in full.

In 1991, the year the CMEA was untidily wound up, Soviet exports to CMEA members fell 41 per cent and imports by 52 per cent. The collapse continued after the division of the USSR, and Russian sales to the same countries declined 33 per cent in 1992 and a further 8 per cent in 1993; Russian imports fell even more precipitately, by 50 per cent in 1992 and 46 per cent in 1993 (ECE, 1994, p.95). Except for a modest upturn in 1993, trade with the developed market economies followed the same pattern. Because with respect to both groups imports fell more than exports, the visible balance was positive throughout, and little, if any, of the earnings were repatriated. The Russian Customs Committee estimated non-repatriated export earnings as 10 billion dollars in 1993, against 15 to 20 billion dollars in 1992. This fall was partly due to a diminution in the share of barter trade—estimated by that same Committee as 25 per cent of imports and 13 per cent of exports in 1992 to 5 per cent each way in 1994 (ECE 1995b)—which was often a cover for non-repatriation of foreign sales. As in Ukraine, privatization—the second stage of which is to be for money, not vouchers—and rouble stabilization could attract back capital now “hovering” (see subsection 6.4).

Trade could be broadened by reviving it with former CMEA States when they emerge—as some already are doing. But as of 1993 these States were still cutting back on imports from the Russian Federation, except for spare parts and semi-manufactures required for plant originally imported from the USSR. Some categories of non-food consumer goods showed buoyant demand, but they accounted for less than 1 per cent of total exports. Trade with the developed market economies could be assisted by better market access; the EU is aware of the help that this would be and has stated the aim of securing a free-trade-area relationship, but without any further stage towards membership. As subsection 6.4 notes, a substantial amount of services is provided free to Russian enterprises under EU national and international programmes of assistance.

Import tariffs on oil average 15 per cent—as stated above—and some other products are subject to both a tariff and quota restrictions on export. Customs officials have been known to determine the value of an import as its sales price within the Russian Federation, rather than its purchase price abroad, so as to augment revenue. As this practice seems to be applied to foreigners, the supplementary tax may compensate for informal exemptions made to favoured (or “mafia”-connected) shippers.

### **6.1.3 The States of the ex-Yugoslav Federation.**

Slovenia experienced hostilities for just a few days and has operated as a normal economy since. Trade was affected only in 1991, when both exports and imports modestly declined; it more than recovered in exports in 1992, but faltered the following year, when a remarkable recovery in the constrained East European market was more than offset by a decline in trade with market economies. It is seen as a potential member of the Central European Free Trade Agreement, the Visegrad group (see subsection 6.1.4) and a good candidate for EU membership. Its neighbour, Croatia, has had some of its territory occupied and has been involved in the war in Bosnia-Herzegovina, and it has run visible deficits throughout 1991-1993; its exports have found little success in either the transitional or the market economies, and with declining home production but consumers used to Western goods, its imports have greatly risen (by 52 per cent in 1993 alone). The former Yugoslav Republic of Macedonia has not been involved in hostilities, but has been severely affected by the United Nations embargo on trade with Montenegro and Serbia—and, hence, on transport as well as export

earnings—and the closure by Greece of its ports to goods destined for Macedonia. It has, on much lower turnover, moved from a visible deficit to a small surplus in 1993. The Federative Republic of Yugoslavia (as distinct from the defunct Federative Socialist Republic), comprising Montenegro and Serbia at the time of writing, remains under the United Nations embargo. Bosnia-Herzegovina subsists under the burden of civil war, supported by humanitarian aid sent through United Nations agencies and the EU.

There are no quota restrictions in Croatia but both imports and exports are taxed, the average tax being 18 per cent and 8 per cent, respectively. Macedonia has quota restrictions on both imports and exports, but no tariffs. Slovenia has a general tariff of 4.5 per cent and quota restrictions only on 2 per cent of import items. The embargo on Montenegro and Serbia and the war in Bosnia-Herzegovina have brought a combination of State administration and contraband.

**6.1.4 States with “Europe Treaties”.** The Central European and Balkan States with Treaties of Association with the EU have an expectation of membership in the Union, though some years after the enlargement to include other market economies on 1 January 1995—perhaps not until the beginning of the 21st century. In the interim they have enhanced access across the EU’s Common External Tariff and a significant liberalization of the quota restrictions previously imposed. The EU limits have not however been lifted on products for which the transitional economies have particular comparative advantage and underutilized capacity—steel and textiles under quota and foodstuffs under the CAP. Taking up these opportunities, all save Bulgaria and, recently, Hungary, have been able to expand their exports to the EU—as they have also to other developed market economies—more than compensating for the loss of trade formerly conducted under CMEA auspices. Thus the Czech Republic increased its exports to developed market economies by 26 per cent in 1992 and 20 per cent in 1993, while those to other transitional economies dropped by 33 and 1 per cent respectively. Hungary, after an early head start—because it had been “marketizing” its economy before the fall of the communist regime—with a 21 per cent export rise to developed market economies in 1991, saw the rate slacken to 9 per cent in 1992 and decline by 21 per cent in 1993. Imports continued to rise throughout, making the visible deficit a regular feature. Poland was remarkable in its first

year of “shock therapy” as early as 1990, in gaining West European markets in place of domestic and CMEA buyers, but subsequent export growth has not been continuous and, being overtaken by the growth of imports, showed a trade deficit in 1992 and 1993. Romania, slow at the beginning because of the disturbed domestic conditions of 1990 and 1991, has subsequently made small gains in its Western exports. Bulgaria, beset by political division and governmental inertia, experienced export declines to all groups (transition, developed market and developing market economies) in 1991 and 1993, but made a better showing in 1992.

Reciprocal concessions are made among members of the “Visegrad” Agreement (the Czech Republic, Hungary, Poland and Slovakia). It was intended to correct the incongruity that arose after they signed “Europe Treaties”, e.g. that goods traded among themselves would meet less favourable tariffs or quotas than between one of them and the EU. The Agreement came into force in March 1993 and an eight-year transition is envisaged to a complete free trade area in non-farm goods. Once a quota restriction is lifted or a tariff lowered, a member undertakes not to reverse the decision; nor will a member allow domestic taxes to create barriers to infra-area trade.

Bulgarian tariffs were generally revised and reduced in July 1992; quota restrictions remain on the export of only six primary commodities. The average tariff in the Czech Republic is only 5 per cent; quota restrictions remain only on imports of agricultural goods and on a few exports. Hungary’s import duties average 11 per cent and a few quota restrictions remain. The Polish tariff average is higher, 18 per cent, and there are no quota restrictions—their removal was part of the ‘shock therapy’ that Poland pioneered. There are some import quotas in Romania and import duties range from 10 to 30 per cent. In Slovakia, a few quota restrictions remain on imports and on exports, and the average import tariff is only 5 per cent.

**6.1.5 The Eastern Länder of Germany.** Upon unification the former GDR became part of the EU and subject to its trade regime. A few transitional arrangements were made to encourage the maintenance of trade with partners in the then USSR, but its collapse and that of the CMEA, both in 1991, largely withdrew the demand. Eastern *Länder* exports to other transitional countries suffered not only because of those

institutional changes but also because of the recession among partners, including the reduction of military procurement under the also-defunct Warsaw Pact. A measure of the change that took place is that whereas imports had constituted 18 per cent of GDP in the former GDR in 1989, they were over half as much, soon after 1992.

The most important factor in the recession of Eastern *Länder* productive enterprises in the face of Western *Länder* competition was the extraordinary overvaluation of the GDR mark for conversion into the Deutschemark (as noted in subsection 6.2). Eastern enterprises could not compete on price or quality terms with Western consumer goods or financial services. Among the factors were pent-up demand of Eastern households for a “taste of the West” (much glamorized by Western television and spiced by enforced isolation from such goods), the networks and size that Western banks and insurance could immediately provide (the Dresdner Bank forthwith reopened in Dresden), and lower efficiency and lack of actual competition in the communist/CMEA period. Recession was accentuated by Treuhand closures—in its early phase—and by the drop in ex-CMEA deliveries cumulated on each other. These reduced demand for investment goods and, when any restructuring was undertaken, orders for equipment were mostly placed in the Western *Länder* by the Treuhand in advance of privatization or by new Western *Länder* managers (drafted by the Treuhand or installed by new Western proprietors). Western *Länder* exports to the Eastern *Länder* delayed the onset of the Western *Länder*’s own recession, which cyclically and in harmony with other OECD economies should have occurred after the 1980s boom. Subsidizing the restructuring in the East cost the Western *Länder* so much—in higher taxes and in high interest rates to sustain government borrowing—that the recession eventually came, and thereby delayed Western European recovery. When, however, the Eastern *Länder* began to emerge all the more competitive for downsizing—perhaps too “lean” for potential future expansion—they checked the West-to-East flow. Indeed, when West German recovery seemed to start in the first half of 1994, no contribution to it was made by net exports, for exports were well exceeded by imports; growth came entirely from construction and stock-building. From 1995, Western *Länder* exports to Eastern *Länder* are likely to fall, and significant trade in the reverse direction should begin.

## 6.2 The establishment of new currencies

The break-up of three federal States, Czechoslovakia, the USSR and Yugoslavia, and the absorption of the GDR into a Federation brought new currencies in all of them, although attempts were made, and have been renewed by its Interstate Economic Committee, for a payments union within the CIS.

The Czechoslovak koruna was divided at the end of 1992 into the Czech koruna and the Slovak koruna—both of which had existed as designations during the Second World War. The Czech currency remained stable, but that of Slovakia depreciated.

The rouble remained in the Russian Federation, which in July 1993 demonetized all banknotes issued before 1993, thereby completing the change from the Soviet to the Russian rouble. This forced the other successor States—except Georgia and Tajikistan, which continue to use Russian roubles—to establish new units where this had not already been done. Two of the units were titled a “coupon” to indicate that during a period of high inflation the unit was transitory and would be replaced by a “definitive” unit when monetary stabilization had been achieved. The Ukrainian transitional unit, introduced in 1992, is formally a “coupon” but is known as the karbovanets, confusingly because it is the Ukrainian name for the rouble, but the eventual stable currency would be termed the hryvnia. In 1993 Belarus issued a coupon, popularly known as *zaichik* (“little hare”), from the picture on the notes, but an agreement on monetary union with the Russian Federation in January 1994 and the CIS economic agreement of September 1994 foreshadowed a return to the Russian rouble. The Central Asian republics, other than Tajikistan, separated their currencies during 1993—into the Kazakh tenge, the Kyrgyz som, the Uzbek sum-coupon and the Turkmen manat. The Uzbek sum-coupon was avowedly a temporary currency and the “definitive” sum was introduced in 1994, and the separate Tajik rouble was introduced in May 1995. In the Caucasus, Armenia introduced the dram and Azerbaijan the manat in 1993. None of these currencies have yet been stabilized, but there was a period (1993-1994) during which the Russian rouble became overvalued, because domestic inflation overtook its depreciation. The Russian Federation remains the only successor State with current account convertibility, which has facilitated the capital flight noted in subsection 6.4.

Against the situation described above, the experience of stability in the Baltic States is salutary (Lainela, 1993). Estonia reverted to the title of its currency, the kroon, used between 1920 and its annexation to the USSR in 1940; Latvia returned to the lat, as used between 1924 and 1940; and Lithuania to the litas, used between 1922 and 1940. Estonia and Lithuania have undertaken not to allow the issue of money to exceed bullion and foreign exchange reserves, pegging the kroon to the Deutschemark and the litas to a basket of currencies. The Latvian lat shadows the Deutschemark, but is not pegged to it.

In former Yugoslavia, that stability can only be claimed by the Slovene tolar, which was born during the disintegration of Federative Yugoslavia without a name—the notes issued bore numerals but no currency designation. War conditions caused all the other currencies to depreciate to the point of the extinction of the Bosnian dinar and the Serbian dinar. In Bosnia-Herzegovina the only tradeable unit is the Deutschemark, and in Serbia, the hyperinflation was ended with the introduction of the “new dinar” pegged to the Deutschemark. The Macedonian denar has significantly depreciated.

Finally the GDR mark was replaced in July 1990, under the terms of the German Economic and Monetary Union, with the Deutschemark at the controversial rate of 1:1 for banknotes and small amounts of savings and 1:2 for larger savings and for stocks (assets and liabilities): In the light of the deficiency of Eastern labour productivity with respect to that in the West, both rates represented an excessive overvaluation. In each of the following years real productivity—defined as GDP per employed person—remained well below 50 per cent of West German productivity (i.e. the 1:2 ratio): 38 per cent in 1990, 33 per cent in 1991 and 40 per cent—due to Treuhand closures and migration of the more efficient workers to Western *Länder*—in 1992 (Burda and Funke, 1993, p.2).

The reasons for the Western (i.e. the Federal) Government’s overshoot of the exchange rate was wholly political, and its welcome by the GDR population was misguided. Rarely in history have voters acquiesced in short-run gain for medium-run loss. In the immediate term, Easterners got 1 Deutschemark for their mark instead of some 25 pfennigs as the productivity ratio and long-term market rates indicated. By Economic and Monetary Union, the Eastern *Länder* lost the power to devalue, which every

other transitional government retained-or, in the case of divided states, seized. In the medium term they suffered searing capacity closures and unemployment-double that of the Western *Länder*—and the inflow of Western *Länder* goods and services (banks and insurance were taken over by Western *Länder* counterparts), as noted in subsection 6.2; in the longer term, they may regain their home market but are now handicapped by high labour costs. Wages by 1994 were three-quarters of the Western *Länder* level because the Western trade unions, organized on an “industrial” basis, first displaced the discredited communist trade unions of the old GDR and then extended their nationwide bargaining to their new members and their employers. Western *Länder* employers were very ready to see their potential competitors forced to pay higher wages. The Eastern trade union members were not averse to collaborating in getting more pay, but this was another case of short-term gain for long-term loss. It is in the labour-intensive products and processes that the Eastern workforce had had comparative advantage, which was then eroded by pay rises approaching the Western level. They feared, when a Western firm bought a Treuhand plant, that they would become a “long work-bench”, that is transferred to processes in the combined enterprise in which the value-added was predominantly wage cost.

### 6.3 Exchange-rate stabilization

Multiple exchange rates were the rule in the Soviet-type system, not only in the obvious division of a commercial rate from a tourist rate, but by the application of a series of “coefficients” to wholesale prices in order to adjust them to those paid abroad for exports and imports (Kaser, 1980). However, such practices are now a thing of the past in all transitional economies. The CMEA economies, as noted in subsection 2.6, allowed disorderly crossrates of which traders in member countries took advantage to the detriment of comparative advantage.

Reference has been made in the preceding subsection to the path followed by new currencies. The Albanian lek, the Bulgarian ley, the Mongolian tugruk and the Romanian leu have devalued, but in a controlled manner. Among the other transitional States, only the Hungarian forint has been stabilized. “Internal convertibility” (current account liberalization) was soon introduced in Hungary, Czechoslovakia and Poland. Already by mid-1993, the currency had been

allowed to float in Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Kazakhstan, Kyrgyzstan, Lithuania, Moldova, the Russian Federation, Slovenia, Turkmenistan and Ukraine. A managed float operates in Latvia, Macedonia, Moldova, Mongolia, Romania and Uzbekistan. The Czech and Slovak koruny are pegged to a currency basket, with a special clearing arrangement between them. Poland adopted a “crawling peg” with its “shock therapy”: initially, in 1990, the zloty was devalued each month by 1.8 per cent with respect to the US dollar, but by late 1994 the rate of “crawl” had been reduced to 1.5 per cent. In May 1995 a managed band was introduced-within which the zloty could float-at a monthly depreciating “crawl” of 1.2 per cent. Following a devaluation in March 1995, the Hungarian forint, which is pegged to a 30/70 weighted basket of the US dollar and the ECU, went on to a “crawling peg”, of 1.9 per cent monthly up to June and of 1.3 per cent thereafter. As noted in the preceding subsection, the Estonian and Lithuanian units were pegged to an external standard.

After the collapse of CMEA and its clearing scheme of “transferable roubles” there was much discussion of a Central European Currency Union (see Drabek, 1992 and references therein), but this undertaking was still-born. The institution of a Currency Union with the CIS was also taken up by a number of Western experts (see Eichengreen, 1993), but may now have been overtaken by the creation in September 1994 of the Interstate Economic Commission which will consider payments relations among members (Turkmenistan and Ukraine withholding admission).

### 6.4 Capital movements and international grants

Reference has frequently been made in this paper to capital flight. Albania, Hungary, Kyrgyzstan, Latvia and Lithuania have abolished capital control, or reduced it to a very liberal degree. Elsewhere capital controls are in place (EBRD, 1993, pp.33-38), and exchange control over current transactions is more the rule than the exception. Outflows, including “laundered” money, are substantial from the Russian Federation and Ukraine. The Russian Federation has sought partly to counter the “dollarization” of the economy by forbidding domestic transactions to be effected otherwise than in roubles, though the purchase and sale of foreign currency ostensibly for current account remains; Ukraine reimposed the rationing of



foreign currencies in November 1993, but allows tightly-controlled auctions (D4browski, 1994, p.121). Estimates vary widely but seem to show that in the Russian Federation capital flight peaked in 1992, the year of maximum inflation. The lowest estimates are those of the IMF which estimated 13 billion dollars in 1992 and 8 billion dollars in 1993; as mentioned, the Russian Customs Committee estimated unrepatriated export earnings at 15 to 20 billion dollars in 1992 and 10 billion dollars in 1993; statistics supplied by Western banks to the BIS show that depositors in the former USSR put 5.8 billion dollars in their accounts in 1992 and 2.3 billion dollars in 1993. Cumulatively some 30 billion dollars are believed to be held abroad by Russian residents and citizens. In 1993, the peak year of Ukrainian inflation, one estimate had 12 billion dollars escaping abroad. Attracting this money back must depend on relative monetary stability and the availability of securities—notably equity in privatized enterprises and in the government bonds now being used to monetize debt. In July 1994 the Chairman of the Russian Central Bank hinted that an amnesty might be offered for illegal acts in gaining foreign capital assets against roubles, but subject to a tax on inward remittance (a 23 per cent rate was being mentioned in Moscow at the time).

Many States in transition have, as already noted, offered tax concessions to attract foreign investment and all have made promotional arrangements for such inflow. The net inflow to the Central and Eastern European States in 1993 was estimated at 3.5 billion dollars, of which 2.3 billion dollars went to Hungary; the Russian Federation was estimated to have received 400 million dollars and Ukraine 100 million dollars. The contrast between the attraction of Hungary, which, by the end of 1993, had accumulated 6 billion dollars of foreign capital and China, which had 15 billion dollars, and the cumulative aggregate of a mere 1.7 billion dollars in the Russian Federation speaks for itself.

Private non-corporate money inflow is also significant. Convertible currency brought into Poland from citizens of the former USSR, either to buy consumer goods or to deposit funds, was cited as the reason for the increase in the money supply in the summer of 1994 and for the National Bank to refuse to cut the interest rate as the maintenance of the economic upswing seemed to demand. Remittances by emigrant workers brought into Albania 330 million dollars in 1993, or

more than the visible export earnings of 125 million dollars.

Grants, technical assistance, bilateral credits and multilateral credits have added further inflows throughout the period of transition so far. The ECE (1995b) estimates show the changing composition of such inflow as private-sector sources increase. Private-sector foreign investment committed by the end of 1994 totalled 117.8 billion dollars, covering 215 projects in the transitional economies, each of more than 10 million dollars. However, much of this very long-term investment—82 billion dollars is in Kazakhstan and the Russian Federation, mostly for oil and gas exploration and development Funds to be spent within the first four years of a project (totalling 17.2 billion dollars) show a different country ranking: Hungary has been the most successful, receiving 27 per cent of the total, followed by , Poland, 24 per cent; the Russian Federation, 15 per cent; Kazakhstan, 14 per cent; and the Czech Republic, 8 per cent (ECE, 1995).

The ECE (1995b, p.149) estimates the financial flows from private sources to Central and Eastern Europe to have amounted to 6 billion dollars in 1990, 5.7 billion in 1991, 6.1 billion in 1992, 14.3 billion in 1993 and 11.5 billion in 1994. Also in 1994, the inflow was 3.6 billion dollars gross through capital markets, 3 billion net as foreign direct investment (FDI), 500 million as net portfolio investment and 4.4 billion as other credits. Corresponding annual estimates for the former Soviet Union were 15 billion dollars when it was still a unitary State in 1990, but only 7.6 billion in 1991, 14.1 billion in 1992, 5.8 billion in 1993 and 3.1 billion in 1994; the latter originated mainly as 1 billion dollars of FDI and 1.9 billion as other credits, and only 200 million dollars in portfolio investment as State firms were privatized. Official flows, from the same source, to Central and Eastern Europe were 2.9 billion dollars in 1990, 7.9 billion in 1991, 5.3 billion in 1992, 2.4 billion in 1993 and 500 million in 1994. Also in 1994, 500 million dollars were grants, 400 million were bilateral credits and 2.2 billion were multilateral credits; 1.9 billion came from the IMF. For the FSU the annual estimated amounts were 5.5 billion dollars in 1990, 8.6 billion in 1991, 500 million in 1992, 5.3 billion in 1993 and 5.2 billion in 1994. In the latter, these were 2.4 billion dollars in grants, 100 million in bilateral credits, 1.2 billion in multilateral credits and 1.5 billion from the IMF.

Among the many criteria relevant to the reversal of capital flight and the attraction of foreign investment

are political instability (including a foreseeable relationship between local and central authorities and among central authorities); a normal legal framework for the foreign investor (including security from fraud and crime); predictable and stable taxes, fees and tariffs, currency liberalization (including the repatriation of capital and of profit); and a "level playing field" for foreign companies. Forces for instability, as discussed in this report, are often allied to pressure for protection by the domestic private sector as new firms and privatized enterprises restructure to meet the new conditions. The task of governments and their external advisers is to balance those many factors in the actual and foreseeable conditions of the States concerned.

## 7. Summary and conclusions

Societal changes are continuous, yet their magnitudes vary from country to country and from time to time. Transitional economies are those in which the rate of change is acute and puts severe strain on the economy and society; they are typified in the ex-command economies transforming themselves towards market-driven incentives in the 1990s.

In order to adopt effective financial management as it is known in developed countries, important transformations are necessary in countries presently described as in transition. These transformations are undertaken with the objective which can broadly be described as an eclectic amalgam of the OECD economies. Despite much discussion by governments, legislatures, companies, consultants and academics, the paths to that objective are perceived as neither uniform nor determined a priori; moreover, the speed, content and desirable order of the actions necessary to achieve it are all the subject of debate. Nevertheless, there is much agreement on the reforms that are needed and on interpreting the evidence of the changes already introduced.

This paper has presented, in a comparative context, the measures that transitional economies have applied in their financial-management strategies, which are almost always macroeconomic and societal as well as microeconomic and individual-centred. Strategic financial management concerns these interdependencies in their longer-term outcomes. A common objective is a general acceleration of financial settlement systems, and many transitional economies experience severe problems of bad inter-enterprise debts, non-performing loans and tax arrears as a

consequence of price and trade liberalization and government "desubsidization". However, it would be premature to impose moratoria or bank recapitalization as short-term solutions which try to alleviate the symptoms before the causes of underlying instability have been identified and eradicated, so that domestic enterprises are able to ensure their own liquidity and stakeholders in them are able to monitor performance. Furthermore, if economic activity remains in recession (as all these transitional economies experienced after 1989), a sophisticated financial intermediation is less important than the assurance of demand to underwrite restructuring and survival. Finally, since the bulk of investment must eventually be financed by domestic resources mobilized by banks and non-bank financial institutions, policy measures to attract foreign lending institutions should not crowd out the flow of savings which domestic entities can appropriately generate and allocate.

The paper has addressed the strategic and policy issues relevant to creating an economic and institutional context in which financial management can fruitfully be exercised; this cannot be a "quick-fix" approach. In developed countries, the foundations for competitive markets have been built over decades or even centuries, although there is a temptation for many reformists to forget this long gestation process. Such evolution of the market systems includes the evolution of law and property rights, security markets, corporate autonomy and accountability, the role of commercial banks and the enterprise sector and many others.

The paper began with a discussion of the notion of transition, of financial management and of the relevance of strategy in longer-term economic development. This was followed by an overview of those inheritances of ex-command economies which influence the accounting and information systems necessary for the successful implementation of reforms. Command economies were centralized and virtually State-owned. "Commands" were based on information which was often outdated. Prices were arbitrarily set to meet the needs of the planners, and finance was no constraint. Such a system was effective in mobilizing resources and concentrating on a few clear and well-defined objectives; but it did not serve the individual needs and aspirations of its citizens well, nor could it accommodate multiple objectives in a pluralistic society. Valuation bases were mainly on historical costs and accounting systems were almost primitive. Information systems did not provide much help for enterprise man-

agers because they were backward-looking and were generated as a by-product of the planning process.

Banks and other financial institutions are the cornerstone of any strategy for “marketizing” the function of money. Issues in banking reform (discussed in section 3) are the usefulness of a two-tier banking system—replacing the monobank—and their interdependence. The stability of a banking system requires efficiency and solvency. The issues discussed in the area of efficiency include permissible banking functions, permissible ownership structure and the rules governing the entry and exit of banks. The issues on solvency included the distribution of non-performing debts, accounting, payments and settlement systems, as well as the assurance of appropriate skills among employees of financial institutions; the major concern is one of capital adequacy in the light of perceived risk.

The recapitalization of banks and the participation of financial institutions in enterprise restructuring has been a characteristic of strategy in five transitional States—Poland, Hungary, Slovenia, Estonia and Latvia—but a further round of debt “workout” could be needed if incentives and skills are not matched among enterprises in general. The paper went on to examine relationships in the enlarging private sector and with the diminishing, but newly-regulatory, public sector.

The existence of property rights is a prerequisite for individualized rewards and incentives and most governments of transitional countries recognize this by undertaking a substantial privatization of State-owned assets.

Essential as a transfer of property rights is to create a critical mass of profit-oriented economic activity forming capital in accordance with prospective efficiency, paradoxically it may not apply to banks, at least in the early stages of privatization. This is because the recapitalization of a State-owned bank can be more readily defended than of a private bank in a democratically-elected legislature. It is also because private banks may be established—or taken over—by criminal and fraudulent persons or groups, both to exploit the potential to create credit for illicit dealing and to conduct external transactions to escape exchange or fiscal controls, such as capital flight or tax evasion. In analyzing the role of the transfer of property rights in general, the paper saw the extension of privatization as broadly parallel to the extension of modern market practices.

Monetary rewards and incentives are eroded by domestic inflation and exchange-rate depreciation, low inflation being one of the yardsticks of efficiency in macro-economic management. As the paper detailed, both revenue and expenditure in the public accounts are reshaped by changes in the economic system and by a consequential variation in economic activity. When most external economic relations have been liberalized, trade and capital flows should enhance competitiveness and efficiency in the economy. Particular problems have, however, arisen from the creation of new currencies as separate States were established and from the initial instability of all currencies.

The central recommendation of this paper is attainment of compatibility with the motivations, incentives and objectives of market-based financial mechanisms. While these may be subject to particular national requirements, the key issue is to assure that economic institutions be transnationally consistent and compatible in order to facilitate integration into a world market economy. Money is the most homogeneous unit of transfer both between and within economies. The attainment of its full characteristics of fungibility and transferability is the prime objective of strategic financial management.

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## II. TECHNICAL AND PROFESSIONAL FINANCIAL MANAGEMENT ISSUES

### IN TRANSITIONAL ECONOMIES

#### Introduction

This chapter—which consists of a paper on the subject issues—addresses the technical and professional dimensions of financial management issues affecting enterprises, both State-owned and private, as well as government proper in transitional economies. Transitional economies are those countries, mainly in Central and Eastern Europe (CEE), which are in the process of transforming their command economies into market-driven ones. The term also covers, to some extent, China's introduction of certain market mechanisms overlaid on the existing system, sometimes referred to as market socialism.

The term financial management is broad since it covers budgeting, accounting, auditing, and selected topics. In addition to the present Introduction, this chapter consists of four sections. Section 1 considers financial management issues in banking enterprises because development of this sector is essential for opening up and nurturing a free market system; special attention is paid to the bank restructuring process, risk management and the role of banks in capital flows. Section 2 examines enterprise financial management in the non-banking sectors, considers the various difficulties posed for cash flow planning and business budgeting, and evaluates the role of accounting in privatization and the development of capital markets. Section 3 considers the status and professionalization prospects for the accounting and auditing functions. Section 4 is devoted to financial management in government proper. The chapter concludes with a Summary and general assessment.

Each section commences with a general description of the system which existed as the transitional process began. This clarifies the threshold level, gives some indications of the stage of maturity of the system following Dean's (1988b) model; and helps to explain some anomalies which persist in current practices. To set the stage, this Introduction concludes with the following brief review of the typical features of

accounting in planned economies.

Because the accounting function is generally conditioned by the culture within which it operates, some of the distinctive features of accounting in planned economies are described so as to identify, in broad terms, the scope of accounting modifications and training needed for transitional countries.

In market economies, enterprise accounting is geared to the needs of entrepreneurs who exercise judgments about volume, composition, and resale prices of output based on market information about consumer preferences. Consequently, effective financial management is essential when enterprise survival depends on maintaining commercial viability through expanding profits under demand-constrained conditions. In planned economies, on the other hand, the State enterprise director operates under resource constrained conditions with the main objective of expanding output to meet centrally-planned production targets. Some of the essential differences between these two types of economies, affecting the accounting function, are listed in Table 1.<sup>1</sup>

Where social considerations prevail, such as maintaining full employment, financial viability is not a vital issue for a State enterprise. Generally, the State could be expected to assume responsibility for covering losses incurred in meeting assigned responsibilities, such as production quotas, as well as eventually writing off unrepaid bank credits. Many small entrepreneurs applying for credit in eastern Europe today are slowly grappling with the concept that loans have to be repaid rather than ignored as in the past. Maximizing wages, not profits, is a major motivating factor particularly where, as in Hungary and Poland, workers' councils participate in management functions. Because "beating the system" in various ways is endemic, internal control assumes increased importance.

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<sup>1</sup>All tables in this chapter appear together, before "References," at the end of the chapter.

Under central planning, enterprise accounting forms part of a series of subsystems contributing to an accounting for the economy as a whole. Each subsystem is connected through common or harmonized charts of accounts, accounting and bookkeeping methodology, and reporting formats laid down by a State authority, usually the Council of Ministers or the Ministry of Finance. The accounting function therefore represents an important tool in national economic administration. The enterprise chief bookkeeper acts primarily as a State comptroller, responsible for acting in the interests of the State and therefore not an integral member of the management team serving the enterprise director.

In exercising the control function, considerable attention is concentrated on satisfactory performance of prescribed procedures, particularly since there is personal material responsibility for errors which strengthens low tolerance of ambiguity and resistance to change. The potential for expanding the use of accounting information for decision-making, rather than treating it as merely a repository of documentary evidence, is diminished for a variety of reasons including (Bailey, 1988, pp.15-16):

- a. The accounting function has low prestige, does not command high pay, and therefore neither attracts highly qualified personnel nor recommends itself as a management information source;
- b. The central authorities (who are generally economists) and enterprise management (which usually consists of specialists) have little or no training in accounting and finance as a rule, and do not appreciate accounting's useful potential;
- c. Centrally processed data is usually compiled in nonmonetary terms rather than in monetary accounting units;
- d. Due to lack of computerized equipment, accounting data which could be useful is processed slowly and, consequently, is not available in a timely fashion;
- e. Because accounting technology does not keep up with the times, the data it provides could be irrelevant and unreliable; an example is the lack of accounting for price-level changes under inflationary conditions; and
- f. Accounting data may be incomplete because not all transactions flow through the system, particularly with respect to the enterprise's bank account. For State control purposes, enterprises are kept cash

poor and all receipts and payments must be channelled through their particular branches of a State bank. Usually the bank keeps the subledger details of the receivables and payables while the enterprise maintains one third-party general ledger account. A net debit balance in this account would be treated as net receivables or a net credit balance treated as net payables on the balance sheet. The bank only releases cash to an enterprise for specific purposes such as meeting a payroll and only after it has checked out the details against some authorization such as the enterprise's plan. Further, the bank does not customarily issue a detailed bank statement, although it will confirm a bank balance.

Additional financial management problems for enterprises and banks are detailed below. Very briefly summarized, the banks' main functions are to act as agents of State control in the receipt and payment of cash. Except for specialized institutions, they do not serve as investment bankers or venture capitalists and have very limited experience with credit risk evaluation.

Where so little emphasis or dependence is placed on the usefulness of accounting information, the accounting function is so standardized, and enterprise financial reports are generally not made available to outsiders, that there is little reason to promote the emergence of an accounting and auditing profession. Poland is one of the few countries in Eastern Europe to have maintained an Association of Accountants with a programme which granted diplomas to those recognized as "expert accountants." This diploma qualified them to check the accounts of State enterprises, typically during release time from regular employment as State enterprise chief accountants, to ensure compliance with regulations. This examination did not include internal control review, audit risk assessment, statistical sampling, and overall assessment of financial condition, results, and cash flows typical of independent auditors' activities in a market economy.

Lastly, the accounting function is usually the least developed in government proper. There are at least two main contributing factors: the first, that the important task of planning the economy, as expressed in the national budget, is performed by macroeconomists who do not use accounting data; the second, that Government operations are not subject to challenge over their economy and efficiency, although lip service, may be paid to those considerations. A third consideration is the common problem in market economies of



attracting personnel to improve government financial management and stimulating the general public to take an interest in it and make an issue of it.

## 1. The banking sector

### 1.1 Banking sector reform

Banks and similar financial institutions (collectively designated as “banks” for convenience) play a critically important role in the economy as a whole and business in particular. They not only act as channels for private and commercial cash flows, for example, but also work together with governments and regulatory authorities to achieve monetary policy objectives. As a consequence, one of the first requirements in transforming an economy and establishing a new financial system is to restructure the banking sector. That is, banks have to evolve from subordinate units of the State administration to independent commercial companies exercising increasingly important influences on the functioning and development of a market economy. This process takes place in two stages: the first, creation of a two-tier system of central and commercial banks; the second, restructuring and consolidation. At the same time, accounting and reporting systems for banks have to be redesigned so as to meet the needs of the new institutional arrangements. This provides an opportunity for standardization of procedures and improved overall control, through computerized operations. This massive effort is complicated by the need for training in almost all functions and at almost all levels. After five years, most of the newly emerging democracies are still in transitioning stages.

Section 1 proceeds with an overview of the unitary banking systems in place in the CEE command economies prior to the transition period, the process of creating new commercial two-tier structures, and the difficulties connected with the existing staff’s lack of relevant banking skills. The diagnostic assistance of international accounting and consulting firms in analyzing bank management needs is illustrated by the Polish experience in privatizing its banking sector. To help appreciate the benefits of speeding up evolutionary processes, the new accounting, reporting, and management information systems for Polish banks is contrasted with that of the Russian Federation which is at a less developed stage. Extensive computerization and the use of standardized charts of accounts has generally facilitated bank modernization. The banking diversity

which has started to develop throughout the region can partly be attributed to alternative approaches to restructuring and consolidation. The section concludes with consideration of bank supervision as well as overall training needs, and approaches to them, in the banking sector.

### 1.2 Unitary banking systems

Until the late 1980s, Eastern European banking systems were unitary, consisting of a central bank with, possibly, some specialized institutions in addition. In Hungary, for example, there were three: the Foreign Trade Bank, an investment bank and a savings bank. In Poland there were five: the Bank for Food Economy, servicing the State-owned agricultural and food processing industries; the household savings bank; the trade bank, primarily offering short-term trade credits; and the Export Development Bank.

A somewhat different situation prevailed in the Soviet Union where, for many years, the banking system comprised three main banks: the State Bank of the USSR (Gosbank USSR), which acted as a central bank and as a commercial bank for the State enterprises; the Bank for Foreign Trade of the USSR (Vneshtorgbank USSR), which handled all external banking operations; and the Construction Bank (Stroibank USSR) which had sole responsibility for capital investment under the five year plans. A fourth bank, the State Savings Bank (Sherbank USSR) operated under Gosbank’s supervision (Essinger, 1994, p.334).

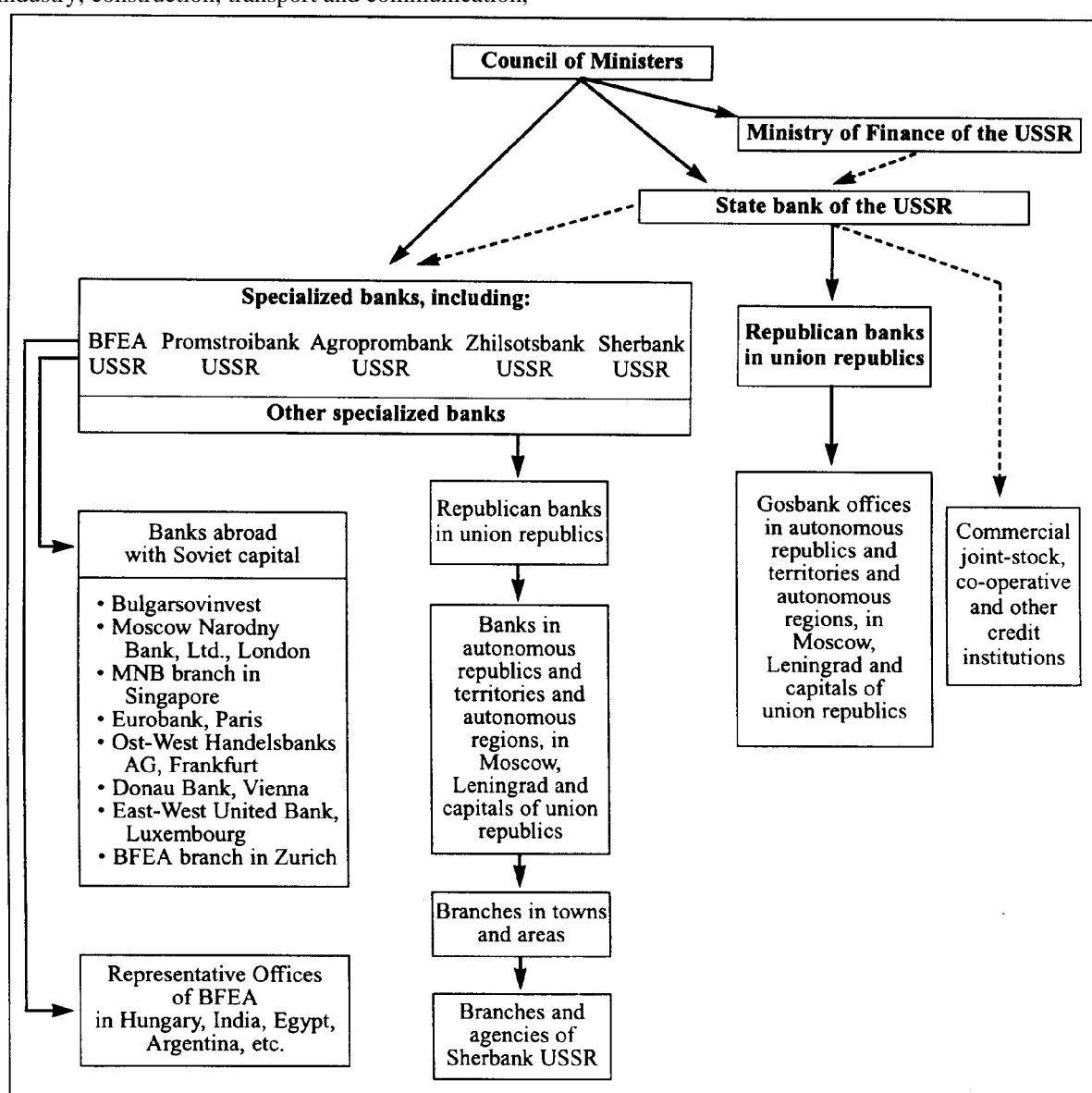
While the functions of the central bank varied somewhat from country to country, the activities of the National Bank of Poland (NBP) were not atypical. After consultation with the Ministry of Finance (MoF), the NBP would examine the production objectives and investment requirements of the Government’s central economic plan. The NBP and MoF would then establish a credit policy designed to enable State enterprises to meet their targets. The NBP was also the country’s largest commercial bank, dispensing about 90 per cent of the credits to the State-controlled sector. Until the household savings bank (PKO BP) was established in 1987, the NBP also functioned as the national savings institution, conducting more than 65 per cent of household and business transactions (Essinger, 1994, p.226).

Following new banking regulations passed in 1987, the Soviet Union introduced a new system as of the beginning of 1988, providing for six main banks, two

of which were new while the other four were modified from the previous institutions. The two new banks were Agroprombank USSR, providing finance, credit, and settlement services to the agricultural sector, and Zhilsotsbank USSR, established to provide finance for housing construction, social service facilities, and development of sports, municipal and consumer facilities. Gosbank's functions were limited to central banking; Vneshtorgbank's role was broadened and it was renamed the Bank for Foreign Economic Affairs of the USSR (Vnesheconombank USSR); Stroibank was also assigned broader duties to provide finance and credit to industry, construction, transport and communication,

and was renamed Promstroibank USSR; while Sherbank USSR loosened its ties with Gosbank and—not renamed—succeeded to the 80,000 or so individual savings banks comprising the previous savings bank system. An overview of the Soviet banking system as of mid-1989 is illustrated in Figure 1. In August 1991, the Soviet Union was disbanded and the various republics started to adopt their own banking systems. In succeeding sections, emphasis is placed on the Russian Federation.

**Figure 1. Overview of banking system in the Soviet Union in mid-1989**



SOURCE: James Essinger, 1994, *Eastern European Banking*. New York: Chapman Hall, p.335

### 1.3 Creating a two-tier structure

Creating a new commercial banking sector consists of two basic processes: privatizing the existing State-owned banks and introducing new private banks into the economy under the provisions of enabling legislation. Decoupling the central bank's political dependence and commercial activities is essential for the banking system to evolve into a mechanism for credit allocation and financial intermediation which is market-driven and market-responsive. This would leave the central bank with functions similar to those in Western countries. That is, issuing currency, acting as the country's central clearing institution, serving as the country's banker, and refinancing and supervising the banking system. The latter function involves monitoring the banks' financial statements, reserve requirements, interest rates, and commercial conduct (Essinger, 1994, p.228).

Among the first countries to pass new banking laws towards the end of the 1980s were the People's Republic of China (PRC), the Russian Federation, Hungary, Poland, Bulgaria and Czechoslovakia, with others following closely behind. Amendments had to be introduced later as the realities of trying to operate financial institutions in transitional economies began to sink in and legal loopholes became obvious. Some of the difficulties which had to be resolved included (Gołębowski, 1994, pp. 82-84):

- a. whether or not some bank functions could be performed by non-banking institutions;
- b. whether or not the National Bank should pay interest on the compulsory reserves maintained by commercial banks. In inflationary periods, which all transitional economies were going through, commercial banks were suffering real losses through holding idle reserves while, on the other hand, governments with budget deficits were anxious to avoid financial obligations;
- c. whether or not the tax authorities should be allowed access to depositors' accounts information;
- d. how to assure the independence of central bank administration from political pressures.

The process of privatizing the existing State-owned banks followed a fairly consistent approach because of the strong similarities in the various transitional banking systems. Essentially, regionally-organized banks

were split off from the central bank and licensed as universal commercial banks, inheriting the physical branch networks, staff, and the loan and deposit accounts of the former monobank. Poland's experience helps to illustrate the growing pains in the early days of the new regional banks.

From the start, Poland's nine regionally organized banks were hampered by two basic and interrelated problems, their corporate client orientation and their lack of experience in modern commercial banking (Gołębowski, 1994, II, p.86). Most State enterprises, having lost their traditional markets, were in severe financial difficulty and conserving cash to meet pay-rolls rather than to pay interest or principal falling due on debt. Furthermore, it was not unusual for loans from the State to be forgiven or converted into equity during the days of a managed economy. Consequently, enterprise managers did not recognize State debt repayment as representing a real liability or responsibility. The cash-flow problems of the banks were aggravated by the regional structuring of both industry and banking. For example, shipbuilding was concentrated in the north, coal mining and steel works in the south, and textiles in the centre, just southwest of Warsaw in Lodz. With entire regions in recession and stagnation, and banks regionally organized, there was no mix of bank clients with varying degrees of liquidity in the regions that were hardest hit. Bank management did not have either the expertise or resourcefulness to cope with the situation since most of their experience involved receipt and expenditure of funds and monitoring of enterprise transactions against their budgets or production plans. Also, low salary scales did not attract new personnel.

To help identify appropriate courses of action, the Polish Ministry of Finance commissioned three international accounting and consulting firms in the fall of 1991, to carry out diagnostic studies of each of the regional banks. Their main findings and recommendations fell into three categories, two of them having to do with the specific functions of strategic planning and risk assessment, the other with management overall (Gołębowski, 1994, II, pp. 87-88):

- a. With few exceptions, the banks had no strategic development plans, typically making short-term oriented decisions. For example, they perceived high margin loans to be the most profitable line of business without taking into account emerging competition and consequent shrinking margins. They needed to decide how they wished to position

themselves, what specializations they should develop, and whether they should proceed individually or seek out a partner, perhaps from overseas;

- b. The banks were criticized for lack of prudence in granting and monitoring credits. On a sample basis, receivables from the largest debtors were analyzed for collectability and, as of mid-1991, uncollectability was estimated at about 25 per cent on the average, including 55 per cent for one of the banks alone. Among the recommendations were, checking on credit-worthiness monthly rather than quarterly; monitoring the degree of credit committed to particular branches of the economy; and assessing the total amount of loans extended to interconnected clients as well as the credibility of other banks in which they placed deposits. The functions of the economic departments in the banks needed to be overhauled, as they were primarily oriented towards reporting on past operations. They should, as in the West, be studying on a daily basis not only credit-related risk but also such other risk factors as changes in the central bank interest rate, exchange rates, and the bank's liquidity position;
- c. The new role of the banks in the economy called for a number of changes in bank management and procedures. In particular, two new functions needed to be developed: marketing and assets management, and—through the creation of new departments—information systems and planning. By consolidating some of the existing headquarters' departments, needed centralization could be brought about as well as more collective decision-making on some key issues. Instead of one small headquarters running as many as 40 or 50 branches, smaller branches should be grouped for supervision by four or five larger branches run by specially appointed vice-presidents. In effect, this would be very similar to the way State enterprises were organized into associated groups in the 1980s and before that into "unions" (zjednoczenia).

After considering the consultants' recommendations, the Ministry went ahead with the next stage of bank transformation which consisted in transforming the nine regional banks into joint-stock companies wholly-owned by a particular State entity—in Poland's case, the Treasury. It also built many of the proposed changes into the design of the new accounting, reporting and management information systems, which are described below. The banks were now subject to the commercial law which allowed for the appointment of

supervisory boards to monitor management as well as for the eventual sale of shares to third parties. It also meant that they needed new accounting and reporting legislation to meet their new role in the financial world.

#### 1.4 Bank accounting and reporting

Accounting and reporting for banks and similar financial institutions is almost invariably differentiated from that of other commercial enterprises because of the specialized nature of banking activities. It is also regulated, usually by relevant provisions of banking acts and requirements of supervisory authorities. Commonly, banks are required to follow standardized or harmonized recording and reporting procedures based on specially designed charts of accounts whose use may or may not be mandatory, depending on the country involved.

For members of the European Union, bank reporting follows the amended Fourth Directive (bis) of 8 December 1986 which established uniform, but very limited, sets of alternative balance sheet and income statement formats. These paralleled the basic (1978) Fourth Directive's rules on company law for non-financial corporations dealing with the content, valuation, and presentation of their annual accounts. To produce these reports, computerized bank accounting systems in Western Europe make widespread use of a standardized chart of accounts (SCA), summarized in Table 2.

The SCA's structure resembles charts of accounts commonly found in countries with Anglo-American accounting traditions where accounts are usually listed in the sequence that they appear in the balance sheet and income statement. In continental Europe, on the other hand, accounts are generally grouped into classifications depending on some shared characteristic. Usually, a maximum of ten groups is provided for, with first-digit decimal identification numbers for each individual group running from 0 to 9. This difference in basic design is illustrated in Table 2, where the SCA and the Polish chart of accounts for banks, BPK 93, appear side by side. The Polish accounts are classified into ten groups; four because the constituent accounts are involved in like types of transactions (groups 1 through 3 and 5); three because of their nature, that is their line item description (groups 0, 4, and 6); two because of their financial statement classification (groups 7 and 8); and one (group 9) for off-balance

sheet items, that is for transactions which are not recorded formally in the accounts.

Poland, together with its fellow members of the Visegrad group (the Central European Free Trade Agreement) of transitional economies (Hungary, the Czech Republic, and Slovakia), aiming at eventual membership in the European Union, has incorporated into its banking regulations general congruence with the amended Fourth Directive (bis, 1986) as well as elements of International Accounting Standard (IAS) 30, "Disclosures in the Financial Statements of Banks and Similar Institutions." A brief description of the Polish approach will follow that of the Russian Federation which, by late 1994, was at a less developed stage. This contrast between the two could be useful for identifying the bridging mechanisms which may be employed at various transitioning stages.

**1.4.1 Bank accounting and reporting in the Russian Federation.** In the Soviet Union and other managed economies, the framework of bank accounting and reporting reflected, congruently, banking's main functions of acting as an agent of State-centralized control and redistributing funds. As stressed earlier, bankers were not involved in making investment decisions based on credit ability and neither loan interest nor principal were necessarily construed by either borrower or lender to represent actual liabilities but possibly potential grants or State equity investments. As a corollary, banks did not have to be concerned about their own financial viability and, further, their accounting information systems were not designed to accumulate or process related data. This situation changed, however, in 1988 when the Soviet Union embarked on banking reforms—continuing in the Russian Federation—which essentially established for the first time in its history a requirement that profit and loss accounting be included in bank information systems.

As of late 1994, all Russian Federation banks must follow the *Rules of Accounting and Reporting for Banks of the USSR*, issued on 30 September 1987 (Enthoven and others, 1994, p.79). This legislation, with subsequent amendments, requires that all banks use a special chart of accounts and sets of financial statements produced by the Central Bank. This bank chart of accounts—first enacted by the USSR State Bank on 16 February 1990—differs from those used in other economic sectors in various respects. For example, account classifications differ. The owners' resources are listed first and liabilities are emphasized

rather than assets; also, assets are listed in decreasing, rather than increasing, order of liquidity.

The chart consists of 26 sections of balance sheet and mixed accounts and 10 sections of off-balance sheet accounts, some of which apply only to central banks and have been omitted in the listing provided in Table 3. The chart's design was heavily influenced by the fact that it was developed by the central bank which, being accustomed to a unitary system, retained many features of a centrally-planned economy. In particular, some of the terminology is outmoded and it is far too detailed, containing, for example, many State settlement accounts corresponding to line items in the State budget. A positive feature of the chart, from a training aspect, is that it does provide a bridge from the old system to the new and does not, therefore, confront the existing bookkeeping staff with heavy retooling needs. However, a revised chart is not expected to appear until sometime in 1996 and this extended delay means that bank information systems are not serving the best interests of their users.

The roots of the old managed system are evident in *Regulations for Compilation and Submission of Financial Statements* of 1988, as amended by the USSR State Bank on 18 October 1991 (Androsov and Golubovich, 1993, p.199), in which the main emphasis is placed on the balance sheet. Under the legislation, banks compile annual financial statements with the following components (idem):

Form No.	Statement
1	Balance sheet
2	Profit and loss statement
3	Allocation of profit
3-a	Capital investment
4	Availability and movements of fixed assets
5	Bank assets, other resources and tied assets
113	Embezzlements and miscalculations

Two other documents are attached to the annual statement, a summarized statistical statement of commissioned objects, fixed assets, and the use of capital investments (form 2 ks) and a short explanatory note. Commercial banks submit the annual reports from

their headquarters to the Russian Central Bank (CBR) department in their locality by 1 February after the calendar year-end closing, or by 10 February if there are affiliates. Balance sheets are also drawn up daily, using a CBR-authorized format. For central bank control purposes, monthly balance sheets must be submitted to the CBR—with a consolidated one also if the bank has representative offices, subsidiaries, or branches—together with an aged analysis of borrowing and forwarding of resources for certain balance sheet accounts.

An example of a Russian commercial bank balance sheet with a listing of off-balance sheet accounts is presented in Table 4.

The Table is based on 1991 balance sheet data for one of the Russian Federation's largest bank, the Commercial Bank for Innovation (MENATEP). A more comprehensible and considerably abbreviated Westernstyle balance sheet format, using the same data, is also included in Table 4 for contrast. MENATEP was taken public in December 1990 and later issued shares which were available for purchase by physical persons, the first such opportunity in Russia—and the former Soviet Union—in the second half of the twentieth century (Androsov and Golubovich, 1993, p.202).

Criticism of the existing accounting and reporting systems for banks includes the following (Enthoven and others, 1994, p. 83):

“The underlying inadequacy of current bank accounting systems, limited understanding of financial statements, rudimentary accounting principles, and the absence of appropriate reporting and supervisory guidelines constitute significant dangers for the financial system. The main weakness in the current system relates to the fact that financial statements do not present a fair picture of bank performance, solvency, profitability, and liquidity to depositors, shareholders, and third parties, and do not demonstrate that banks satisfy prudential criteria.”

Recognizing the need to raise accounting and auditing standards in the banking sector, the Russian Government prepared a four-stage plan for accounting reform (Enthoven and others, 1994, p. 84):

- a. To adapt the existing system so as to bring it into line with international practices with respect to

principles and presentation;

- b. To disseminate instructions to make financial statements congruent with the new standards;
- c. To draft a new chart of accounts and detailed instruction manuals by a set deadline; and
- d. To prepare a calendar to carry out a detailed reform of the accounting system over a two to three year period.

While all transitional economies have different sets of needs, the experiences of the Visegrad countries with speedier institution of bank accounting reforms could be useful for others.

#### ***1.4.2 Bank accounting and reporting in Poland.***

Polish bank accounting and reporting is governed by the President of the NPB's Instructions, No. 1/91 dated 12 February 1991, on the topic of standardized principles of bank accounting. Financial institutions are required to use the chart of accounts for banks (BKP 91, now BKP 93) in accordance with the NBP President's Instructions No. 24 of 31 October 1990. However, they are free to modify the basic chart (illustrated in Table 2) to meet particular circumstances, as long as they do not deviate from the standardized reporting formats.

In designing a standardized chart, one of the most basic considerations is determining the information needs of the users of the accounting and reporting systems who depend on the chart for foundations. A first priority can be drawn from the introduction to IAS 30 which recommends that bank financial statements include presentation of a commentary covering such matters as the management and control of liquidity and risk. This is because of widespread interest in, and concern for, the topics of bank solvency and liquidity, as well as the relative degree of risk associated with different types of activity. In identifying bank information system users and their needs, detailed below, this concern takes first precedence (Jarugowa and others, 1994, p.60):

- Bank managers, as a tool for analyzing financial structure and risk control;
- The stockholders of domestic and foreign banks, as well as the general population;
- The monetary authorities, for carrying out monetary policy and checking its effects;
- The General Inspectorate of Bank Supervision; and

- Auditors and bookkeeping inspectors.

In the technical construction of the chart, there are two types of accounts, general and designated (Jarugowa and others, 1994, p.67). General accounts identify different types of operations and are disaggregated through the use of four numerals. The first provides the account group classification, the second the subaccount, the third the type of subaccount, and the fourth details of the type of subaccount, as in the following example:

Numerals	
1	Group classification: Operations with monetary assets and with financial entities
11	Subaccount: Central bank
110	Type of subaccount: Current operations with central bank
1100	Detail of subaccount type: Current <i>nostro</i> account (that is, the bank's account with the central bank, in contrast to a <i>loro</i> account which would be a customer's account with the bank)

Designated accounts represent descriptive details providing additional information to facilitate financial and monetary analysis. Nine designated accounts are allowed for in the chart (Jarugowa and others, 1994, p. 69), the first two of which are used in preparing the balance sheet and income statement and form part of the design of Table 2:

1. The currency, domestic or foreign, in which the transaction is denoted;
2. Whether the partner to the transaction is a resident or a non-resident;
3. The type of opposite entry;
4. The period of the transaction's original contract;
5. The settlement period remaining;
6. The terms of the transaction's fixed or variable discount rate;
7. Refinancing by the NBP;
8. Classification of the economic entity (enterprise, partnership, etc.); and
9. Credits guaranteed or not guaranteed by the State.

### 1.5 Bank financial reporting

IAS 30 requires that banks present a balance sheet and an income statement, each providing certain disclosures. In addition, certain other categories of information, listed below, should be reported:

- a. Contingencies and commitments, including off-balance sheet items;
- b. Maturities of assets and liabilities;
- c. Concentrations of assets and liabilities;
- d. Losses on loans and advances;
- e. General banking risks; and
- f. Assets pledged as security.

The balance sheet should present groups of assets and liabilities by nature (i.e. line item identification), and listed in order of liquidity. Whether liquidity should be in ascending or descending sequence is not specified. The income statement should group income and expenses by nature, rather than function, disclosing the amounts of their principal types. The Standard also identifies certain specific line items which should appear in the balance sheet and income statement, although banks are free to add others.

Poland's balance sheet and income statement formats for banks, illustrated in Tables 5 and 6, generally conform to the 1986 Fourth Directive (amended) and to IAS 30. In fact, the Standard's requirements are exceeded by the Polish provisions for a mandatory third statement, illustrated in Table 7, which presents the status of off-balance sheet accounts.

The financial statements also include a three-part annex (Annex D) providing the following information (Jarugowa and others, 1994, p.85):

- D-1: Details of the prior year's profit;
- D-1: Details of the profit confirmed for the prior year, and its distribution;
- D-2: A listing of securities and their over evaluations, if any; and
- D-3: General information about the bank's management and organizational structure.

In addition to the published annual reports, the NBP imposes a number of internal reporting requirements aimed at strengthening overall control as well as facilitating financial and economic analyses. Mainly, these consist of monthly and semiannual reports, including certain annexes (Jarugowa and others, 1994, pp. 86-

87).

The monthly reports, together with Annexes A and B, are used by the Central Bank to analyze monetary policy in the light of the growth of money and credit in the domestic economy as well as the turnover of financial transactions by Polish residents overseas. Annex A is a five-part document which considers the distribution of credits and deposits across economic subjects, that is, the financial and budget sectors, etc., according to basic time periods for payment, as well as information about securities. Annex B also consists of five sections and is used by the General Inspectorate of Bank Supervision (GINB) for evaluating solvency and liquidity as well as for analyzing the safety of the banking system, that is, the degree of risk. The semiannual report includes a presentation of costs and revenues as well as a multi-step statement of the bank's financial result.

The other main monthly reports involve two series of forms: Z and K. The series Z forms, 1 through 4, rank the varying degrees of creditworthiness of economic subjects, identifying those against whom reparation-liquidation processes have been instituted. The Central Bank has, therefore, a considerable amount of proprietary, centralized, and valuable credit information at its disposal. The monthly K series forms report on the month-end status of agricultural credits (K-1) and credits for housing construction (K-2).

Banks are also required to submit economic information to the NBP, on a separate series of forms numbered F1 through F6, falling into three major groupings:

- a. Balances at the end of the reporting period for:
  - selected elements of the bank's assets and liabilities (F-1);
  - investments transferred between banks (F-2); and
  - assets of non-budgetary funds and foundations (F-3).
- b. Information about interest rates used during the reporting period for:
  - domestic currency credits (F-4);
  - domestic currency deposits (F-5); and
  - foreign exchange credits and currency deposits of residents (F-6).
- c. Monthly information about average exchange rates

for basic convertible currencies, such as US. dollars, German marks, British pounds sterling, and French francs, used in currency transactions during the reporting period.

In summary, Poland has established a comprehensive system of internal and external financial reporting as well as an internal information system designed to provide data to management and the bank supervisory authority that would help in evaluating financial condition and risk as well as compliance with micro- and macro-monetary policies. While this is a significant achievement, much needs to be done in the areas of staff training to carry out the new systems as well as supervision of actual operations: as discussed later.

## 1.6 Computerizing the banking sector

The complete overhaul taking place in bank accounting and reporting, combined with the availability of funding from various international sources, provided transitional economies with an excellent opportunity to computerize banking operations. Some of the larger banks in the Visegrad countries chose proprietary mainframes to realize their priority of making clients whole-bank, rather than one-branch, customers. Other reasons why such banks need expensive, centralized approaches with large, continuously updated databases include: ability to learn in real time what and where cash balances are so as to manage liquidity ratios; opportunity to offer a range of services at as many locations as possible; and tight requirements for data security and very high reliability (*Business Central Europe*, October 1993, p. 36).

Komerční Banka carried out considerable market research with many firms over a long period before deciding on a 100 million dollar integrated IBM mainframe system to foster a global customer orientation. Despite considerable advance planning, however, the conversion period was six months behind schedule and, with its millions of accounts, the system started to succumb to volume problems which entailed work on tuning applications and transfer to a more powerful mainframe module. It has successfully pushed its way through to pilot programmes, which include optical key cards, interactive voice response and a billboard system in branches (*Business Central Europe*, October 1994, p. 58).

Local banks, with more restricted operations and high vulnerability to the poor telecommunications infra-



structure that plagues the region, as well as larger banks taking a lesser global view of their dispersed clients, have selected distributive systems—such as Unix-based systems—over mainframes. These are operating systems designed to enable computers to communicate with each other more easily and make use of the considerable amount of common software applications available. Such users include the Russian Federation's State savings bank, Sherbank, whose automation cost somewhat under 130 million dollars; the Czech National Bank; Česká Spořitelna, the Czech savings bank, which increased the number of its fully-automated branches from 330 to 640; and Hungary's largest savings bank, OTP, with over 400 branches (*Business Central Europe*, October 1994, p.58).

Installation problems in transitional economies resemble those experienced elsewhere, such as the usual technical glitches and training difficulties associated with an older workforce quite unfamiliar with modern information technology, but with the addition of cultural dimensions. Personnel from the United States and the United Kingdom who installed Ceska Spontelna's custom-made Octagon system, for example, were unfamiliar with the different hierarchy of personnel they encountered and had to learn to choose words very carefully because of terminological misinterpretations. They were also unaccustomed to the volume of changes that occurred in the Czech accounting and banking regulations which seemed to require system-updating frequently. Other training issues and approaches are discussed in subsection 1.12. In the meantime, during the restructuring and reform activities of the indigenous banking systems, transitional economies were being opened up to private banks and financial institutions in order to attract badly needed foreign capital.

### 1.7 Attracting foreign capital

The process of attracting foreign capital requires licensing approval from a responsible State authority, such as in Poland the president of the NBP in consultation with the Ministry of Finance and in Hungary the State Banking Supervisory Authority. Conditions laid down in the banking laws include mandatory legal structures (usually joint stock companies), and minimum capital requirements (e.g. 25 million dollars for banks in Hungary, 6.2 million dollars [5 million ECUs] in Poland), but were tightened up to restrain competition in those countries where the domestic

banking system was in serious difficulty. Poland, for example, added new requirements for thorough business plans, three-year financial projections, and detailed information about shareholders, and denied branch banking facilities except to the two foreign banks which were already operating before the banking laws were amended. In the Russian Federation, a new draft banking law having its second parliamentary reading in December 1994 would permit only those foreign banks licensed before November 1993—which had already started operating—to deal with local clients and would not allow any increase in the number of foreign banks licensed, currently 11 (*The Moscow Times*, 11 December 1994, p.53).

The most numerous private banks are in the Russian Federation where 2,000 or more institutions styled as commercial banks had sprung up by mid-1993, perhaps only two dozen of them with solid financial foundations (*Business Central Europe*, June 1993, pp.40-43). In Hungary as of mid-1994, there were 37 banks, 6 specialized financial institutions and 256 savings cooperatives (Hungarian Chamber of Commerce, 1994, p.16). At the same time in the Czech Republic, there were 55 banks and more than 300 investment funds (*The Economist*, 22 October 1994, p.92). Poland had licensed seven Western banks by mid-1994 while six more still wait with applications which have been pending long beyond the legal six-month limit, some up to two years (*Business Eastern Europe*, 22 August 1994, p.4). Two of the nine regional banks spun off from the NBP have been privatized; one is in the privatization process, and the remaining six are targeted for privatization by the end of 1997. The six specialized banks, including the PKO BP national savings bank, which is the only institution to offer mortgage loans, are still State-owned. Over the past five years, some 94 licenses have been issued for private banks with some 80 in operation. By far the most numerous—about 1,600—are the cooperative banks which mostly, although not exclusively, serve the agricultural sector. They offer a full range of services and often they provide the only bank in some of the smaller towns.

### 1.8 Restructuring and consolidation

The growing diversity in the transitional banking systems of Central and Eastern Europe can be attributed both to differences in restructuring programmes themselves and to the influences of individual programme

managers. Experiences so far point to the crucial importance for effective results of initial, well-devised plans, and strong will and support to carry them through. This was the approach taken by the Czech Republic which was firm at the outset in clearing the balance sheets of valueless assets, injecting new capital and getting banks into private hands quickly. The Komerční Banka—widely considered to be the most successfully transformed bank in Central Europe—provides an impressive case study of government effort to ensure the survival of a transitional economy's industrial and manufacturing base (*Business Central Europe*, October 1994, p.42).

At the start of the transition, Komerční had no retail base and it inherited almost all of the outstanding Czech industry loans which were minimally secured and generating little interest revenue. Writing them off was not possible because there were virtually no loan-loss reserves. Maintaining them, on the other hand, posed another type of problem. They were mainly long-term credits and Komerční had no long-term financing sources. The dilemma was solved with three main steps: (a) the inherited loans were commercialized by raising interest rates 400 percent, a move which would allow for a 7 per cent margin on new loans; (b) the old loans were secured by collateralizing assets at 120 per cent of their previous value; and (c) the bank stopped issuing the inter-company "perpetual" loans, which had previously constituted a form of trade financing, and quadrupled the interest rate to 23 per cent on those trade loans still outstanding. The State very heavily underwrote the write-offs and recapitalization needed for the credit squeeze policy required to meet the government's macroeconomic objectives but which took its toll of Komerční's Czech industry client base.

By 1992, Komerční's net interest revenue constituted 73 per cent of net revenues enabling the bank to build up loan-loss reserves which were also tax deductible. After a full audit by a Big Six international accounting firm, Komerční was privatized in the first wave of vouchers which put 50 per cent of its equity into the hands of individuals and about 200 investment funds. Two years later, in 1994, it had 429 branch outlets, 80 per cent of its deposits were corporate accounts, and it collected some 23 per cent of all deposits in the Czech Republic. At that time, it depended on interbank and central bank funding for only about 25 per cent of its requirements and dispensed about 30 per cent of all commercial lending, 60 per cent of this to private sector clients. Komerční itself suffered from the shortage

of long-term financing which affected the entire region, particularly in those countries with higher inflation rates where loan money was scarce and, when available, was usually only offered for the short (3 months) or medium (6 months) terms. Komerční could, however, obtain foreign bank financing which allowed it to offer seven- or eight-year loans, giving Czech banking a unique feature.

As the Komerční case illustrates, the two basic and interrelated problems in restructuring commercial banks across the entire region had to do with resolving the treatment of bad debts and deciding how to carry out the required recapitalization which this entailed. It is estimated that, in 1992, the collective bad debts in the balance sheets of Hungarian, Polish, Czech, and Slovak banks were somewhere in the region of 12 billion dollars, or possibly anywhere from 20 per cent to 40 per cent of the outstanding bank loans. These four countries, as well as Slovenia, tried various but similar solutions, that is, either placing some of the bad debt portfolios in special "hospital" banks or setting up recovery departments in commercial banks (*Business Central Europe*, June 1993, p.36). In Komerční's case, help was provided by the Czech "loan hospital" Konsolidacni Banka (*Business Central Europe*, October 1994, p.43). Poland took a somewhat different tack. Following the detailed analyses of their credit portfolios by consultants, referred to earlier, the nine commercial banks went ahead in early 1992 to identify assets which fell into the doubtful and loss categories, creating loss reserves of 50 per cent and 100 per cent respectively, and then set up work-out departments to determine what could be salvaged. These departments had to be staffed by foreign and domestic consulting firms due to the lack of qualified and experienced personnel (Essinger, 1994, p.235). Because of the general lack of professional factors or reputable debt collectors, banks have resorted to various ways of trying to realize receivables. These include: publication of debtors' names, addresses and amounts owed in the newspapers, presumably for psychological effect, at least; efforts to sell receivables; and debt/equity swap arrangements. It should be pointed out that the banks are not alone in suffering credit risk. It is not at all unusual for business enterprises, public or private, to require up-front cash payment for sales or services, both because of the credit squeeze and the wave of unscrupulous business behavior which accompanied the breakdown in the political system.

Shoring up a bank's equities-side balance sheet, and

how to accomplish it, is as much a political decision as an economic and financial one. The banks have to be given new financing in order to make them more attractive to potential buyers and to boost their capital adequacy ratios. A popular approach has been to issue bonds but this pushes up government spending, running counter to International Monetary Fund (IMF) requirements that governments decrease deficits. A negative aspect of recapitalization is that it allows the banks breathing space to continue their old habits of lending to their former—and financially hopeless—corporate clients and thereby restarting the cycle of reserve loss provisions.

In transitional economies, at least two formidable roadblocks hamper assessment of the net realizable value of receivables and collateral; one is the lack of centralized credit information, and the other the absence of collateral registration as well as other difficulties with establishing ownership title. After several years of trying to perform with due diligence through various informal means, the banks had, by 1994, become rapidly computerized and were starting to collect credit information systematically and to share it on a limited basis. For example, the Union of Polish Banks was building a database on bank deposits and expected soon to have access to police data on certain documentation. Their main objective in searching for available data bases and trying to link them up was to develop a fairly complete package of information about clients' credit histories, their current payment records, and document reliability (*Gazeta Bankowa*, No. 44, 29 October 1994, p. 6). The extent to which banks could be expected to share credit information with outside parties, particularly competitors, is another matter. Furthermore, the concept of freedom of access to certain information, publicly available elsewhere in the world, is foreign to those in the bureaucracy who view knowledge as power and the basis for authority.

The processes of registering ownership title and collateral are likely to take considerably longer. A start has been made in Hungary, Poland and the Czech Republic by a US-based firm which is computerizing the real estate ownership records of certain municipalities. This task involves preparing detailed lot maps to make sure that all the existing property is inventoried, as well as ploughing through hand-kept records which are not necessarily complete or up-to-date. Once titles can be insured, and long-term money becomes available, mortgage banking should be able to make headway. The main incentives for municipalities to fund the land

registration research were the perceived benefits of increased property taxes through complete tax rolls and the opportunity to shift to ad valorem assessment rather than imposing a flat rate as at present.

Registering collateral, on the other hand, has no such revenue producing potential to attract public funding and little if any progress is reported while credit is still in the doldrums. The best lenders can do in the meantime is to take whatever practical steps they can to determine whether prior liens may exist on property offered as security.

Bank consolidations constitute a form of restructuring because more financially sound partners can help to shore up their shakier colleagues. Consolidating also provides the benefits of economies of scale, allows development or sharing of branch networks and permits the consolidated entities to finance out of their combined resources projects which they could not attempt individually, such as larger restructuring projects and participation in certain privatizations. Consolidation also represents an important defense strategy for coping with foreign competition.

Domestic bank consolidations, as well as drawing in more foreign investment through foreign bank participation in the economy, are basic planks in the "Strategic Plan for Poland" drafted by economist and Finance Minister Grzegorz Kolodko. With the cooperation of the NBP, two approaches have been tried to carrying out this strategy, neither particularly successful. One was the NBP president's attempts to develop strategic alliances between domestic and foreign banks, which stirred little interest in the West even though pairing with a domestic partner was presented as a necessary condition for speeding up approval of banking licenses. The other approach was to offer a block of shares to a foreign bank when privatizing an attractive domestic bank. The selected candidate was the Bank Slaski whose shares, offered at 25 dollars each, were to be traded on the Warsaw Stock Exchange in January 1994. The Netherlands ING Bank purchased a 25 per cent interest, at the issue price, for 56 million dollars, and the issue was heavily oversubscribed. Because of the massive public interest and various inadequacies in the infrastructure, very few shares had been released by the time trading started. Those who were lucky enough to get them benefitted by the huge rise in their market value to 300 dollars, causing an outcry from the general public over several issues—including the familiar one in privatization exercises that foreigners received undervalued national

assets. Two outcomes were that the Minister of Finance resigned over the affair and Polish banking stagnated for most of the year until a wave of mergers occurred in the late fall of 1994 (*Central European Banking Review*, October 1994).

### 1.9 Bank supervision

With new banking laws and accounting regulations in place, the restructured central banks in most transitional countries now have the basic infrastructural conditions they need for effective bank supervision. In fact, however, basic questions are being raised about the degree of implementation of this essential function as well as the quality of the supervisory personnel (*Business Central Europe*, October 1994, pp. 52-54). Out of four tightly-bunched countries in the region, bank supervision has informally been rated as best in the Czech Republic, followed by Hungary, Poland, and Slovakia.

The Czech Republic's ranking was based on the quality of its new laws passed in July 1994, which detail unacceptable practices and related prescribed penalties, and provide for a new mandatory deposit insurance plan. In addition, supervisory staff are undergoing extensive training aimed at bringing them up to relatively sophisticated standards.

Hungary also has stringent laws, but bank supervision suffers from a tripartite division of responsibility between the State Banking Supervision (SBS), the National Bank of Hungary (NBH), and the Ministry of Finance (MoF). Under the Financial Institutions Act, a regulatory system was provided for to be administered by an independent body, the SBS, which was to perform both off-site monitoring of information gathered by the NBH and on-site reviews by bank examiners. The SBS was not, however, provided with the resources to carry out its mandates, since its staff numbers only 100 and it has no on-site inspectors. According to one of its officials, the agency needs at least 2,000 to 3,000 more personnel plus some experienced and well-paid managers, although the World Bank's estimate of personnel needs is more modest.

The SBS was supposed to be administered by the ministry without portfolio but, after this ministry was closed down, the task was assigned to the MoF even though it lacks banking experience. Further, it placed the MoF in a conflict-of-interest situation because it was already a tax collector and held over 80 percent

equity interests in some of the largest banks which it had heavily supplied with capital reserves. The NBH, on the other hand, through its data gathering ensures that banks are liquid and oversees their foreign exchange transactions, and it has resources that the SBS lacks but not the jurisdiction. A practical way out of the dilemma, in view of the Hungarian Government's budget constraints, would be to amend the Financial Institutions Act so as to merge the SBS and the NBH. However, this would still defeat the Act's intention to establish independent supervision and, thus, points up the problems transitioning economies face when they lack the financial means to implement superior strategies.

In Poland, bank supervision is conducted by the NBP through its arm of the General Inspectorate of Banking Supervision. It has a growing number of well-trained staff, ample legal resources at its disposal, and strong support from the NBP's president. The NBP has already applied to liquidate two banks—one export and the other cooperative—and put about 50 cooperative banks under administration because of poor financial condition. Four of the larger, State-owned banks are also in trouble, but politics will probably deter the NBP from taking action further than public announcement.

In Slovakia, bank supervision is the responsibility of the Central Bank's supervision department. With a staff of only 13 it is both inadequately staffed and trained to meet the needs of the growing banking sector, but political instability and budget constraints prevent practical remedies from being found at present.

### 1.10 Training needs and approaches

Technology transfer is one of the most important advantages associated with foreign bank penetration in transitional economies, at least from the viewpoint of the host countries. The fact that training is needed in almost all areas of banking is evident from the multiple and various problems exhibited to a greater or lesser extent across the entire region. Because small business is the greatest loser, market economies cannot be built up through the main mechanism of small entrepreneurs until they can get adequate access to working capital. First priority, then, needs to be accorded to putting the banking sector into proper working order.

Some of the most severe problems are to be found in, but are not exclusive to, the Russian Federation where,

as mentioned earlier, there are over 2,000 self-styled commercial banks. Many of them are undercapitalized and may be wholly-owned by factories, or groups of factories, which view them as external treasury departments with ability to obtain cheap credits for their owners on the interbank currency markets. Generally less than 10 per cent of their resources are in the form of loans to individuals and small companies for investment projects and working capital, while significant amounts are placed in correspondent accounts with other banks and the interbank credit market. Mainly because the investment climate is perceived as too risky, with three- and four-digit inflation rates, coupled with limited understanding of and experience with risk assessment, bank profits are usually earned from fees rather than loan interest. Fees, which can be relatively substantial, may be charged for all manner of banking services such as opening accounts and accepting deposits. The savings bank, Sherbank, is the largest and most significant source of long-term loans—which could be defined as over six months depending on the environment—and it has been under heavy government pressures to make such funding available to certain industrial sectors (*Business Central Europe*, June 1993, pp. 40-43).

Elsewhere, with relatively more developed banking sectors, banks generally prefer to deal with large, relatively risk-free companies, and are targeting large privatized firms and foreign joint ventures. Small business loans are considered too small to be profitable as well as too risky. Banks have no history of small business lending, the would-be borrowers themselves have little or no experience with borrowing money and, as described previously, little if any credit data is available. When loan money is available, very significant amounts of collateral are usually required, mainly in the form of cash, tangible assets or real estate with title, as well as very high interest rates, a combination which puts bank borrowing beyond small business means. For many high-level bank managers, attention has to be focused on working out problem loan portfolios with no time to consider building up new markets such as small business lending. In the meantime, preferred bank investments are government securities where no underwriting is required and the interest rates earned are comparable to what could be charged for loans. As a result, credit-starved businesses co-exist with banks afloat with unavailable financial resources.

Most of the training in modern banking operations, in

order to improve management and increase capital flows, has taken the traditional approaches of courses in banking schools, use of financial consultants for on-the-job training, and sending staff to correspondent banks in the West. Poland has tried two less traditional methods both of which were successful and are being adopted elsewhere. They are the bank “windows” small loan programme, designed by Chicago’s South Shore Bank, and the twinning programme funded by the World Bank.

Windows is a joint lending programme established in late 1990 by the Enterprise Credit Corporation (ECC), a wholly-owned subsidiary of the Polish-American Enterprise Fund, in cooperation with 10 Polish banks. By early 1994 it had trained some 75 loan officers and 30 local staff in making loans of up to 75,000 dollars, an amount subsequently increased to 500,000 dollars, although few loans exceed 100,000 dollars, on the basis of evaluation of the loan purposes, analyses of projected cash flows and background character checks. The programme gets its name from the fact that loan applicants had to go to a particular counter, or window, in the cooperating bank. Bank cooperation was essential because the ECC did not have a banking license. By mid-1994, some 3,400 loan commitments had been made and there were 1,525 active borrowers with an average loan of about 28,000 dollars. The ECC not only provided the training but it also paid the salaries of those bank staff who worked in the windows programme until this subsidy was removed in 1994 when it was apparent that the banks could make their own way and were building up their small loan business. Many of the banks have now withdrawn from the programme for this and other reasons and ECC is continuing to serve small business financing needs through establishing loan production offices in communities where it previously operated loan windows.

In the Czech Republic and Slovakia, a windows-type programme was not so successful for two main reasons: first, some short-term, small loans money was available elsewhere; second, loan applicants were required to attend training sessions in preparing business plans before loan application decisions were made. For the more sophisticated borrowers this was considered to be largely a waste of time, while those less sophisticated felt cheated if, after investing time in training, their loan applications were turned down. The underlying reason for requiring the two-day training experience was the expectation that borrowing would be for start-up businesses in view of the lack of entre-

preneurial activity over the previous 40 years. However, the few loans that were made—to about 2 per cent of the some 2,000 people who took the courses—went to established businesses or to those who had already come in with detailed business plans. This experience points up the need for a thorough thinking through of such large-scale operations to make sure that there is congruency between the constituent parts.

The small loan programme of the Hungarian-American Enterprise Fund, also established in late 1990, involves joint arrangements with two commercial banks. Once again, banking partners had to be found because the Fund did not have the banking license it needed to make loans. Further, it did not have the resources to invest 25 million dollars, the minimum capital requirement, to establish a bank. A total of 5 million dollars was set aside to fund loans in the range of 10,000 to 100,000 dollars to be administered by the participating banks. Loan loss risk was divided equally between the Fund and the banks from loans made out of the Fund's initial 5 million dollar investment. The banks assumed full financial responsibility, however, for losses on loans made subsequently out of the proceeds of repayments. The small loan programme is still in operation; the Fund provides training and assistance to borrowers as needed, and also pays for staff training in cash flow lending. Much of the instruction is provided by the International Management Centre in Budapest.

The Bulgarian-American Enterprise Fund's small lending Kompass programme is closer to the Polish model and was also designed by the South Shore Bank. The joint lending program was established with four banks; the Fund committed 5 million dollars to the project and the first loans were made in September 1994, the local bank staffs being assisted by two South Shore Bank staffers.

The various American Enterprise Funds in these countries also operate smaller loan programmes with an upper limit of 20,000 dollars, although most lending is for considerably smaller amounts. They are usually administered directly by a fund, or its agent, and resemble the type of small lending activities typically carried out by Western banks, but which have yet to take hold in the transitional economies. Because the funds are concerned with capital maintenance, all exchange risk remains with the borrowers with loans denominated in dollars. Borrowers have yet another inconvenience to accommodate, namely compliance

with foreign exchange laws in both taking out and repaying foreign currency loans. In Poland, for example, it is a very complicated procedure when a payment falls due to determine exactly how much domestic currency has to be exchanged, to make arrangements for the transfer, and to make sure that the lender is notified of the transfer of funds in a timely fashion.

### 1.11 Training through twinning

A second, non-traditional, training approach which does not, however, have the advantage of unlocking flows of working capital, is the "twinning" programme developed in Poland by the World Bank. Twinning arrangements are aimed at building strong institutional arrangements between entities carrying out similar activities while, in this process, skills are transferred from the more experienced to the less experienced partners. It differs from more traditional technical assistance programmes in several important ways: it provides a broader range of services over a longer period of time, typically several years rather than several months; it allows the more experienced partner to pass on lessons learned during its own earlier development as it works through early stages with its new partner; it gives the less experienced partner the chance to tap into the resources it needs and which are not usually available to a consulting firm; the experienced partner usually has many backup personnel available to step in where and when needed; and the less experienced partner has easier access to the commercial services that the senior partner can provide (Essinger, 1994, pp. 75-76).

Foreign banks were asked to bid on the following scope of work, and contracts were signed in the late spring of 1992 (Essinger, 1994, p.76):

- a. Development of a strategic planning capability and preparation of an initial strategic plan and supporting business plans;
- b. A review and revision of the existing organizational set-up and the introduction of budgeting systems, to build a structure and internal financial and managerial tools conducive to realizing the objectives identified in the strategic plan;
- c. Strengthening of the banks' credit function by developing prudent and credit policies and procedures, and building of an asset- and liability-management capability;

- d. Assistance in the automation of the banks' operations and building of management information systems;
- e. Building of marketing and human resource development capabilities, strengthening and modernization of the banks' internal audit function, and development of large-scale staff and management training programmes.

By the summer of 1992, teams from foreign banks started to work with their partners—seven of the nine regional banks which had been split off from the NBP. The partners were the following (Essinger, 1994, p.230):

Bank Depozytowo-Kredytowy w Lublinie SA—Bank of Ireland

Bank Gdabski SA w Gdarisku—NMB Postbank

Bank Przemyslowo-Handlowy SA w Krakowie—ABN Amro-Bank NV

Bank Zachodni we Wroclawiu SA—Midland Bank

Powszechny Bank Kredytowy SA w Warszawie—Istituto Bancario Sao Paolo di Torini

Pomorski Bank Kredytowy SA w Szczecinie—Unibank A/S

Wielkopolski Bank Kredytowy SA w Poznaniu—Allied Irish Bank

Although the scope of work was designed in discrete modules, it soon became evident that adjustments had to be made in the order of things. For example, training called for in the final module had to be started before the first module because the host management was quite unfamiliar with routine concepts in strategic planning. Delays were also experienced through language, terminology and translation difficulties, particularly during the early stages and when attempts were being made to document existing structures. Working through strategic planning exercises enabled some of the host banks to appreciate the risks inherent in the rapid expansion of branch networks on which they had already embarked as well as to decide about which operations to specialize in. Different approaches were taken to organizational restructuring. Some banks

decided to pull control in to the centre while others opted to move it out somewhat.

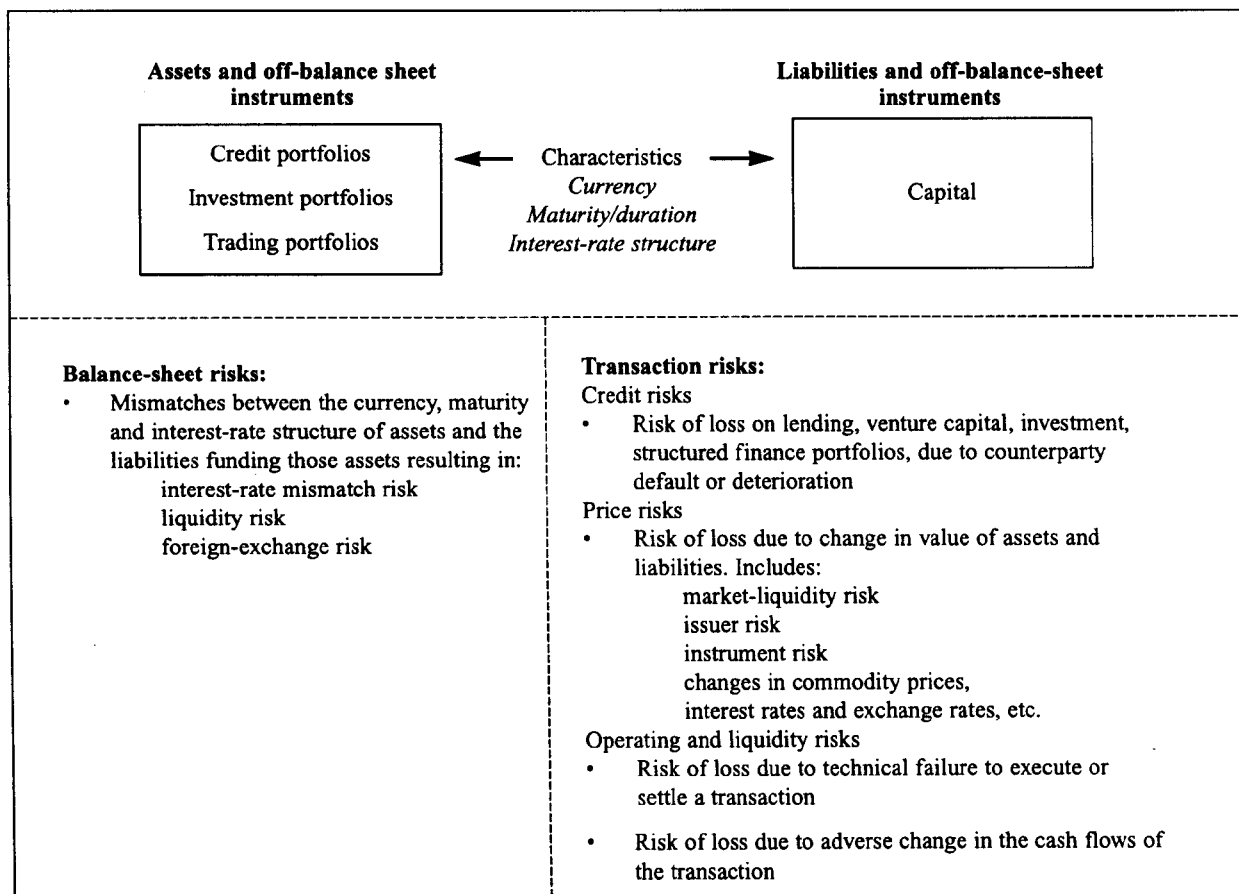
Training trickled down through the system through the introduction of planning and budgeting in the branches. The unfamiliarity of top management with transfer-pricing and branch-profitability analysis led to other solutions being adopted for the short term, such as lowering credit ceilings available to branches and tying branch merit pay to achievements against budgets. Impressive progress was noted in strengthening the credit function by standardizing credit application forms, completing new credit manuals, drafting manuals for dealing with problem loans, and introducing loss classification systems. However, improvements were constrained by the poor quality of management information and human resources difficulties. Few banks had started to address their overstaffing of undercapable employees and lack of personnel with quality-risk management capabilities.

Because risk management is what the banking business

is all about, this is the training area which demands top priority. As Figure 2 illustrates, risk—defined as the volatility of future income and how it affects the value of the firm, from the banker's viewpoint—underlies balance sheets and various transactions. To manage it requires a basic understanding of accounting and finance and the application of various analytical tools such as those currently being employed in some American and European banks. In fact, quantitative approaches to risk management are increasingly taking hold in Western banking to the extent that a managing director in the risk management group of a major US bank forecasts that bank financial statements should soon contain a new paragraph in which risk management auditors certify to shareholders that accepted risk-management principles and methods have been applied on their behalf (*The Economist*, 10 April 1993, p. 4).

Academic training to bring transitioning bankers up to a basic level of competence in modern banking calls for banking diploma programmes, such as those

**Figure 2. A banker's view of risk**



SOURCE: *The Economist*, April 10, 1993, p.4.



offered by the University of Phoenix, USA (Central *European Banking Review*, June/July, 1994, p.4). The Phoenix programmes currently offered in Hungary are designed to meet the advanced education needs of working professionals and are held during evening hours at accessible locations. Banking Diploma I introduces fundamental financial concepts and analysis in four, six-week courses in financial accounting, business analysis, executive management in the global economy, and cash flow analysis. The follow-up programme, Banking Diploma II, provides advanced-level analytical tools to help identify and monitor the risks associated with loan transactions. The four courses for this diploma are: macroeconomics for business decision-making, projections and the lending decision, loan structuring and pricing, and loan management.

### 1.12 Conclusions

A well-functioning banking sector is critical for transitional economies seeking to nurture free markets, particularly when would-be entrepreneurs are reluctant to agree to equity financing. So, it is in the first order of things to teach bankers how to extend credit, teach lenders how to apply for it and comply with its terms, and provide the conditions for the circulation of loan capital. Basing the new structure on well thought out and designed accounting, financial, and management information systems is an essential element of the process.

The difficulties of restructuring the banking sector and retraining its staff mirror those experienced in other parts of the changing infrastructure. That is, the problem of mind-set: opening eyes and explaining both “how” and “why,” is usually the most necessary but the most tedious and lengthy first step to tackle in building a sense of business, rather than bureaucratic, thinking. Until these business decision-making qualities are encouraged, there is little if any appreciation of the accounting function’s basic role in the financial management process. This is mainly because of the many decades in which that process was restricted to book-keeping and non-analytical activities. As the Polish experiences illustrated, the redesign of banking information systems was heavily influenced by Western consultants from the accounting and banking communities who ensured that essential accounting-related priorities were integrated into the banking databases. As a result, banks can generate reports for such essential purposes as helping the NBP assess monetary poli-

cies and the financial community evaluate credit. While bridging systems, that is those that make a gradual transitioning in order to ease the retraining process, may be appropriate in early stages, there needs to be a fairly speedy—say two- to three-year effort to make major overhauls. Otherwise, the banking sector will be lagging significantly behind other sectors and, thereby, dysfunctional.

The “twinning” and “loan-windows” programmes in Poland demonstrate the value of having training programmes delivered on site by experts providing hands-on advice to those individuals who need and use it. Major drawbacks to conventional sessions in classroom settings have to do with whether appropriate candidates were selected for training and whether the environment to which they return will encourage, or even tolerate, application of what the trainee has learned. Behavior modification is usually more effective when the trainer can be observed on the job. In a banking setting, for example, the trainer shows how to evaluate credit risk by using data drawn from the bank’s accounting and finance records in conjunction with, say, a prospective borrower’s business plan. The need for a basic understanding of accounting and finance in risk management should make the importance of accounting apparent to the banking community. Bankers, in turn, could be expected to pass on their concerns about good record-keeping and financial management to their prospective borrowers. Without computerized operations, banking reforms would be considerably hampered. Computerization expansion has been adversely affected less by financing problems than by technical ones. A massive amount of effort is needed to update the telecommunications networks across the whole Central and Eastern European region.

The question of banking expansion through opening up the sector to foreign competition is a vexing one, particularly in the medium term when domestic banks are beginning to find their way. Different countries have followed different philosophies but, overall, domestic banks have, to some degree, adopted international accounting and finance-based banking practices.

## 2. Non-bank enterprises in transition

### 2.1 State enterprises in transition

The introduction of political and economic reforms in

the CEE region some five years ago led to significant changes in the external and internal conditions within which State enterprises operate. Externally, there were drastic alterations in the institutional arrangements under which State enterprises functioned. Internally, enterprise managers were forced to redefine their objectives and their operating methods in the face of considerable business uncertainty. Virtually for the first time managers had lost their twin anchors of seller's markets and guaranteed financial support. Now they were confronted with tight monetary policies and unsalable goods and services. The need for sound financial management came to the forefront.

The process of shifting from a planned to a market economy brought on similar problems across the region; that is, plummeting demands for goods and services, high inflation, layoffs and rising unemployment, and the drying up of cash flows. For most transitional governments, a major priority was to curb inflation. In Poland and elsewhere, the approaches taken were to introduce stringent fiscal and monetary policies connected with loosening price structures, cutting back on subsidies and restructuring taxation systems. The policy makers in government seemed to believe that the market mechanism itself possessed some mystical power to help enterprises struggle through the difficulties of the transition. They also failed to realize that development of market mechanisms could take some time and that various interim measures were called for. Firms, whether public or private, were largely left to their own devices to operate in an unstable and ambiguous environment where the command economy model had been officially abandoned but a functioning market economy was not yet in place.

For businesses attempting to cope with the transitional difficulties, the State enterprises were under the heaviest pressure, not merely because they were the main economic force. When economic reforms began, they were already in financial trouble; the government continued to regard them as a main source of public revenue, and State enterprise managers—most of whom were not accustomed to competitive conditions—had limited decision-making ability, particularly in Hungary and Poland where the workforce enjoyed certain managerial prerogatives.

The initial financial problems of State enterprises stemmed from overdue loans for investment projects, both enterprise—initiated as well as directed by the State. As inflation flared, bank interest rates—which

were variable, not fixed-skyrocketed, and neither interest charges nor the monthly principal installments could be paid, mainly because of poor business conditions and very low liquidity. As economic reforms began to take hold, the financial condition of State enterprises appeared to go through several phases.

In the introductory period, usually the first year, mounting inflation produced accounting profits, even though sales volumes had started to fall, because relatively low costs of earlier acquired goods or products were matched against inflated sales revenues. The artificiality of this appearance of partial prosperity was not apparent because none of the transitional countries had introduced, or were encouraging, inflation accounting. In the second stage, that is for the next two years, financial problems started to accelerate. Foreign and domestic demand was reduced, particularly in the markets of the Council for Mutual Economic Assistance (COMECON). Trying to collect receivables and pay the workforce became main concerns. Liquidity problems were aggravated by the lack of loan money and high interest rates coupled with high collateral requirements.

Payment bottlenecks which seem even after five years to be prevalent everywhere, present a major impediment to market transformation, that is, lack of timely settlements of amounts due between enterprises, between enterprises and banks, and between enterprises and the government. Governments caught in a money squeeze increased pressures on State enterprises—which were still their main revenue sources—through heavy tax burdens, including income tax, a tax on the value of fixed assets, and a tax on the increase in average pay rates over a defined limit. Enterprise response was to try to avoid holding assets where they could be accessed by the government, such as in banks. Special price concessions were offered for cash payments and it was common for cash to be moved around in various containers and by various forms of transportation. Enterprise managers kept up their formal and informal networks, loaning and borrowing cash between themselves under emergency conditions and potentially disguised for accounting purposes. Networking represented one of the reasons why more firms did not go bankrupt. Another was tax evasion, coupled with the inefficiency of the fiscal authorities in collecting taxes.

Limitations on management's decision-making ability have to do primarily with the role played by the workforce. In some countries, such as Poland and Hungary,

major decision powers were assigned to workers' councils. With the rise of trade unions in Poland during the 1980s, a situation—commonly referred to as a Bermuda Triangle—prevailed where power was shared by three groups: management, the workers' councils and the trade unions. Any major decision affecting workers' rights, employment conditions, and pay rates, for example, could cause workplace paralysis until meeting the payroll became a priority consideration when planning cash flow. It also motivated managers to seek corporatization, that is, having the enterprise become a corporation or limited liability company with the State Treasury as the sole shareholder, as a first step in the privatization process. The State enterprise would be removed from the public enterprise register and be reregistered as a company subject to the Commercial Code. Management would then be subject to considerably less labor pressure, although subject to the oversight authority of a Supervisory Board on which the workforce would be represented.

Management also faced pressures from above. During the first three years of the transition, Poland's Ministry of Industry and Trade reshuffled 86 per cent of industrial enterprise management positions (Goiembiowski, 1994, I, p.145). Of this total, 23.4 per cent of the managers were removed at the initiative of the enterprise's founding authority, and 76.6 per cent at the initiative of the workers council. Among the limitations on their authority, enterprise directors most frequently cited unstable legal regulations, economic system rules, lack of funds and capital, high interest rates on bank loans, trade union intervention, and employee pressure.

Management views on the main factors considered in assessing their performance from below and above assumed the following criteria: improvement of economic and financial results, enterprise financial condition, steady growth in employee earnings, better economic effectiveness, problem-solving ability, and enterprise restructuring activities. The threads that connect these criteria are demonstrations that the enterprise can survive and become more viable so as to guarantee employment and provide revenues for the government and workforce. Because these are perceived to be the main criteria for judging management effectiveness they would also be the main criteria underlying enterprise financial management.

In transitional economies, generally, State enterprises have suffered critical survival problems. Empirical research in Poland identified the following obstacles to enterprise development under growing market condi-

tions (Goiembiowski, 1994, I, p.143):

- a. High investment risk, mainly caused by changes in socio-economic policy as well as the lack of long-term development planning;
- b. Excessive taxation of the State enterprise sector;
- c. Preferential treatment to accorded private business in the initial transition period;
- d. Infrastructural inefficiencies of the introductory market mechanisms;
- e. Inherited financial investment debts; and
- f. Insufficient information about the availability of accessing foreign development assistance.

Clearly, much of the responsibility can be attributed to the lack of vision by new governments, coupled with the political instability characteristic of early reform periods.

To summarize, in the initial stages of economic reform the main goal of State enterprise was to try and survive. Managers had long enjoyed sellers markets and soft loans or other subsidies which were often converted into equity, as well as directed strategies. In the next stage—which lasted several years, depending on the enterprise's particular situation in the economy or the relative severity of economic conditions—a main objective was to achieve financial liquidity while trying to find a market niche. In the third stage, which some countries have not yet reached, market share expansion and profits maximization—hallmarks of a more developed economy—become the main goal. It is only then that financial management, as the concept is understood in market economies, can employ the more mature practices of integrated budgeting, or planning and accounting, both financial and managerial.

## 2.2 Changing the basic accounting model

In the command economies of the Central and Eastern European (CEE) region and China, the basic accounting model was fund-based as it is, for example, in local governmental accounting in the United States. This means that groups of assets are shown on an enterprise balance sheet matched up with corresponding groups of funding sources. From a bookkeeping standpoint, a single transaction affecting more than one fund group would require several sets of bookkeeping entries to

reflect the effects of the transaction on the different funds.

The basic balance sheet for a State enterprise, based on fund accounting, would resemble the following (Berry and Świdorska, 1992, p.18):

ACTIVE	PASSIVE
Fixed assets and investments in process	Fixed assets fund
Circulating assets	Circulating assets fund
Special purpose assets	Special purpose funds
Loss for period or Distribution of profit	Profit for period or Coverage of loss

In shifting to a market economy, it follows that the financial statements of State enterprises should be commercially—rather than fund-oriented. This involves introducing some radical changes to the complicated bookkeeping system as well as basic concepts of commercial accounting and reporting in order to permit expanded and improved financial management techniques. In particular, the changes in the basic financial and management accounting systems should facilitate the process of harnessing the accounting function to the financial management of the enterprise.

In Poland, the basic shift in accounting models commenced with the law of 31 January 1989 (*Dziennik Ustaw* No. 26, poz. 152). Three of its major provisions were to change the revenue realization principle to a full accrual basis; to eliminate the main correlations between the sources and uses of funds in the bookkeeping system; and to establish a new tax in the form of a dividend payable to the State Treasury based on the amount of the State's investment which was accumulated in a newly-created charter fund (*fundusz założycielski*).

The main structural change was to sort the funds, representing the sources of assets on the balance sheet, into two groups—the charter fund and the enterprise fund. The calculation of these two beginning balances was complicated and the formula undoubtedly related to maximizing the State's dividend. The dividend percentage was set annually in the State Budget Law, taking two main factors into account—the interest rate charged by the Polish National Bank and the percentage of net profit anticipated in the coming year for the economy as a whole. The dividend was accounted for as a deduction from net profit after taxes and could, therefore, put the enterprise into a loss position. It had to be paid to the State Treasury, however, without regard to the enterprise's financial position. Having converted the governmental fund accounting model to one more resembling a commercial model, the stage was set for the design and introduction of major changes in the basic accounting regulations.

### 2.3 New accounting regulations

As all the transitional economies started down the long road to the market—many of them in the direction of associate membership in the European Union—it became evident that significant changes would be needed in the accounting and reporting regulations so as to make them congruent with the functioning of a modern society based primarily on private ownership principles. For most countries, this process has involved two stages—getting an initial version in place while elaborating a more comprehensive set of financial laws. In Poland, the first new accounting regulation was issued as an instruction from the Ministry of Finance in the fall of 1990 and put into effect as of 1 January 1991 (*Dziennik Ustaw* No. 10, poz. 35). A comprehensive accounting law was passed, on 22 September 1994, after much discussion in the Polish accounting community.

All countries in the CEE region, with the exception of Poland, require standard charts of accounts. These national charts are diverse, depending on a particular country's prior experiences with charts of accounts, as well as on the source of advice from outside accounting experts. The basic charts of accounts for five different countries (Bulgaria, the Czech Republic and Slovakia, Hungary, and the Russian Federation) are listed in Table 8 for comparison purposes. The Polish experience has been, however, that bookkeepers and accountants, long accustomed to working with stan-

standardized charts of accounts, were uncomfortable about their responsibilities in a less restricted set of circumstances. As a result, the Association of Accountants in Poland sponsored a model chart of accounts which many enterprises have adopted on a voluntary basis.

Although most countries adopted balance sheets almost identical to those used in countries conforming to the European Union's Fourth Directive, the new Russian balance sheet—according to 1993 supplementary modifications to the accounting and reporting law—shows some of its old roots as illustrated in Table 9. For example, it has retained the familiar category of small value, short-lived items in the current assets classification; also, it includes reserves for doubtful accounts among the liabilities, because of the fact that they have credit balance. This account should be, according to Western practice, netted against the accounts receivable item. These reserves, incidentally, represent new practice for the Russian Federation. Under the previous system, bad debts could not be recognized unless legal efforts to collect unpaid amounts had proved fruitless. This is still generally the case for tax purposes in former command economies. In the Czech Republic, the fiscal authorities are considering allowing tax relief for unpaid collectibles, mainly because Czech businessmen are voicing strong opinions about the negative effects of taxing unrealized sales, particularly during the widespread and prolonged cash crunch.

Caution should also be exercised when examining balance sheets prepared under new regulations as the underlying accounting principles might differ from those generally accepted elsewhere. Some of the accounting provisions of the Law on Accounting No. 563/1991 of 12 December 1991, of the then Czech and Slovak Federal Republic, contain a number of items that are neither in accordance with international accounting standards, nor, as it happens, with generally accepted accounting principles in the United States. These include:

- a. Interest is not imputed on long-term receivables or payables which are non-interest bearing or carry an unreasonably low interest rate;
- b. Except for the lease of major segments of a business, virtually all leases are accounted for as operating leases;
- c. The direct costing method may be used for inventory valuation;

- d. Deferred taxation accounting is only required for depreciation and amortization differences when a company is consolidated. It is not required for other temporary differences or in other cases;
- e. The completed contract method is used for long-term construction, manufacturing and service contracts, or as otherwise provided for in the contract; and
- f. Unrealized foreign exchange gains on foreign currency transactions are not recognized in income until realized.

#### 2.4 Accounting reform in China

New accounting standards were introduced in China through four accounting regulations released in 1992 by the standard-setting body, the Chinese Ministry of Finance. Their stated purpose was "... to improve the accounting of stock companies and interests of the investors and creditors ..." (Winkle and others, 1994, p. 52) and intended to accelerate the socialist market reform movement. The fourth of these regulations, issued in December 1992 and effective as of 1 July 1993, applied to all Chinese business enterprises in order to standardize practice and make Chinese accounting more congruent with international principles. While there continues to be a high degree of governmental control over the accounting function, more accounting decisions are now permitted at the enterprise level.

Some differences between the Chinese accounting standards for business enterprises and accounting practices generally accepted in the United States, should be noted, for example, by those considering joint venture operations. These differences include (Winkle and others, 1994, p. 55):

- a. No provisions exist for lower-of-cost-or-market, or mark-to-market, valuations of certain assets—strict adherence to the historical cost convention is required;
- b. Issues of imputed interest, lease obligations, and contingent liabilities, among others, are not addressed;
- c. Certain subsidiaries whose line of business is considered unsuitable for consolidation may be excluded. Consolidation is otherwise required where the parent enterprise has a 50 per cent interest or more. In the United States, more than 50 per cent is

specified in such cases.

A complete revision of the accounting standards and upgrading of the accounting profession is currently underway, supported by a 2.6 million dollar loan from the World Bank, and spearheaded by one of the large international accounting firms in cooperation with the Ministry of Finance, to meet a target date of 1995 (Winkle and others, 1994, 52).

## 2.5 Utilizing accounting information

The motivations underlying the restructuring of the accounting function went beyond satisfying the needs of the fiscal authorities and enterprise oversight bodies. There was some general expectation that the information the newly designed systems would produce would prove helpful for important decisions. At the present time, however, the benefits are not too clear. Two sweeping and significant infrastructural changes have been taking place: small- and large-scale privatization and the development of stock markets. The role of accounting information in enriching these activities has not been demonstrated and may be attributed to a few key factors: (a) at the beginning of the reforms, government officials and the general public were unable to read and interpret financial statements; (b) the data processed by the new systems consisted of balances accumulated under the old regime and the valuations they contained probably did not reflect economic realities; and (c) privatization amounts and stock offer-prices were based on considerations other than accounting-based data, such as prices that the market would bear. In large-scale coupon privatizations—such as in the Czech Republic and Russia—accounting data did not really enter into the equation. When it did—in the Czech Republic—book values were used as the speediest and least costly solution to the valuation quandary. Arguably, the most systematic approach to enterprise valuation occurred in Germany during the pre-privatization financial restructuring of former East German State enterprises, in an attempt to assure their financial viability. This process is described in the following subsection.

## 2.6 Structural reform of State-owned enterprises

A first step in transforming State-owned enterprises (SOEs) into private enterprises is to change their legal status from public sector bodies to private companies.

Germany took a unique approach by effecting the change in one piece of legislation rather than on an individual basis. Under the *Treuhandgesetz* (Trusteeship Act), SOEs were converted into private limited companies and conglomerates into joint stock companies as of 1 July 1990. The main reason for this overall change in legal status was to speed up the ownership transformation process so as to facilitate development of the market sector.

Another major step, taken by most of the CEE countries, was to revalue the new companies' assets and liabilities as part of a financial restructuring plan. In some countries, such as Poland, attempts were made to financially restructure privatizing enterprises in order to make them more attractive to investors before changing their legal status, whereas in Germany legal status change generally occurred first. In Czechoslovakia, it was omitted altogether to avoid the difficulties of the revaluation process and pass on the financial restructuring problems to the investor. Once again, a speedy opening up of the market sector was the main objective. The German rationale was to provide the privatized enterprises with minimum capital so as to be financially viable. Further, it was argued, investors, whether domestic or foreign, would require financial information presented in accordance with international standards and conforming to the European Union's Fourth and Seventh Directives concerning financial reporting and consolidated accounts. Accordingly, the German process was dual in nature in that it adjusted the basic accounting model to that followed in West Germany as part of the balance sheet revaluations.

The German experience with bringing the former SOEs into the general market economy was affected by economic, financial and social factors not generally found elsewhere. For example, domestic and foreign investment capital was available and, consequently, the use of privatization vouchers was not considered necessary; the banking system was well developed and soon reached into the new *Länder*; and there were functioning, sophisticated capital markets. Quite unique was the need to consolidate two currencies, which complicated the valuation process. Different conversion rates, for example, were needed for different balance sheet elements. Most importantly, perhaps, the West German Treasury could be called on to assume some of the financial burdens of the privatization exercise. The mechanics of the restructuring process, and the valuation problems that had to be addressed were common

in other countries. Further, all transitional economies faced the constraints of trying not to curtail living standards, working out difficulties over lack of a comprehensive social safety net, and trying to enable as many SOEs as possible to survive the transition.

The German approach to the latter difficulty was to privatize some SOEs with all or part of their existing debt but translated into new capital. Doubtful loans were transferred, usually, to the privatization agency (*Treuhandanstalt*) to pursue potential collection. Moreover, interest rates under the old regime did not reflect risk and there were no collateralized loans in the western sense, except for the assets they financed. Also, loans usually had long maturity periods and might well be forgiven eventually. Consequently, as mentioned in section 1 (which deals with the banking sector), the necessity to repay loans was not well understood or accepted.

From an accounting standpoint, however, East Germany and some other countries such as Hungary and Poland had always tolerated small and medium-sized private enterprises, primarily in the services and handicrafts sectors. Consequently, there was some existing spirit of entrepreneurship. More importantly, perhaps, all the planned economies had double-entry bookkeeping systems, many of them built essentially along German lines. They also had comprehensive inventory systems which facilitated efforts to value or revalue assets and liabilities.

At least four major accounting-related problem areas face those engaged in economic reorganization: valuation issues, consolidation methods, cash flow analysis, and firm-structure questions. Valuation issues are considered in some detail below. Consolidation methods have to do with the fact that the balance sheets of the various SOEs which constituted a combine, were simply added together without elimination of intra-combine activities. Furthermore, combine membership and the trade ties that connected the individual constituent SOEs, made it difficult to assess the potential stand-alone strength of a particular SOE after its combine had been disbanded. Cash flow analysis, lastly, ran into trouble in drawing a line between where the State ended and the SOE began, a problem related to firm-structure questions. This stemmed from the way that SOEs were financed by State-determined, planned credit lines or funds which were directly contributed or administered by State agencies. These credits were intermingled with the cash flows generated by the SOE itself. Clearly, a cash flow statement designed in the

format recommended by International Accounting Standard No. 7, would be needed to help assess a privatizing SOE's potential for future cash flow generation.

## 2.7 Valuation rationale and issues

A main objective of establishing fair values for the assets and liabilities of a privatizing SOE is to help establish a selling price. In Eastern Germany, this goal was linked to another, that is, to ensure that each SOE or conglomerate was capitalized at the minimum amount required under the appropriate company legislation. A company with more than the minimum capital would be required to turn the excess over to the Trust Agency. Conversely, one with a capital deficit would have an equalization claim against the Agency listed among its assets. In general, the capital balance was calculated as the difference between revalued assets and revalued liabilities, following western accounting conventions. However, some exceptions to generally accepted accounting principles (GAAP) were permitted in order to maximize the possibility of creating the minimum capital balance, thereby easing the strain on the Trust Agency. A notable exception to GAAP was permitting internally created goodwill, trademarks and brands to be valued at the lower of replacement cost or fair value taking technological maturity into consideration. Under western GAAP, only purchased intangible assets are usually permitted to be listed as balance sheet assets. Evaluation considerations and solutions with respect to particular balance sheet items follow.

**2.7.1 Land.** In the German Democratic Republic, combines paid a single lump sum for permanent user rights to the land made available to them. In other planned economies, user rights were granted to SOEs by the State without charge. In nearly all cases, land was public property and, therefore, was not listed by the users on their balance sheets. In Eastern Germany and elsewhere, there was no functioning property market to establish fair values. As a surrogate, the German Ministry for the Economy provided special sets of coefficients for land valuation; these set the basic value of land at DM85/sq.meter multiplied by coefficients of land quality and potential or actual uses or purposes. This same approach to land valuation, particularly in agriculture, is used elsewhere in the world (including Lithuania, for example). Values arrived at through use of these coefficients were considered to represent pre-

liminary estimates—not to exceed three years—until real estate markets developed sufficiently to permit valuation corrections. An additional factor which had to be borne in mind was the potential for land value decreases due, for example, to restitution claims, environmental protection costs, and liability for waste disposal. Such provisions were either netted out against the land's gross value or shown among the liabilities. In the calculations, attention to the potential effect on equalization claims played a role.

**2.7.2 Buildings.** Attempts were made to value buildings at market, however determinable in the absence of independent transactions, either reduced by an allowance for future required maintenance or at gross with a special reserve for the expected future maintenance costs. This reflected the general failure in the past to perform building maintenance or carry out major repairs. Further, the straight-line depreciation method commonly used provided for life spans which were about four or five times longer than in West Germany. So, even if the buildings' book values were—more by coincidence than anything else—realistic, depreciation allowances were very inadequate.

**2.7.3 Machinery and equipment.** In the GDR, machinery and equipment acquisitions had been recorded at planned prices (*Industrieabgabepreise*). These were calculated as production costs (*gesellschaftlich notwendige Selbstkosten*) plus or minus premiums or subsidies and plus the producer's profit margin. Periodically, most recently in 1985, required revaluations of planned prices were made in the accounting records, using standard coefficients. The 1990 privatization valuations of machinery and equipment estimated current reproduction or replacement costs, adjusted by a depreciation allowance to approximate fair market value. Alternatively, other source information considered more reliable or appropriate could be used, such as data from catalogues and sales at auction. Items which could no longer be used had to be valued at their disposal amounts. Special valuation problems were posed by items of a unique or specialized nature or which were not otherwise widely traded, as well as items with outdated technologies. In such cases, educated guesses or special depreciation charges had to be resorted to.

## 2.8 Accounting and stock market development

Transitional economies need mature stock exchanges for at least two major reasons (BCE, February 1995, p.38): to help finance private sector growth and to help in determining market prices for newly privatized enterprises.

The experience of the Warsaw Stock Exchange (WSE), which opened in 1991 and within two years had become the fastest growing market globally, shows that financial information about traded firms plays little, if any, role in investment decisions. Rather, the retail investors—who made up about 50 per cent of the 400,000 or so investment accounts at the end of 1993, and who tended to act in concert—stimulated market volatility through seemingly irrational trading, such as buying when reported earnings were less than expected, or showing no interest in new offerings with potential growth and profitability. This behavior has discouraged institutional investors who could provide needed stability.

Another factor is the presence or absence of regulations. Closed-end mutual funds face prohibitive tax law difficulties and Poland's State pension plan would have to be restructured in order to attract pension fund investors. Furthermore, a newly enacted 0.2 per cent stock transaction tax introduced by the Ministry of Finance and levied on the seller, would discourage large volume trading.

## 2.9 Stock markets

By the end of 1994, the WSE had slid to penultimate place—only above Turkey—in the rankings of emerging markets.

Perhaps emerging markets need stock exchanges like NASDAQ. As a sign of increasing diversity, the Budapest Stock Exchange signed a cooperation agreement in late 1994 with the French futures exchange, Matif, to develop a derivatives market (BCE, October 1994, p.61).

The Prague Stock Exchange (PSE), which lists some 1,000 companies and is policed by the Ministry of Finance, has been suffering from concerns over tax regulations and secret trading (BCE, October 1994, p.69). Much of this stems from the requirement that every legal transaction has to be registered at the Securities Centre (SCP) for a uniform fee regardless of the value of the transaction. Larger traders can benefit, therefore, from bulk transactions. Prices are published if transactions are conducted on the PSE or the over-



the-counter system (RM system), which had 470 stocks in the system by October 1993 (BCE, October 1993, p.57). Direct trade prices are not published, however, if transactions occur off-market. This leads to concern about possible insider trading and, as a consequence, the PSE is anxious to outlaw direct trading between companies and institutions. Their recommendation is that a Securities Commission should be established along the lines of the United States' SEC and its role be limited to that of share-ownership registration.

A further area of concern relates to inadequate disclosure of company information. Because analysts feel that financial data provided through the PSE does not permit sufficient evaluation, they are reduced to travelling around to the companies for on-the-spot assessments. This situation has stimulated interest in providing publicly available independent information on all firms as a service to the investing community. With the second wave of voucher privatization imminent—almost doubling the listings by adding an additional 800 companies—calls for market regulatory reform have assumed some urgency.

### 3. Professionalization of the accounting and auditing functions

#### 3.1 The rebirth of accounting and auditing

The accounting and auditing needs of the newly emerging market economies made it possible for these functions to start taking on professional status. For some countries the process has been faster than for others. Two factors which seem to make a difference are the particular country's accounting tradition and the amount of political support that nurtures professional development.

This section commences with case studies of three countries at different levels of professional maturity; Russia, China and Poland. Russia, with virtually no professional tradition and a high degree of political instability, is at an early stage. China has a long tradition in professional accounting and auditing, although not in recent decades, and currently enjoys government support; consequently, its stage of development appears to be more advanced. Poland has maintained a professional association of accountants since the early part of

this century, except for the war years, and has had government backing of its restructuring activities; it is one of the professional leaders in the region. These case studies show the effects of the environment on professional development while at the same time disclosing some apparent training requirements.

The case studies are followed by a description of the professional examination requirements in the Czech Republic and Poland so that their more advanced training needs may be better appreciated. The Czech Republic's use of a heavily-weighted case study in the written part of the examination is a novel approach to testing a candidate's ability to use academic training in a decision-making environment.

Expansion of accounting and auditing training at the university level is illustrated by examples of courses offered in Poland. This is followed by a short description of training approaches used by audit firms.

The section concludes with a summary of what trainees need to learn, what trainers should consider in the training process, and the role that governments or other supervisory organizations should consider in connection with professional training programmes.

#### 3.2 The auditing profession in the Russian Federation<sup>2</sup>

In Russia, development of the auditing profession is still in the very early stages—a situation which may be attributed to a number of key factors. For decades Russia was alienated from societies where the accounting and auditing professions assume leading roles in the economy and, as a result, there is widespread and general lack of understanding about the nature and significance of these functions. In any event, the State has always enjoyed pervasive power and a history of vertical administrative relationships checked by higher level inspectors. Also, politically unstable conditions have delayed the passage and implementation of legislation to put these new professions on a sound footing. Until the need for a more mature profession becomes evident in Russian society, progress is likely to be slow. A decade has already passed since the early moves towards perestroika in 1985 and pessimists do

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<sup>2</sup>Drawn from Mustafa and Krylova (1995), and Enthoven and others (1994), pp. 71-75

not anticipate much acceleration in the tempo with which accounting and auditing move towards more advanced professionalization.

**3.2.1 First steps.** The emergence of Soviet-Western joint ventures in the latter part of the 1980s opened the door for creation of an auditing function differing somewhat from other control organizations. Under the first joint-venture regulations, issued in 1987, joint-venture audits had to be performed by so-called independent auditors, restricted to Soviet commercial auditing organizations practicing for a fee. To that end, a government institution, named INAUDIT, under the control of the Ministry of Finance, was established to perform statutory audits of banks and other financial institutions, as well as of certain enterprises, on a fee basis. Its main audit goal, congruent with its institutional affiliation, was investigation of fiscal compliance. The so-called "Big Six" major international accounting firms were subsequently permitted to enter the market to provide management consulting and financial auditing services.

**3.2.2 Market expansion.** The rapid growth in new enterprises at the beginning of the 1990s, coupled with the lack of professional oversight, provided opportunities for proliferation in both the number of people claiming to be auditors and the number—estimated at over 2,000—of new auditing firms. The lack of barriers to market entry, particularly with respect to quality control, coupled with the general public's lack of sophistication in financial affairs, continues to raise serious concerns about consumer protection.

Efforts to pass audit legislation have been ongoing for several years but impeded by a deep-rooted division of opinion over the audit function's main purpose and, therefore, where the supervisory authority should lie. One school of opinion holds that auditing should be subordinated to the National Tax Service which reports to the President. Another holds that the auditing profession should be controlled by an Audit Chamber, reporting to the Supreme Soviet; the Chamber would exercise substantial control over the audit function, resembling the former Committee of People's Control. A third school of opinion holds that auditing should come under the jurisdiction of the Solicitor General. It is therefore evident that there is little, if any, official support for the creation of a relatively independent auditing body. The draft of a comprehensive audit law, prepared in cooperation with experts from the largest Russian and international accounting firms, as well as the United Nations, and covering such elements as

auditors' qualifications, certification and licensing, was in fact vetoed by the President in late 1993 over the question of its relationship with the National Tax Service.

In the meantime, the Ministry of Finance initiated a process to create a conceptual framework for auditing, based on legal rather than private sector initiatives, and requiring the use of international auditing standards. A conceptual framework should, of course, be an integral part of new audit legislation, or at the least, congruent with it. However, there is currently no such guarantee because two independent groups, one in the executive and the other in the legislative branch, are developing their own versions of an audit law. They are the President's Audit Committee and the State Duma's Committee on Budget and Finance.

The profession operates under the Temporary Rules of Auditing in the Russian Federation, approved by Presidential decree No. 2263 on 22 December 1993 (Enthoven and others, 1994, p.73). Under these temporary rules, all individuals engaged in auditing practice had to be certified by 1 October 1994, and all auditing firms by 1 January 1995.

Auditing may be carried out by auditing firms—which includes foreign auditing firms and joint ventures—and certified auditors who hold a special license and are listed in the State Register of Auditors and Auditing Firms. Professional certification and licensing is carried out by special certification commissions, based on the following requirements: a degree in economics or law from a university or similar institute, or a specialized vocational training school or college, plus three years' experience, obtained during the prior five years, in accounting or auditing or in the teaching of accounting and finance. The executive branch has complete control over auditor certification and licensing, as well as considerable oversight of auditing practice, through the pertinent institutional arrangements. State oversight is coordinated through a specially-created Auditing Committee which reports to the President. This Committee writes all the principal rules, setting the licensing and certification procedures, for example, as well as the fee rates for required audits on behalf of a court or public prosecutor. However, audit certificates, which currently exceed 3,000 in number, may be issued by three different authorities: the Ministry of Finance, the Federal Committee on Control of Insurance Companies and the Central Bank. This is related to the fact that there are four different types of licenses to practice: a general audit license and

three specialized ones for banks, insurance companies, and stock exchanges and investment funds. Thus, the trend has been set early for the auditing profession to develop along specialized lines rather than the generalist approach mainly followed elsewhere. Auditors are restricted to related activities such as accounting, auditing, financial analysis or consulting, and are required to report to the authorities any statutory violations uncovered during an audit engagement. Roots of the old system are visible in the auditor's personal financial responsibility in the event of losses resulting from the violation of any required audit procedures; in such an event, the auditor would have to pay a penalty as well as cover the costs of a new audit and reimburse both the State and the auditee for any losses suffered.

### 3.3 Auditing in China<sup>3</sup>

Independent auditing has a long history in China, starting from its roots in governmental auditing tradition several millennia ago. In the more recent past, independent auditing was introduced throughout China by turn-of-the-century entrepreneurs from many nations. The profession flourished until the upheavals of the Second World War and ensuing political changes, which resulted in its being abolished in the early 1950s. As elsewhere, re-orientation of the economy towards market conditions and the emergence of private ownership brought about the profession's rebirth.

The roots of the present system lie in tentative rules concerning the establishment of accounting consultant firms, issued by the Ministry of Finance in December 1980, following the 1979 law on Chinese/foreign equity joint ventures which was designed to encourage foreign investment. The main purpose of the temporary accounting rules was to control tax payments, which is why it was considered essential that auditing be restricted to Chinese nationals. Other auditing objectives were to certify the investments made by all parties to a joint venture, and to examine the venture's annual report as well as its final accounting report upon liquidation.

It was during the second wave of economic reform, starting in 1985, that the profession's role was strengthened through the Law on Regulation of

Certified Public Accountants of the People's Republic of China, issued by the State Council in 1986. With the expanded focus of accountability systems in State-owned enterprises, and increasing investments in private firms, the audit mission also broadened in scope. Public accountants had to verify the amount of capital subscribed to new companies and to audit the responsibility contracts when they were both signed and completed. The expanded audit scope requirements gave impetus to the founding of the Chinese Institute of Certified Public Accountants (CICPA) in 1988. This received official recognition in the CPA Law of the People's Republic of China, approved by the National People's Congress in October 1993. By the end of that year, CICPA had some 37,000 members, and there were about 2,400 CPA firms as well as 25,000 CPAs.

The 1993 CPA law represented the culmination of a year-long drafting effort in which dominant roles were played not only by Chinese government representatives but also by experts from the six major international accounting firms, as well as others, primarily from Hong Kong, Japan, the United Kingdom, and the United States. The law is a very comprehensive piece of legislation containing seven chapters whose major topics, among others, deal with general principles, examination and registration, scope of activities and codes of conduct, and legal liability. The responsibility for directing and monitoring the CICPA, CPAs generally, and CPA firms is shared by the central Government's Ministry of Finance and the finance authorities of local governments. The formulation of auditing standards, however, is under the jurisdiction of the CICPA, subject to final approval by the Ministry of Finance which is the licensing authority.

Development of quality auditing standards is a priority task of the CICPA, which anticipates a three-year endeavor to formulate a modernized set of general, field work and reporting standards. Because generally accepted auditing standards form the core of audit practice, lack of such standards or even basic understanding of some key auditing concepts represents a fundamental weakness in professional standing. Attention has to be directed to, and training prioritized for, internal control study and evaluation, audit risk and materiality, internal auditing, and the confirmation process.

A second major task assigned to the CICPA is organizing the nationwide CPA examinations which have been held three times—in 1991, 1993 and 1994.

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<sup>3</sup>Relies mainly on Zhang (1995)

Candidates for the examination must have already completed a higher education degree of approximately 165 semester-hours, although no particular major field is specified. At the present time, four topics are tested: accounting, auditing, financial management and taxation, although it is planned to increase the number of examination parts to nine in order to reflect the wide scope of knowledge required of a CPA. Passing rates on the examinations have varied considerably, with only 5 per cent passing the first one in 1991, 50 per cent in 1993, and 25 per cent in 1995. Professors of accounting and auditing are exempted from two parts of the examinations. A reciprocity agreement permits overseas accountants to take the examinations, and 500 accountants from nine foreign countries did so in 1994.

### 3.4 The auditing profession in Poland

Poland was the first transitional country in the CEE region to issue and implement new accounting regulations, and to announce its plans for establishing an independent accounting and auditing profession. Some four years later, Poland is arguably the region's frontrunner with respect to the degree of professional development and the richness of its academic accounting programmes. At least two important contributing factors may be identified: a long tradition of professional association among the accounting and finance workforce, and the strong backing of the supervisory authorities.

The Association of Accountants in Poland, which traces its roots back to 1909, not only brought together its members for exchanges of theories during its frequent meetings but also provided some considerable training opportunities. During the period 1958-1986, for example, cumulative attendance at various training courses numbered just under 675,000 as detailed below (Berry and Świdorska, 1992, p. 5):

<b>Courses</b>	<b>Enrolment</b>
Enterprise accounting	67,905
Data processing	80,154
Professional diploma training	63,857
Specialty courses	335,082
Conference courses	88,780
Advanced classes	38,482

**674,260**

Following the 1982 economic reforms, a consulting service in finance and accounting was established in Poznan, primarily to assist State-owned enterprises in improving their cost accounting systems to comply with new demands by the State for increased financial viability. This service proved very popular, completing over 3,000 engagements in its first year, and was quickly imitated elsewhere; it is staffed mainly by accounting instructors from local institutions.

Despite the growing opportunities for financially rewarding careers in the accounting and finance fields, particularly in the 1980s, accounting courses generally attracted few candidates. For example, the University of Gdansk had only 12 students registered for 50 available places in accounting courses in the early 1980s, while the nearby Technical School of Economics in Sopot had barely enough students to organize one accounting class. At the Central School of Planning and Statistics in Warsaw—now renamed the Chief School of Business (Szkola Główna Handlowa) which was its prewar title—not one student majoring in that field accepted employment in accounting and data processing over a three-year period (Berry, 1985, p. 93).

The main reasons for this lack of motivation to study accounting or to consider the field as an attractive career opportunity can be attributed to accounting's low social prestige plus the then poor pay and working conditions. It also had strong associations with entrepreneurship which were politically not acceptable. As a result, students usually majored in economics—particularly in foreign trade which offered opportunities for foreign travel and experience.

Under the prior system, State enterprises were required to be audited annually by qualified personnel who were certified as expert accountants. To obtain the diploma, among other requirements, candidates had to pass qualifying examinations and satisfy certain educational and experience requirements. They were then entered on the register of experts maintained at the Ministry of Finance. To a certain extent then, Poland had the basic institutional arrangements for establishing an independent profession already in place when the political changeover occurred. However, auditing was neither taught nor tested as a separate discipline or function and certain auditing standards did not exist. The expert accountants who performed State-enterprise audits were, for the most part, chief accountants at other State enterprises on unpaid leave. While the basics of inde-

pendence were observed, the auditing function mainly consisted of detailed reviews of bookkeeping records to make sure that there were no legal violations. The notions of materiality, risk assessment and statistical sampling would have been quite foreign, particularly since the auditors had personal material responsibility in the event of failure to detect malfeasance.

The new birth of Poland's auditing profession received its impetus from the law of 19 October 1991 on the auditing and publication of financial statements as well as expert auditors and their self-government.<sup>4</sup> The self-governing body, the National Chamber (Krajowa Izba), and its structural arrangements were formally inaugurated at the profession's constitutional convention in June 1992. Two of the main advisory groups to the Association of Accountants in Poland and the Ministry of Finance on the topics of professional organization and auditing practice, were the Institute of Chartered Accountants in England and Wales, with financial assistance from the British Know-How Fund, and the government of North Nadrenia and Westphalia. The French profession, through the France-Poland Foundation, provided specialized training in auditing banks and insurance institutions.

Within the next 18 months, almost 9,100 individuals registered with the Ministry of Finance as qualified to practice. During the same period, just under 600 professional offices (chambers), as well as some 330 entities which registered their qualifications to audit financial statements, commenced auditing operations. In the meantime, various groups within the National Chamber were working to develop practice standards and the principles for verifying professional work, while the State Examination Commission developed a plan for professional examinations. Under the circumstances, it was inevitable that problems regarding due care and quality of performance would arise.

A review by the National Chamber financial statement audits in 1992 disclosed that the quality of audit work was much worse than had been anticipated. The most frequently encountered problems were as follows:

- a. Failure to notify the National Chamber that they had undertaken an audit, in violation of the code of

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<sup>4</sup>Drawn from Jan Bałński (1994). "Il Krajowy Zjazd Biegłych Rewidentów", *Rachunkowość*, March pp. 109-112

ethics;

- b. Undertaking an audit without having required specialized knowledge, such as auditing computerized records without having any knowledge of data processing;
- c. Issuing an opinion, whose format was not in accordance with professional standards;
- d. Omission of certain required contents of the audit report;
- e. Errors in compiling and filing audit documentation, particularly with respect to working papers; and
- f. Failure by entities authorized to perform audits to notify the National Chamber of changes, as required, in organizational structure or management.

Two main conclusions were drawn from this survey: (a) the need for systematic improvements in professional knowledge—particularly in operating a practice; and (b) the need to intensify efforts to build an understanding among practitioners of the new profession's goals, duties and operating conditions. In addition, because audit work deals almost exclusively with bookkeeping records, expert auditors the National Chamber opined—should feel a moral obligation to help the Association of Accountants in Poland in the training of the new accounting workforce.

Some 33 matters had been reported to the Disciplinary Committee, of which 27 were in the preparatory stages of initiating proceedings.

New legal provisions, effective as of 1 January 1995, introduced certain improvements in the institutional arrangements.<sup>5</sup> The main innovations provide that:

- a. The National Chamber will maintain two registers of expert auditors: those who have earned the diploma and those that have the right to practise their profession. Previously, those who were engaged in other activities were automatically removed from the rolls whereas now they will still be registered as inactive members;
- b. Audit activities may be carried out under three legal forms of organization: sole practitioners, civil

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<sup>5</sup>Drawn from Projekty Ustaw O *Rachunkowości I Biegłych Rewidentach* (1994), *Rachunkowości*, September, pp. 373-374

partnerships with all partners qualified as expert auditors, and legal persons, such as share companies or cooperatives, in which the majority of management members as well as the supervisory organs are certified auditors;

- c. Those expert auditors who do not have a higher education degree have, until the end of 1998, the right to continue to practise without having to take an additional examination. At that time, they will have to decide whether or not they wish to continue in the expert auditor career;
- d. Not only individual expert auditors, but also enrolled auditing firms, must be members of the National Chamber. This makes them subject to rules set for audit practice, to the code of ethics and to the jurisdiction of the Chamber's Disciplinary Court.

### 3.5 Summary of the status quo

In summary, the Polish case illustrates the headstart benefits of having a professional association in place when restructuring is designed and implemented. Russia was the most poorly placed among the countries studied, because of the political instability combined with real conflict over auditing's role in society and where oversight authority should be lodged. China's more developed status can be attributed to government support of market socialism and of the accounting and auditing profession as a tool in helping it meet its overall social and economic objectives. That consideration has not yet taken hold in the Russian Federation.

Poland is the only country to have assessed the quality of audit performance and openly found it seriously flawed. Part of the problem is that the existing expert accountants had little understanding of, and no experience in, modern auditing. Another contributing factor was the relative ease with which one could get on the Ministry of Finance's register. The registration rules were, apparently, elastic enough to admit candidates without formal accounting education. Indeed, when evaluating the quality of audit work it was found that about one-third of the practitioners were quite unfamiliar with the auditing literature distributed by the Association of Accountants in Poland. Furthermore, keeping the registration rules elastic, at least initially, represented one line of defense for the local auditing profession which was fearful of being swamped by overseas competitors. Stiff examination requirements,

described in the following subsection, should help to improve quality control.

### 3.6 Professional examination requirements

Of the three countries surveyed, the Russian Federation has not yet instituted examination procedures, and those in China are relatively modest. Poland, on the other hand, has started to implement an ambitious series of written and oral examinations which should have the effect of improving overall quality. These provisions are detailed below. The Czech Republic has also commenced the professional examination process, and details of its approach follow those of Poland for purposes of comparison and contrast. A unique feature of the Czech system is the inclusion of a heavily-weighted case study as a part of the written examination so as to test a candidate's decision-making ability in a professional situation.

**3.6.1 Poland<sup>6</sup>.** The professional examination arrangements for expert auditor (EA) candidates were announced on 21 December 1993 by the National Council of Expert Auditors (NCEA) in agreement with the State Examination Commission (SEC). The examination is oriented towards the problems of enterprises (whatever their legal form), financial institutions, insurers, and budgetary units and undertakings. The first examination series was scheduled for the fall of 1994.

The examination is organized into three oral and seven written parts. The oral parts start off the examination cycle: the first deals with information systems and principles of data processing connected with testing ability to make use of computers, the second deals with examination of the problems of auditing financial statements and practicing the EA profession, and the third deals with the topic of management economics.

Written examination topics are:

- a. Financial accounting and reporting, including financial analysis;
- b. Management and cost accounting;
- c. Finance, including financial planning;
- d. Civil, labor and commercial law (laws on economic

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<sup>6</sup>Based on Rachunkowość, February 1994

activities, commercial code, formation and bankruptcy, foreign currency, securities, budgetary, banking, and insurance);

- e. Tax law-I (laws on tax obligations, tax procedures, taxes on goods and services, excises on gambling and wagering, and customs);
- f. Tax law-II (laws on local fees and taxes, Treasury charges, income taxes on legal and physical persons, international agreements regarding double taxation, taxes on wage increase, dividends, and interest on capital); and
- g. Financial statement audits and other EA services.

Examination candidates must be Polish citizens who satisfy three conditions: (a) they are legally able to function and have full civil liberties according to their own hand-written statement; (b) they have not been convicted for economic criminal activities, for falsification or for offenses and transgressions of a criminal nature connected with the Treasury, based on a certification from the Ministry of Justice's Central Criminals Register, (c) they have a higher education degree, as documented by an authenticated copy of the diploma.

The examination may be taken in two stages as well as for a third time if the candidate did not pass at least four of the parts. The first parts that candidates must pass are the first oral computer-related examination and the written examinations on financial and management accounting. They are then free to take the remaining oral and written parts in any sequence.

The conditions for taking the final part, the professional examination, are: passing all other parts of the examination; credit for two years' professional practice experience to acquire the ability required of an independent accounting practitioner; and satisfactory completion of a two-year apprenticeship in an entity authorized to perform financial statement audits, with the objective of acquiring the ability required of an EA. This apprenticeship may take place after completing all parts of the examination with the exception of the final, professional part.

**3.6.2 The Czech Republic**<sup>7</sup>. Professional examinations are given twice a year—in the spring and autumn—and consist of two parts: a written part,

weighted at 70 per cent of the grade and lasting a maximum of six hours, and an oral part, weighted at 30 per cent of the grade and lasting no more than two hours.

The examinations focus on testing both theoretical knowledge and the capacity to apply such knowledge to audit activities, to the extent required for practicing the auditing profession in the following areas:

- a. Accountancy and financial management, and analysis of financial statements, including consolidated financial statements;
- b. Approaches and methods used for reviewing financial statements, application of mathematical and statistical methods for review, control in conditions of an electronic data processing environment, and developing and reviewing an internal control system of accounting units;
- c. Commercial, tax and financial laws.

The written part of the examinations consists of a test focused on knowledge of the required subjects, with a maximum weighting of 30 points, as well as a case study with a maximum weighting of 40 points.

Applicants may only take the oral part of the examination if they achieve a minimum number of points on each of the two parts of the written examination. The oral examination, weighted at 30 points in total, consists of a number of questions drawn from a question pool and answered before a Board of Examiners. The Board is composed of four members, two of whom are representatives nominated by the Ministry of Finance, and two, nominated by the Chamber of Auditors, who are drawn from experts in economic and legal theory and practice. To pass the oral part, a candidate must achieve a minimum score on each question. Providing that a minimum score has been achieved on each question in the oral part, and each of the two written parts, a total score of at least 50 points out of 100 represents a passing grade on the examination as a whole.

### 3.7 Accounting and auditing education

Rapid growth in the fields of accounting and auditing creates great demands for education and training, demands which are being met, however inadequately, in a variety of ways and from a variety of sources. In Russia alone, it is estimated that some 2 million accountants and bookkeepers need retraining; in addition, at least 300,000 professional positions will be

<sup>7</sup>Drawn from Chamber of Auditors, Czech Republic (1994), Examination Rules of the Chamber of Auditors of the Czech Republic.

available each year for the next five years. Under the current educational system, however, only about 5 per cent of the potential demand can be satisfied by new entrants into the workplace during that same period (Mustafa, 1995). The situation in China may shortly be showing similar trends. In both countries, the problem is exacerbated by difficulties in attracting recruits to a field which for decades has had a negative image.

Efforts to cope with education and training needs have been varied in both approach and source, with a considerable amount of resources being provided to the CEE region by Western Europe, and to a lesser extent, the United States. Unfortunately, the rich array of educational programmes which were put in place suffered in various ways from the basic fact that the donors' motives were not particularly altruistic. That is, some of the major exporters of accounting systems—such as France and the United Kingdom, which have very different views about the world of accounting—were quick to perceive the opportunities in the CEE region for the large-scale competitive advantages associated with providing free, or highly subsidized, training in their own particular accounting model. As a result, there has been little, if any, training coordination between donors. Further, host countries or institutions, as the case may be, sometimes faced limited choices with respect to, say, course contents or materials because the donors were only promoting their own publishing houses or suppliers. Also, there have been some evident cultural mismatches between donors and hosts, such as installation of case-law based systems in code-law countries. In the long-run, however, some of these problems will undoubtedly work themselves out. From the standpoint of effectiveness and efficiency, however, those host institutions which evaluated alternatives and chose what appeared to be the most favorable of competing options fared better.

In the CEE region, there has been a noticeable shift during the past five years from reliance on foreign lecturers and trainers in universities and other institutions of higher learning to strengthen and enrich course offerings with national instructors. Nonetheless, outside material assistance has proved invaluable—due to the pressing budget problems generally prevalent.

In Poland and elsewhere, there have been widespread improvements in accounting-programme design, a strengthening of instructor training and retraining, concentration on the production of new texts, and the enrichment of accounting teaching methods (Jarugowa and Marcinkowski, 1994, p.19). Almost all of the

departments of economics and management in the major universities now offer courses in accounting, a situation which differs radically from that some ten years or so ago. Also, new attention is now being paid to auditor training and procedures which are congruent with the European Union's Eighth Directive. A listing of the core accounting courses and the related semester hours involved for some noted Polish institutions is presented in Table 10. With considerable help from certain countries (such as Canada, France, Germany and the United States), as well as programmes funded by the EU required and elective courses in accounting and auditing have been added, or restructured, in accordance with Western practice. This effort was also aided by overseas apprenticeships for faculty or students completing their last year. Examples of current course listings for a relatively small accounting programme at the University of Gdańsk, and a much larger one at the University of Łódź, are presented in Table 11 as an illustration of the metamorphoses which have been taking place in the academic accounting world. The relatively small number of accounting majors, however, is cause for concern. Further, unlike some Western universities, particularly in the United States, introductory accounting courses are not required by other faculties.

Professional recruiting and training by auditing firms, particularly the large international ones in the CEE region, has had to be modified from approaches in other geographical areas because of the relative lack of sophistication in decision-making situations.<sup>8</sup> This is particularly important in the auditing field and is widely held to be a first consideration. In general, the "Big Six" firms encourage staff to enroll in accounting and auditing correspondence courses emanating from the United Kingdom, which lead to an ACCA diploma. The staff study on their own time but the firms usually fund their courses if satisfactorily completed. One of the firms sends its local staff to its main training headquarters in the United States and another to the Netherlands. Others send selected local staff to overseas branches for on-the-job training. The expatriate staff are often fluent in the local language, frequently because of family background.

From the local staff's perspective, one of the comments most often made has to do with the foreign work ethic,

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<sup>8</sup>Based on interviews conducted in the CEE region in the fall of 1994



that is, the expectation of heavy workloads and long working days and the requirement that attendance at professional meetings be taken as annual leave without reimbursement of expenses by the firm. The concept of making an investment in one's position is slow to take hold in an environment where it has never been put into practise.

### 3.8 Conclusions

A common feature of transitional economies is the symbiotic relationship between expansion of private enterprise and increased demand for accounting and auditing services. Yet another common phenomenon is the scarcity of candidates for positions in these professions—mainly due to negative perceptions of their potential for interesting and rewarding careers. Consequently, recruiters and trainers need to be particularly sensitive to the ways in which potential candidates are identified and selected, and career opportunities are presented.

In the accounting field, workforce shortages can be partly alleviated through computerization, which is now widespread in the CEE region. It is at the professional levels of chief accountants and other accounting management personnel, as well as in auditing, that demands are the heaviest. Retraining may present as many challenges as training newcomers to the field, if not more.

Accountants and auditors, most fundamentally, have to expand their conceptual base. That is, they must develop new functions, in particular, those connected with making major decisions under risky, ambiguous circumstances. They have to appreciate the internal audit function and evaluation of internal controls as well as be trained in valuation techniques. All of this is incidental to, or concurrent with, assimilating the underlying strategies of auditing standards.

Trainers, particularly those from other cultures, need to take the accounting laws and environment into consideration when planning all courses, especially those at the most basic levels. One of the most frequently encountered inadequacies in training programmes is the lack of local familiarity by the trainers and, therefore, inability to provide the training at the appropriate level of understanding. Another is the comparative lack of government understanding and involvement in training programmes. It is up to those charged with oversight of the accounting and auditing profession to

set training priorities by developing and analyzing lists of training needs. The various training programmes should be coordinated for two main reasons: to provide for congruency between them and, at the same time, meet goals set for the profession. Special attention should be paid to the trainers themselves, that is, whether they have been appropriately selected and whether they are under pressures—such as competitiveness or commercialization—which might work against the best interests of their clients.

## 4. Financial management in government

### 4.1 Introduction

This section considers past and present financial management practices in government, as well as the future directions these practices may take. It commences with a review of how the three essential financial management functions—budgeting, accounting, and auditing—were carried out in the former command economies. This is necessary not only to appreciate the points of departure for the transitional economies but also to understand how much of what went on before can be traced in current approaches. The inadequacies of the former financial management systems are then summarized and their evolutionary stage is assessed using Dean's (1988) model.

Developments which have taken place in budgeting, accounting and auditing in the transitional economies during the past five years are described in connection with the following specific topics:

- a. Government budgeting: diversifying revenues, controlling expenditures and adopting the programme concept;
- b. Government accounting and the use of charts of accounts in government;
- c. Computerization and its usefulness in government operations, particularly those involving fiscal operations;
- d. Central/local government relations and the implications for revenue sharing;
- e. Government auditing and the concept of external accountability; and
- f. Training programmes to develop appropriate skills

in governance.

The section ends with a summary and assessment of the status and future implications of financial management processes.

#### 4.2 The budgeting function

In the former command economies, budgeting—generally referred to as planning—was the core function underpinning socialist financial controls exercised horizontally and vertically throughout society. In general, the main objectives of these controls, while varying in detail or expression from one country to another, were to:

- a. carry out economic strategy based on national economic criteria;
- b. contribute to the improvement of the constituents of expenditures and revenues;
- c. help enforce economy; and
- d. ensure protection of State property (v. Grumbkow, 1984, p.57).

Two basic budgetary principles dictated the institutional arrangements for meeting these objectives: “budgetary compliance”, or coordination of the budget into all economic activities, and “democratic centralism”, or incorporation of the receipts and expenditures of local budgets into the overall State budget (Jaruga, 1987, p. 106). The approach taken in the German Democratic Republic provides an illustration.

In the GDR, financial control was carried out by three main groups to whom a secondary set of goals, within the framework of the main objectives, was assigned; that is, to:

- a. determine the most effective national economic plan appropriations;
- b. find the most rational ways and means of fulfilling and exceeding the plan; and
- c. ensure State law and order (v. Grumbkow, 1984, p.57).

The three main control groups were State organs, administrative organs whose activities involved financial control, and organizations with specific control responsibilities. The first group consisted of the top level of State government and administration, the Parliament (*Volkskammer*), district governments

(*Bezirkstage*), and national agencies of the circles (*Kreise*), towns, town districts, and municipalities.

There were two main ways in which control was exercised at this top level—through the process of drawing up and carrying out their budgets, and through the discharge function which acquitted the ministerial and local councils of their responsibility for carrying out budgeted activities and making use of planned resources.

Administrative organs whose activities related in some way to financial control constituted the second group. They included the State Planning Commission, all ministries and similar central State organs, and councils of the districts, circles, towns, town districts, and municipalities. These organizations bore joint responsibility for financial control in the entities they supervised.

The third group had specific responsibilities for overall control, financial control, or information, and were independent of, and therefore not responsible for, those they controlled. This group included the Workers and Peasants Inspection which was an organ of the State Central Committee and the Council of Ministers; the Ministry of Finance, including the State audit function; all banks; the State Office for Prices; and the State Central Statistics Office.

#### 4.3 Planning techniques<sup>9</sup>

Planning techniques varied widely within and between command economies, not only because of different sets of management models and economic activities but because of the diverse approaches taken by various planning bodies. Czechoslovakia had the most stable planning techniques in the region, mainly due to its special law on economic planning. This law specified different types of plans, including economic development plans, for both the Czech and Slovak Republics individually as well as the Federation, and for supervisory and public organizations as well as regional plans for national committees. Particular units prepared financial plans which formed the basis for federal and republic budgets and the nation’s foreign currency and monetary plan.

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<sup>9</sup>This section relies heavily on Gajl (1986), pp. 77-92.

Planning was divided into three time-frames: long term (10 to 20 years), medium term (1 to 5 years) and annual. Component subsidiary plans varied according to the time period covered. A five-year plan, for example, included the following elements: production and sales for all branches of the economy, science and technology development, investment outlays, technical and material supplies, employment and wages, financial, price increases, foreign trade, and growth in quality of living conditions. The law also laid down the organizational structure of the State Planning Commission and other planning authorities at various levels of government.

In the other neighboring command economies without this type of legislation, normative planning techniques were laid down by an authoritative body, such as the State Planning Commission (SPC) in Poland. There, as elsewhere, the planning function was dichotomized; economic planning was performed by the SPC and financial planning by the National Bank in cooperation with the Ministry of Finance. All three bodies worked to some extent in tandem to effect congruity between economic and financial plans, with the Council of Ministers arbitrating any related difficulties.

Poland's national economic plan was issued in two stages. In the first, various alternatives were drawn up and presented for discussion purposes, Parliament selecting a preferred version. In the second, the plan was completed after additional discussions and analysis as well as coordination with international partners, including fellow COMECON members. After the plan was confirmed by the Senate, the budget was published and adopted in the form of a budget law.

#### 4.4 Financial planning

The annual and multi-year socio-economic plans formed the basis of financial plans of various kinds, not all of which could be accommodated in the annual budget law because of their size and variety. For example, financial planning covered most, if not all, of the activities of State-owned enterprises (SOEs) which were the mainstay of the economy. Their operational financial activities fell outside of the budget but certain elements were fitted into the socio-economic plan. These elements included payments to the State Treasury (also known as the State Budget), out of profits; increases in funded depreciation (that is, matching charges for depreciation expenses with payments to the State for fixed asset replacement purposes or as a

charge for fixed asset use); and payments to the SOEs by the State for various types of subsidy. Also included were price supports for certain products (such as infants' clothing) whose retail prices were kept very low in the public interest.

Financial planning covered at least three main areas—credit, balance of trade and purchasing power. Credit plans prepared in command economies served a dual purpose: (a) they allowed banks to evaluate the general economic situation as well as that of particular socio-economic groups who might make use of credit; and (b) they provided for operational division of financial resources in the form of anticipated credits. In effect, a credit plan projected the financial resources to be made available to banks and how they were to be used. In Poland, the National Bank of Poland (NBP) prepared the credit plan and forwarded it to the Minister of Finance for presentation to the Council of Ministers for approval. After 1982, this prerogative fell to the Parliament. Credit planning had other features elsewhere. In Czechoslovakia, the annual credit plan established criteria for granting credit and also set credit limits. Should certain SOEs not agree with those parameters, supervisory organizations could arbitrate between them and the national bank.

Balance of trade planning was carried out in most command economies by the Ministry of Finance, the Foreign Trade Ministry in Poland, and the Council of Ministers in Romania. The basic elements of the plan were forecasts of foreign purchases and sales, involving the so-called "transfer rouble," the common unit of account used within the COMECON, or hard currencies for non-COMECON trade. One of the main purposes of this plan was to budget foreign currency reserves.<sup>10</sup>

The basic financial plan of inflows and outflows, referred to as a balance sheet, usually had the following components (Gajl, 1986, p. 91):

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<sup>10</sup>Influential members of COMECON could alleviate their own foreign currency needs through contracts with weaker members payable in convertible rouble credits. Items to be delivered under contract (such as component parts) would be specified as acquisitions from designated sources requiring hard currency settlement by the subcontractor.

**Inflows**

- a. Financial accumulation of SOEs for the period
- b. Balance of foreign trade turnover
- c. Cash payments for depreciation charges by SOEs
- d. Budget revenues
- e. Retirement fund revenues
- f. Increases in the funds of financial and insurance institutions
- g. Growth in the population's monetary reserves
- h. Credit payments by the general public and the non-socialized economy
- i. Other

**Outflows**

- a. Current outlays: (i) budget; (ii) retirement fund; (iii) workplace and cooperative funds; (iv) credits for the general public and non-socialized economy
- b. Outlays for accumulation: (i) investments; (ii) capital repairs; (iii) increase in inventories
- c. Other
- d. Reserves

This balance sheet was on a macroeconomic scale and, therefore, did not identify specific contributing or recipient parties. It merely provided a general basis for drawing out inferences or conclusions. More specifics were provided in other subsidiary plans.

A third financial plan provided a statement of the general public's income and expenditures to allow assessment of purchasing power and thereby, assist in assessing the money supply. Its components were generally as follows (Gajl, 1986, p. 92):

**Inflows**

- a. Net payroll
- b. Social services
- c. Transfers for use by the general public
- d. Credits
- e. Other

**Outflows**

- a. Purchases fund for acquisition of goods
- b. Payments for services
- c. Taxes
- d. Repaid credits
- e. Other
- f. Changes in inventory levels of contributions and cash

For those economies where local authorities had their own budgets, the central financial plan included transfers in the form of receipts and expenditures between the local and central treasuries. During the 1980s, central governments began to exert heavy pressure on local levels to assume more of the financial burdens in order to ease the growing strain at the centre. By the mid-1980s, self-financing percentages of local budgets in four neighbouring countries were as follows (Jaruga, 1987, p. 107):

Country	Local budget self-financing percentage
Poland	20
Soviet Union	25
Czechoslovakia	35
GDR	40

**4.5 Budgetary accounting<sup>11</sup>**

Budgetary accounting for government institutions in former command economies mirrored the diversity which then existed—and persists around the world—in accounting for government. That is, some countries kept simple cash records of receipts and disbursements; others, notably the GDR, adopted a form of cameral accounting which incorporates some accrual features into cash accounting and provides side-by-side comparisons of budgeted (*Soll*) and actual (*Ist*) line item amounts; while Poland—in the minority among command economies—had used double-entry accrual

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<sup>11</sup>This section draws on Jaruga (19887), pp. 111-113

accounting for government since the early 1950s.

In Poland, budgeted revenues and expenditures were structurally organized as follows (Cewe, 1978, pp. 18 to 24):

a. By division (*dzial*), that is, according to a basic activity or branch of industry. For example:

01	Industry
31	Construction
40	Agriculture

b. By section (*rozdzial*), that is, according to defined groups or activities within a particular division. For example, sections within the division 70 Local Economy (*gospodarka komunalna*):

7221	Street cleaning
7262	Street lighting

c. By paragraph, that is, by line item definition of defined sources of budgetary revenues and types of budgetary outlays. For example:

42	Inflows from material services for the general public
45	Inflows from the sale of goods
11	Salaries and wages outlays
35	Utilities (energy) outlays

Budgetary accounting in Poland was organized in such a congruent fashion that periodic reports could be forwarded to supervisory organs, comparing actual and budgeted revenues and expenditures by reference to budget divisions, sections, and paragraphs. Because there was no necessary correlation between the way budgeted amounts were estimated and the way they were accounted for, budgetary accounting's potential for future-oriented decision making was limited. It did, however, provide for after-the-fact control and accountability by being budget-integrated.

The reason why budgetary accounting was largely underdeveloped in command economies had to do with its classification in the nonproductive sphere of the economy which consumed, rather than created, national income. This distinction carried through to accounting-system design whereby revenue generators engaged in the material production sphere appropriately used double-entry accrual-based systems. In examining the functions that budgetary units carried out, it is evident that double-entry systems which kept track of receipts and expenses by programme would have been the most appropriate. Services generally

provided to the public at large included overall State administration, finance and insurance, justice administration, internal security, and a wide range of scientific activities. Programmes provided for individual citizens included health, education, and welfare (Jaruga, 1987, p.108), and considerable sums were expended in sports and the arts. Budgetary accounts designed to match budgeted and actual programme costs would, of course, have helped in the analysis of economy and efficiency in the use of budgetary resources. However, only in the GDR was any overt recognition given to harnessing the accounting function to help in the financial management of the economy. Budgeting personnel at the central level were trained in macroeconomics and, in so far as they used accounting data in their planning, they generally obtained it from the State Statistical Office.

The case for programme budgeting and budgetary accounting strengthens when considering the organizational arrangements for service delivery. Generally, three types of government institutions constituted the nonproductive sphere: "budgetary units", "budgetary entities", mainly in Poland and Czechoslovakia; and "auxiliary undertakings", also known as "auxiliary enterprises". "Budgetary units" were fully funded by the State and their services (listed above) were provided free of charge to the recipients. Budgetary entities provided services partially funded by the State although, theoretically, they were supposed to generate enough revenues to cover their costs; this shows a clear need for accrual-based, double-entry accounting on a programme basis in order to set break-even fee scales. These services typically included a variety of activities ranging from nursery schools to various recreational pursuits. Auxiliary enterprises were the most self-sufficient of the three groups, and were established as financially and organizationally separate entities to carry out various sets of economic activities for related budgetary units. An example was a workshop attached to a technical school for automobile repairs, and maintenance instruction and training. Generally, these auxiliaries covered their costs through revenues although some received State budget subsidies.

Several differences in accounting practices and institutional arrangements distinguished budgetary entities from auxiliary enterprises. For example, budgetary entities did not include depreciation on fixed assets in their operating expenses. Auxiliaries did, but had to forward to the State budget matching cash (depreciation funding) to cover the expenses. Theoretically,

depreciation funding was to provide for asset replacement. Also, if budgetary entities underspent their appropriations in any one year, the underexpended balances could be carried forward as in cameral accounting. The benefit of this arrangement was that it avoided the phenomenon of year-end spending to use up quotas by deadlines. Auxiliaries were allowed to retain profits in the form of special-purpose funds, and were also permitted to apply for bank credits.

Accounting for those three types of institutions in the State budget was as follows (Jaruga, 1987, pp. 112-113). For fully-supported budgetary units, the State budget included planned receipts and expenditures, under the so-called gross budgeting method. The estimated expenditures were calculated to encourage economy, particularly by penalizing units for building up inventory and receivables balances, through use of the following formula:

- a. Accrual cost of services to be provided, calculated by applying budgetary coefficients, i.e. normative (standard) quantities of services times normative monetary costs per quantity;
- b. Add:
  - Beginning accounts payable balance plus
  - Normal level of inventory
- c. Deduct:
  - Beginning inventory balance and
  - Beginning accounts receivable balance
- d. Equals planned budget expenditures.

Theoretically, the reliability of the budgetary coefficients was supposed to be tested against actual costs and quantities of services provided. In practice, however, there was little interest in developing cost accounting techniques or using cost or other accounting data for that matter.

The so-called net budgetary method was used for budgetary entities and auxiliary enterprises, that is, the projected revenues and expenses were netted out and the projected surplus or deficit was entered in the State budget as a revenue or expenditure line item.

#### 4.6 Budgetary reporting

Budgetary financial reports were mainly intended for use by various government bodies, such as the Central Statistical Office, the fiscal authorities, the National Bank, the State Audit Service, the executives of various

“spending” ministries, and certain workers’ groups. Their content, format and frequency varied from country to country as did the jurisdictional authority—usually the Central Statistical Office or the Ministry of Finance. Because the main purpose of budgetary reporting was to provide statistical data for macroeconomic control purposes, reporting formats were standardized. To facilitate the reporting process, the official forms usually included some identifying data, such as chart of account numbers on certain lines on the form to indicate where data from the accounts were to be entered.

Budgetary reports prepared at the local level provided the nucleus for additional reports consolidated at increasingly higher levels of government. Consolidation was merely additive, however. No adjustments were made to eliminate matching inter-organizational receipts and expenditures which is the practice in Western corporate consolidations. The reports generally included a variety of statements, such as statements of budgetary receipts; budgetary expenditures; budgeted and actual payrolls; inventories, receivables, and payables balances; actuals versus budgeted normatives for certain items; and off-budget receipts and expenditures. It was also usual to include a statement of year-end general ledger balances referred to as a balance sheet. As is evident, this collection of statistical data did not represent a financial management report which would provide a picture of stewardship of national resources.

#### 4.7 Budgetary auditing

In command economies, the audit function is subsumed under the general area of economic control and may be carried out by different organizational entities for different purposes. In the former Soviet Union, for example, there were at least three separate sets of institutional arrangements: internal control over subordinate entities by superior organizations; external control through the banking system; and oversight by the Control and Audit Administrations (CAAs) organized at various levels within the Ministry of Finance (Berry, 1984, pp. 436-438).

The CAAs had three main client groups: ministries, departments, State committees, and other administrative units; the Ministry of Finance, or a department immediately below the CAA’s authority level; and Gosbank. Internal control reviews conducted by supervisory administrative units were conducted indepen-

dently, rather than coordinated through a Supreme State Audit Service (such as the General Accounting Office in the United States).

In planned economies with a State audit service, such as Poland's Supreme Audit Chamber (NIK), audit of the national socio-economic plan and the State budget performance was the responsibility of the Chief Auditor. A brief survey of NIK and its mission and institutional arrangements in the early 1980s serves as an illustration (Kurowski and Sochacka-Krysiak, 1990, pp. 265-283).

The responsibilities assigned to Poland's State audit service (NIK) were similar to those in market economies, although it lacked the institutional independence from governmental bodies which should be guaranteed to those functioning as State internal auditors. For example, NIK's activities were based on a defined work plan presented to the Polish Parliament (*Sejm*) and the State Council. Its audit engagements could be self-initiated or be directed by order of the *Sejm*, the State Council, or the president of the Council of Ministers. Review of facts or documents forming the basis for decisions handed down by State supervisory organs could only be carried out if directed by one of these three authorities.

NIK enjoyed the usual rights of access to records and other evidence it needed to conduct its activities. It could call on experts if needed, take part in the engagement, and convene a meeting of the auditee's employees at which they could be required to furnish written or oral clarification of the auditee's affairs. Auditees, on the other hand, were expected to provide working space to conduct audit activities, as well as a telephone and transportation services if necessary and available. Auditor independence was also an issue. An auditor, commonly referred to as an inspector, was not to participate in an engagement if audit activities, or potential audit results, could affect his/her rights or obligations, or those of a spouse, relative or close associates. In the event of adverse audit findings, such as a threat to safety, lack of good management, waste or carelessness in the use of resources, NIK had the right to issue orders immediately to the auditee's management to correct the situation. These orders had to be carried out even though the auditee might be in the process of appealing the decision to NIK's president. Should management delay taking corrective action, the auditor was empowered to issue a written order with a specified time limit.

Institutionally, NIK issued written reports directly to the Parliament, as is common for a State audit service. These reports were of three types: (a) an annual report on its activities; (b) analyses of how the national socio-economic plan and the State budget had been carried out; and (3) presentation of the audit results for engagements carried out at the instance of the *Sejm*, the State Council, the Council of Ministers, and any other clients.

#### 4.8 Fiscal auditing<sup>12</sup>

Fiscal authorities, which were organizationally separate from the Ministry of Finance in Poland, performed not only tax-related audits but were also responsible for setting administered prices for goods and services of local importance, if set prices for them were not otherwise in general use (Kurowski and Sochacka-Krysiak, 1990, p. 295). It would be fair to say that the term "audit" was synonymous with the concept of control, with heavy emphasis on legal compliance.

In Poland, the tax departments (literally, tax chambers: *izby skarbowe*) carried out their audits in accordance with annual plans as well as unplanned reviews and engagements requested by the public prosecutor. Employees of the Ministry of Finance or the tax departments who were authorized to carry out fiscal audits enjoyed considerable discretion in selecting auditees for examination. They did, however, need the consent of the organization which had jurisdiction over the financial control of the client before commencing the audit. As in the case of NIK, auditors had to observe the regulations governing professional independence. It was also customary for the auditee to provide working space and other amenities such as access to a telephone and to transportation.

The fiscal auditor's main responsibility was to reliably and objectively attest to the factual status of audited matters, and to determine the causes of any irregularities and transgressions as well as those responsible for them. The auditor had the usual rights of access to whatever records and proofs that were needed, including the assistance of experts such as expert accountants. An important point of concentration was the way in which the accounts were kept, in particular, the

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<sup>12</sup>This subsection is drawn from Kurowski and Sochacka-Krysiak (1990), pp. 294-306

methods of physical inventorying of the assets and liabilities. Holding particular individuals personally responsible—from a financial standpoint—for their custodianship of State enterprise assets, was an important element of socialist management. Physical counts had to be made in the presence of the appropriate custodian who signed his/her agreement on every inventory sheet. Usually, if the custodian was absent, the assets could not be removed. This is why department store counters, for example, would be closed and roped off if the sales clerk were out sick.

During the course of their examinations, the auditors could make use of secret—that is, unpublished—regulations which they could cite, but not disclose, to the auditee, thereby adding to the ambiguity of the tax assessment process. At the written initiative of the auditor, management could be required to issue orders to correct certain situations, or otherwise refuse in writing to do so. In serious situations, the auditor was required to notify the public prosecutor or the security service immediately.

At the end of the engagement, the auditor provided the auditee with a written statement (protocol) of the findings. The latter could provide the auditor with a written explanation, or delay doing so for seven days. An alternative was to issue a report instead of a protocol.

In summary, the State and fiscal auditors—both generally referred to as inspectors—enjoyed considerable audit rights vis-à-vis the auditees, concentrated on legality issues related to following regulations, and could cite auditees for infringements without detailing the foundations.

#### 4.9 Summary of financial management inadequacies

Although planning techniques were relatively well developed, the accounting function was not harnessed to help in the financial management of the economy. This was mainly due to the general perception that accounting was a purely bookkeeping activity for archiving historical records. The lack of institutional connections between the economist planners and the accountants meant that there was no necessary correlation between the ways in which planned amounts were calculated (often through the use of econometric models), and the ways they were accounted for. Accordingly, accounting records could only disclose

that budgeted, versus actual results, were similar or different to budget, but not why they were. This meant that accounting information had little relevance because, although it could provide limited feedback data, it did not offer the predictive ability which could help planners budget better. Although lip service was paid to the need for cost control and efficiency in government, budgets were not constructed by programme detailing the financial objectives of each set of budgeted activities. Constructing the accounting systems similarly by programme could have helped in determining whether these financial objectives were being met.

External accountability was virtually nonexistent because politicians were not subject to criticism for their financial decisions, unless it were considered politically expedient, and there was no free press. Financial reports, including the balance sheets of State-owned enterprises, were treated as confidential documents and not available externally. In any event, they would not have provided a reliable picture of national resources stewardship because of the faulty way in which they were packaged—duplicate transactions were not eliminated in the consolidation process.

The State internal and fiscal auditors, who would have otherwise formed part of an external accountability function, were heavily oriented towards issues of control and legal compliance. Consequently, there was considerable emphasis on auditees' obligations but little consideration of their rights. The punitive nature of their operations did not, therefore, build up the respect for the public audit service that is needed in an ordered society. Further, the State audit service lacked institutional independence as well as freedom of action because the government could restrict its scope of activities.

#### 4.10 Evolutionary status

Before examining the sweeping changes that started to take place in governmental financial management during the late 1980s and early 1990s across the Central and Eastern European region, it would be useful to consider the general level of maturity of financial management systems in government proper at that time, based on Dean's model of the evolutionary stages of governmental financial management systems, set out in Table 12.

In accounting, budgeting and auditing, most countries



studied were in the basic stage of emphasizing regularity and control. That is, procedures were in place to make sure that regulations were followed, responsibilities could be fixed and historical records maintained. Little of an analytical nature was provided for, budgeting and accounting activities were segregated, the accounting function was not involved to any extent in management decision-making, and auditors did not consider such procedures as risk assessment or statistical sampling. Some, notably the GDR, had moved along the continuum into the second stage where the accounting, budgeting, and auditing functions were involved in the managing of governmental finances. However, little progress into the second stage was evident because of the overriding importance of control functions in the command society. After reviewing some of the changes which have taken place in the last five years, Dean's model is referred to again as a vehicle for measuring progress and highlighting training needs.

#### 4.11 Restructuring the budgetary process

The process of dismantling government control over the economy under conditions of instability and economic crisis creates an emergency situation for the budgeting function. In the initial stages of economic reform, the simple priorities of raising revenues wherever they may be found and cutting back expenditures to the greatest degree possible tend to dominate strategy in governments that are struggling to carry out unfamiliar tasks in ambiguous circumstances and under competing political pressures. Russia coped with the situation by operating without a budget for 1992 and 1993 and bringing in a 1994 budget half-way through the year. Inevitably, some conditions have to stabilize before attempts can be made to start refining budgeting techniques so as to develop reliable revenue estimates to form the basis for rational expenditure decisions. While the transitional economies in the CEE region adopted broadly similar approaches to effecting the changeover, implementation measures and speeds of application varied. Important influences were the strength and sources of social pressures applied, as well as the degree of political consensus and commitment.

Common problems which new governments experienced when trying to prepare revenue and expenditure estimates were falling output, high levels of unemploy-

ment and inflation, and accumulated budget deficits. Some countries, notably Hungary and Poland, had massive foreign debt obligations to meet. During the past five years, most transitional economies have not been able to balance their budgets, mainly because of over-optimistic revenue targets—due to unfulfilled assumptions about increased economic performance—rather than over-budget spending. Lack of political stability could also have been an influencing factor, for example in Hungary, Poland, Romania, and Russia (Deloitte, Touche, Tohmatsu, 1994, p.5). The Czech Republic, on the other hand, which enjoyed greater political stability, managed to keep down inflation while balancing its budget more closely.

#### 4.12 Diversifying budgetary revenues

A pattern of gradually diversifying revenues and shifting from direct to indirect taxation options has started to emerge in the transitional economies. In the process, a number of issues had to be resolved—for example, how to restructure revenue-sharing arrangements, how to use the proceeds from privatization sales, and how to raise and collect taxes. Prior experiences were an influential factors.

#### 4.13 Revenue-sharing considerations

Revenue sharing, that is, uni- or bi-directional flows of revenue between the central and local authorities, was a common feature of command-economy financing. The mainly uni-directional flows for tax revenues in the People's Republic of China provides one example while the mainly bi-directional flows in Lithuania—a former Soviet republic—provides another.

One of the main reasons for China's recent overhaul of its national tax system was to achieve more significant control over tax revenues by the central Government (*The Economist*, 18 March 1995, p. 15). Fiscal revenues constituted some 30 per cent of China's GDP at the time economic reforms commenced, in the late 1970s, under an arrangement whereby local authorities collected taxes and forwarded a fixed quota to the central level. This fixed amount, however, remained unchanged while economic growth expanded, resulting in a one-third drop in the percentage of total tax rev-

venues allocated to the central Government. The situation was exacerbated by local tax incentives to new enterprises, excusing them from taxes due to the central Government. One of the main features of the new structure is a 17 per cent value added tax (VAT), which replaces other turnover taxes, of which only one-quarter is allocated to local governments. There is also a standardized 33 per cent tax on corporate profits. Most importantly, the direction of the tax allocation payments will be reversed, that is, payment will in the future go from the central to the local levels through national tax offices to be established locally. This arrangement should also give the central Government more opportunity to control local economic policies, particularly those related to fiscal matters; if successful, increased tax revenues could be used to reduce the budget deficit as well as form the financial basis for national unemployment and welfare systems. Until some social safety nets are in place, the badly needed rationalization of large SOEs will not be attempted on a large scale.

The budgets of former Soviet republics were fully integrated at the "All-Union" level, an arrangement which continued until various members declared their independence. For Lithuania, this occurred in March 1990. Previously, Lithuania transferred portions of its major revenue sources—turnover, income and profits taxes—to the Union and, although budgetary resources flowed back from the central Government, providing, *inter alia*, the main funding for the social security system, the Union generally benefitted from net positive transfers.

With independence came new and different sets of opportunities and obligations considered in Lithuania's budget law of July 1990. On the revenues side, a profit tax, a personal income tax and a tax on fixed assets were introduced, and land tax rates were increased. An enterprise profit tax was initially set at a high effective rate, although subsequently a reduction was allowed for those profits retained for investment purposes. This approach has been applied elsewhere, most recently in Hungary. The tax on the fixed assets of SOEs is, essentially, a charge for the use of State capital, and, similarly, the land tax is a land use charge paid by State enterprises which occupy State-owned land. Leasing land from the State is also common in agriculture. As the new government developed an improved sense of revenue planning, the revenues structure started to develop into a more mature pattern of decreased direct taxation and increased indirect

taxation. In 1991, the turnover tax was replaced with a value added tax which started to assume major importance as a revenue component. To replace the previous Union budget funding, an extra-budgetary social insurance fund was set up to finance the system from a 30 per cent payroll tax together with a 1 per cent payroll tax levied on employees.

#### 4.14 Privatization proceeds

Whether or not to include the proceeds from privatization disposals of State property in State budget revenues is a controversial issue because it converts investment into consumption, emotionally expressed as "selling the family silver to pay one's way."

In general, transitional economies tried to avoid using privatization proceeds for operating needs. In the Czech and Slovak Republics, the proceeds from small privatization auctions were deposited in each republic's National Property Fund. They were to remain there, frozen, for two years; afterwards they could be deposited in the banking system, although use for budgetary purposes was prohibited (Frydman and others, 1993, p. 79).

In Lithuania, cash receipts from the sale of SOEs and houses flow, respectively, into an Enterprise Privatization Fund and a Housing Privatization Fund. Under a decree of July 1992, Parliament may allocate some of the Enterprise Privatization Fund revenues for a number of purposes which would have the effect of decreasing budget burdens, but not necessarily decreasing outlays for operating expenses. These purposes could include paying domestic debt, promoting hard currency investments and exports, recapitalizing State banks, or improving infrastructural facilities scheduled for privatization. Any balance would be allocated to privatization-related outlays. The Housing Privatization Fund revenues were to be shared, 30 per cent going to the State for new housing financing and 70 per cent to local governments to assist those in need.

In Bulgaria, the municipal authorities are permitted to retain 50 per cent of the proceeds from privatization of municipal assets, but may only use these funds for debt repayment and investment purposes, and not for current expenditures (Frydman et al., 1993, p. 27). Small-scale privatization proceeds are to be split three ways: the companies themselves receive 40 per cent; a State or municipal investment fund receives, 30 per

cent; and the remaining 30 per cent is allocated for foreign debt payment purposes (Frydman and others, 1993, p.31). In large-scale privatizations, 20 per cent of the shares of privatized State enterprises, as well as other contributions, are deposited in a mutual fund. The Council of Ministers may then allocate the fund's resources to capitalize the social security fund, finance free share distributions to Bulgarian citizens, compensate former owners, maintain an Agricultural Assistance and Development Fund and a State Fund for Reconstruction and Development, as well as other purposes (Frydman and others, 1993, p.30).

#### 4.15 Tax reform

In planned economies, taxes levied on SOEs constitute a major element of budgetary revenues. As the socialized economy became less and less able to bear the main tax burden, transitional economies were forced to start the process of tax restructuring. Despite the passage of almost five years, the results are very uneven across the CEE region (*Business Central Europe*, September 1994, pp. 68-69). The main criticisms fall into various categories, for example:

- a. The lengthiness of the tax reform process-in Bulgaria, for example, personal and corporate tax laws drafted in 1991 had still not been adopted three years later;
- b. Ambiguities and inconsistencies in the new tax laws with insufficient details about essential elements of the legislation;
- c. Paucity of explanatory information supplied to taxpayers, with the exception, however, of Hungary and Slovenia which keep taxpayers informed and allow them more latitude in meeting tax obligations;
- d. The self-assessment schemes generally adopted place too much burden for compliance on the taxpayers. On the other hand, certain loopholes exist such as the lack of requirement to register for tax purposes in Russia and Slovenia;
- e. Lack of flexibility in the periodicity of tax payments, particularly when earnings are seasonal or when taxpayers cannot collect from their customers, which is a region-wide phenomenon.

In short, the new tax laws should be clarified, and more recognition needs to be given to taxpayers' rights to confidentiality, certainty about tax obligations,

updated information, and an impartial and speedy appeals process.

The seriousness of the inadequacies of fiscal reform is mirrored in the fact that problems with the fiscal base and poor control over collections constituted two of the three main reasons for shortfalls in budgetary revenues (Deloitte, Touche, Tohmatsu, 1994, p.5), namely:

- a. The fiscal base was neither adequate nor well structured, mainly due to excessive reliance on taxation of the State sector as well as direct taxes in general;
- b. Poor fiscal control over tax evasion and non-payment of taxes generally; and
- c. The continuing recession-which depressed sales and taxable income-and consumer spending concentrated on lower-taxed necessities rather than on higher-taxed durable goods.

China, however, has been slow to act because the situation is aggravated by political considerations (*The Economist*, 18 March 1995, p. 16). The SOEs are still viewed as the main source of State budget revenues, even though many of them are not operating profitably, and the central Government will not consider large-scale privatization as a way of improving financial performance. It is, however, ready to sell smaller firms or restructure larger ones into joint stock companies in which employees could become shareholders, where there would be less potential for massive lay-offs and no subsistence incomes.

The pressure in the Russian Federation to restructure taxation—in particular corporate taxation and the excess wages tax—stems from two main concerns: the fact that investment is virtually at a halt and that there has been a 25 per cent decrease in industrial production (*Business Central Europe*, October 1994, p. 67). The new strategy being considered is to lower corporate tax rates and to step up tax collection efforts. The latter is an urgent problem because collections were 45 per cent below budget for the first half of 1994, which meant that expenditure plans were cut about one-third across the board.

The tax on excess wages originated in Hungary some 15 or more years ago and was designed to link pay raises with productivity increases. State enterprises were fined, in the form of an onerous tax, if the average pay increase exceeded a specified growth in productivity. This strategy was adopted by Hungary's neighbors and soon found favor as a new tax measure

with the productivity link abandoned. Under the Russian tax laws in effect at the end of 1994, companies have to pay a tax of 38 per cent on wages which exceed six times the minimum wage, whether or not they are earning profits. Although such a tax has anti-inflationary value, its effect is to discourage firms from trimming staff and employing a smaller but more highly-paid and efficient workforce because it would drive up the average pay rate. In Poland this tax was lifted from privatized enterprises and private firms, and the Czech Government is considering its removal as not being appropriate in an emerging market economy. It had been expected that the Russian Federation's new tax laws would remove the tax also; in the event, however, it has been raised under recent legislation to apply to wage increases higher than four times the national average wage, rather than six times as before.

The value added tax, now virtually universally adopted, has more than filled the gap in company income taxes, representing a very significant revenue source. Personal income tax is another phenomenon which increases the tax burden on the general public.

Coupled with developing new revenue sources is the problem of ensuring cash flows through accelerating the process of tax collection. All the transitional economies have a calendar fiscal reporting year, although Poland allows a taxpayer to choose a different fiscal period. Most countries require tax installments to be paid monthly in advance, or quarterly in certain cases, depending on the amount of the tax liability. Generally, estimates are based on the prior year's liability; in Bulgaria they are based on taxable profits in the prior quarter and in the Russian Federation on estimated current year's profits. Filing and final payment is usually required by 31 March of the following year. A system of personal withholding taxes, with frequent deposits of withheld taxes by the employer, is now a commonplace feature of transitional economies.

To combat the problem of chronic tax evasion, certain innovative measures had to be considered, including the experiences of other countries. In Mexico, for example, a tax of 1.8 per cent of the value of a firm's fixed assets is imposed on companies which do not report any taxable income for a specified number of years. Poland's approach has been to institute a prepayment tax based on gross sales. Companies have to file tax returns in order to claim any refunds of these prepayments.

#### 4.16 Planning budgetary expenditures

Budgetary-expenditure planning is as much a political as an economic and financial exercise under most circumstances. In the transitional economies, such as those which were previously republics of the former Soviet Union, public services that were previously the responsibility of the "All-Union" budget have to be provided for—such as national defence, police protection, and the foreign service apparatus. For those applying for foreign economic assistance, international organizations, such as the World Bank, impose budget deficit limitations which severely limit the room to manoeuvre. For others, such as the Russian Federation and China, inflation poses yet another threat target control.

China's inflation rate—currently about 27 per cent annually—threatens not only budget control but also continued economic growth. Out-of-control spending, mainly by large SOEs, is the main contributing factor. These enterprises, which account for over 50 per cent of industrial output and employ over 110 million workers, come under heavy pressure from the workforce to increase pay rates as prices rise. This, of course, increases the money supply which, by the third quarter of 1994, was 37 per cent higher than a year earlier. The fear of worker unrest is a basic problem hampering the central Government's attempts to bring inflation down; another is the fact that banks are controlled by local authorities. With some 45 per cent of the SOEs operating at a loss and over 3 million employees not being paid regularly, the banks will not be allowed to cut back the flow of enterprise credit until a comprehensive social security system is in place.

As Dean's model (Table 12) illustrates, the second evolutionary stage in governmental financial management systems is marked by clearer, better justified and more understandable budget presentations. Such an approach is greatly facilitated if some general framework is used to identify what objectives are being pursued in the proposed expenditure plans. In mature budgeting systems this is referred to as programme budgeting, a maturity level which none of the transitional economies has yet reached. State budgeting in Poland, however, takes place within the framework of an overall economic strategy, titled "Strategy for Poland" and authorized by the present Minister of Finance (*Rzeczpospolita*, 5 August 1994, p. 5). Expenditure estimates are not, however, grouped by programme as is evident from the following short

description of considerations that guide budget planning actions.

The Polish Government's budget strategies for 1995 were defined in its budget proposal to Parliament as: upholding economic growth tendencies, reducing the 1995 inflation rate to 16 per cent, and limiting bank financing of the State budget deficit. Heavy emphasis is placed on controlling budget outlays in view of the limited possibilities for raising budget revenues. Expenditure priorities in the longer term would include reforming the social security system, restructuring the health protection sector, reforming the central administration and limiting the so-called gray area of unreported economic activities. However, budget realities place significant limitations on such initiatives.

About one-half of the budget outlays leave little room for discretion. These include servicing the public debt, subsidizing the social security fund, settling with banks, and providing subsidies for local authorities as well as some agencies and funds. Additional costs are those of the President's chancellery, the Parliament, the Senate, the Supreme Court and the State Audit Service. Of the remaining 51 per cent of potential outlays, about 23 per cent was set aside for raising the salaries of government employees to help maintain their real value in the face of rising consumer prices and to try and deal with the widening gap between remuneration in the public and private sectors. This leaves about 28 per cent for investments, subsidies and other non-pay expenditures. Consequently, absolute limits have to be placed on total budget outlays although Ministers and province governors (*wojewody*) have some discretion over how the totals may be structured. Such discretion is subject to two limitations, however: (a) certain defined outlays cannot be changed without permission of the Minister of Finance; and (b) limitations set on pay, as calculated under obligatory methods, cannot be exceeded.

A further essential element in progressing to a higher evolutionary level of governmental financial management is logically structuring the budget itself.

#### 4.17 Budget restructuring

The organizational structures of budgets should be closely connected with those of governments and other administrative units. This is the case in Poland, where budgetary accounting and reporting is uniformly organized for all local authorities, budgetary units, bud-

getary enterprises/workshops and auxiliary entities. Uniformity consists of like organizations using the same charts of accounts, standardized budget classifications, and standardized accounting principles and reporting formats. Essentially, three main types of activities underlie budgetary accounting practice. Financial planning of budgetary receipts and expenditures, at the local level, is performed by the groups charged with their receipt and disbursement; these groups keep track of what was raised and what was spent, by comparison with financial plans, through budgetary accounting. Furthermore, the tax authorities are included in the budgetary accounting process in their role as collectors of both taxes and non-tax budgetary incomes. At the central level, budget planning and evaluation is consolidated in the Ministry of Finance which, like all other budget-supported units, uses budgetary accounting to record its financial activities.

The budget law of 5 January 1991 distinguished two types of budgets: State and local. Both types continue to organize revenues and expenditures into the traditional classifications: (a) Divisions, according to the basic areas of activity in the national economy; (b) Sections, according to defined groups of organizational units or types of budgetary tasks; and (c) Paragraphs, according to defined sources of budgetary revenues as well as types of budgetary outlays.

Four other sets of data appear in a separate division of budgetary classifications: (a) the excess of revenues over budgetary outlays; (b) the budget deficit; (c) inflows from the sale of obligations and State or local treasury bonds, shares and other securities; and (d) inflows and outflows from loan transactions.

However the budget document is formatted, there should be symmetry with the organization of budgetary accounting to facilitate comparisons between planned and actual amounts which will provide both feedback and predictive ability. This means that the economist planners should be involved in joint training sessions with budgetary accountants so that each can better appreciate how their respective functions should mesh and be of mutual assistance. It is only when the budgeting system has been overhauled to meet the new sets of requirements in transitional economies-with the participation of accounting information system designers-that choices can be made about the most appropriate budgetary accounting system design to adopt.

#### 4.18 Budgetary accounting reform

Countries undergoing major shifts in cultural values, such as those in transitional economies, have an array of alternative models to consider when redesigning their public sector budgeting and accounting systems. This is because governmental accounting has a richer, more varied evolutionary history and methodology than its private sector counterpart due to the fact that indigenous systems of accountability and control over the public purse tend to reflect more closely the citizenry's value systems. Design alternatives include underlying principles, bookkeeping techniques, coordination of the main financial management functions, organization of the system's elements, reporting systems and formats, and auditing arrangements and formalities. In making its choices, each country should be guided by its own sets of priorities and stage of political and economic development so as to avoid the anachronism syndrome (Dean, 1988b, p.164), that is, the adoption of reforms which are not consistent with the host country's evolutionary state and therefore do not best serve its needs.

Over the course of centuries, four budgeting and bookkeeping methodologies have evolved: cash, cameral, modified accrual, and accrual, with the latter rapidly gaining popularity around the world. For efficiency, long-term potential uses should be considered when making system choices. Design, installation and training are all costly; accordingly, the entire process should be carefully thought through. Dean's listing of the characteristics of more advanced evolutionary stages of government financial management (Table 11) provides useful guidelines.

Whichever type of bookkeeping and budgeting methodology is selected, a basic design feature would be to devise an account numbering system which would link these two functions together. Prior to German reunification, for example, both Germans used the cameral accounting and budgeting approach first developed by mercantile economists in the 17th and 18th centuries. This is a cash-based system which integrates budgeted revenues and expenditures with the accounting system through the use of the same identifying numbers for budget line items (Berry, 1987). The cameral system has certain accrual features because it provides for carry-forwards of prior and current years' unused budget receipts and outlays, and also accom-

modates multi-year budgeting.<sup>13</sup>

Cameral nomenclature is evident in the new Bulgarian chart of accounts—very similar in design to the French—which is integrated in the sense that it can be used for both private and public sector entities. Because of this dual purpose, accounting is on the accrual basis. Selected accounts are as follows (Republic of Bulgaria, 1992):

<b>Account No.</b>	<b>Account Title</b>
630	State budget expenses
641	Expenses of budget-financed enterprises
642	Expenses of non-budget-financed enterprises
741	State budget revenue
742	State budget revenue for distribution
743	Amounts carried over from prior period budgets
744	Extra-budgetary revenue

Poland, which has integrated its budgeting and accounting systems, on an accrual basis for over 40 years, has the potential to move its government financial management systems further along the evolutionary path because the basic structures in place are adaptable to modification. A short description of Polish budgetary accounting follows.

#### 4.19 Polish budgetary accounting

In Poland, the main objective of budgetary accounting is to supply numerical information, expressed in monetary terms, about how budgeted activities were carried out. This function is considered essential for budget analysis work, planning and control, and for other purposes connected with making decisions of an economic

<sup>13</sup>Refer to Berry (1987) for a comprehensive description of German cameral accounting techniques.

nature.

In order to facilitate comparisons between budgeted and actual revenues and expenditures, the Minister of Finance provided two charts of accounts in December 1991, listed in Table 13. One is to be used by local authorities, and the other by the budget units, budget entities, and auxiliary enterprises.

Budgetary accounting is governed by a number of regulations: first of all, it is covered by the decree of 5 January 1991, article 51, which established the budget law; accounting comes under the order of the Minister of Finance of 15 January 1991; charts of accounts are included in the Minister of Finance order of 30 December 1991; and budgetary reporting is covered in the Minister of Finance order of 14 January 1992 (Bakalarska, 1993, pp. 14-15). The following seven basic principles of budgetary accounting are specified (Bakalarska, 1993, p. 20):

- a. Economic transactions must be entered completely, systematically and chronologically in the reporting period to which they belong;
- b. Transactions must be recorded in accordance with their substance rather than the form in which they are presented;
- c. Switching categories of balance sheet or income statement items is not permitted;
- d. Data necessary to establish an entity's financial situation must be reported individually, whereas other times may be grouped;
- e. Assets and liabilities, as well as data influencing the financial result, must be valued at purchase price (transaction amounts) or production cost;
- f. Reserves are to be created, and revenues of future periods segregated, so as to ensure the reality of the financial result;
- g. Continuity of the entity's existence is assumed.

Accounting and reporting is uniformly organized for all local authorities: budget units, that is, those that are budget-dependent, budget entities that generate some revenues, and auxiliary enterprises which attempt to be self-sustaining. That is, like types of organizations use the same charts of accounts, standardized budget classifications, and standardized accounting procedures and reporting formats, in order to integrate the budgeting, accounting and reporting functions.

The procedures for ensuring that transactions are

accounted for in the same way as they are budgeted, and that the budget and actual comparisons are accurately reported constitute part of the defined duties of the Chief Accountant, laid down by the Council of Ministers' instructions of 2 May 1991. Basically, the Chief Accountant is responsible for checking the legality of documentation, making sure that transactions have budget authorization and do not exceed budgeted amounts, and preparing as well as analyzing budget reports. There are also six additional sets of duties. The first covers all aspects of the bookkeeping process-documentation flows, preservation and maintenance, protection of the entity's property, and general supervision of the accounting staff. The second covers various aspects of financial management, that is: making sure that disbursements are budget-authorized; ensuring that agreements entered into by the entity are financially sound; protecting monetary assets; ensuring timely collection of receivables; and investigating questionable claims. The third has to do with analyzing the uses of resources allocated from the budget, or other extra-budgetary resources at the entity's disposition. The fourth identifies certain activities carried out within the framework of internal control. The fifth has to do with directing the work of subordinate organizational units and their employees. The sixth entails preparing proposals for internal regulations issued by the management which have to do with the accounting function; in particular, this involves the organization's chart of accounts, the processing of accounting documents, and the principles of carrying out inventory-taking and making sure that all is accounted for. A system of signature verifications exists to show that the chief accountant has performed these duties.

Various penalties are provided for in case of failure to observe the budgetary regulations. These include reprimands as well as monetary penalties handed down by appointed investigative commissions. Depending on the seriousness of the infraction, a monetary penalty is usually calculated as a multiple of the average monthly salary in the socialized sector of the economy.

#### 4.20 Budgetary reporting

Budgetary reporting is covered by the Minister of Finance order of 14 January 1992 and its purpose is to supply user needs for analysis, planning, control and other economic decisions (Bakalarska, 1993, p.210). Essentially, the reporting system matches the organiza-

tional structure of the budget and reports consist of a series of official forms, 10 for local governments and 12 for the State. The reporting frequency depends on the type of information furnished. Monthly reports are provided on budget receipts and outlays, identifying budget classifications by division, section, paragraph and line item, and comparing annual planned amounts with actual year-to-date figures. Semi-annual and annual reporting forms concerning revenues and outlays are organized in the same fashion but have columns showing amounts in excess of, or under, budget.

Each reporting entity forwards its reports to the next higher supervisory authority so that an entire package eventually arrives at the Ministry of Finance, with copies provided to the State Audit Authority (NIK). Local authorities file annual reports on their budget performance directly with the Ministry of Finance, listing account balances at the beginning and end of the year, as well as off-balance sheet data.

The process of streamlining budgetary accounting, and improving the quality and timeliness of budgetary reporting owes much to the widespread computerization of government which has accelerated in the CEE region over the past five years.

#### 4.21 Computerization

Both central and local governments in the CEE region have been significant purchasers of computer hardware and software since 1990. By the end of this decade, the Polish government alone expects to have invested about 1 billion dollars on computer solutions (*Business Central Europe*, October 1993, p. 36).

Two of the main user needs relate to improving tax collection and updating the Central Statistical Offices. In efforts to identify the tax base and increase collection, Poland's Ministry of Finance, for example, ordered the Poltax system with application estimates ranging between 80 million and 200 million dollars; the Czech and Slovak Governments invested 13.5 million Deutschmarks in a large number of networked RS/6000 Unix workstations, while, by 1993, the Hungarian Government was considering bids for a system budgeted at 29 million dollars. To modernize statistics gathering and processing centrally, Hungary has laid out 9.5 million ECUs, Romania 3 million ECUs, and Poland 10 million ECUs.

In other applications, the Czech Republic invested in a

15 million dollar system for its State Health Insurance Company, and Poland 14 million dollars for the Forestry Administration. More generally, a huge demand is growing across the region for investment in the computerization of social security administrations as well as geographical information systems and land registries so as to introduce comprehensive and rational property tax assessments and other benefits for the growing real estate markets.

Computerization has not proceeded smoothly, however, with serious problems emerging from public sector contracts having to do with lack of sophisticated buyers, lack of established buying procedures, and difficulties in applying standards guidelines. Experience in Poland and the Czech Republic showed that there were unrealistic expectations on the part of the buyers and insufficient experience in systems integration on the part of the suppliers. As a result, both the Polish and Czech tax administrations ran into significant installation problems and delays. Lack of established procurement procedures meant that purchaser requirements were not well defined and opportunities existed for conflicts of interest. Some countries, recognizing the urgent need to control calls on the public purse, have instituted new government procurement regulations in the recent past. However, there has probably been much waste of effort and money as governments have scrambled to acquire new technologies without clear ideas on what was needed. In cases where computerization funding came from World Bank loans or the European Union's PHARE program, the potential for misuse of funds was considered in the stringent procurement guidelines that are applied. Otherwise, where governments—such as the Czech Republic's—favor open systems, application of standards guidelines has been very difficult to achieve, pointing up the need to forge understanding and acceptance of responsibility and accountability among government officials.

#### 4.22 Fiscal auditing<sup>14</sup>

The practice of fiscal auditing reflects some of the inadequacies of new tax legislation referred to earlier. That is, the tax laws are open to various and

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<sup>14</sup>This subsection relies on Deloitte Touche Tohmatsu International (1994), pp. 7-17, and *Business Central Europe*, September 1994, pp. 68-69.



conflicting interpretations, the taxpayer is often uninformed, and the appeals system may be so vague or protracted that some may find it more convenient to attempt on-the-spot negotiations. Under such conditions, there is potential for over-exertion of authority by the fiscal auditors, particularly where, in some jurisdictions such as Slovakia and Russia, fines collected are redistributed among the tax inspectors.

In most countries throughout the world, the audit powers of the fiscal administration are broad, and this is so in the case of eight countries in the CEE region, listed in Table 14. Old ways of doing things are reflected in the general lack of provisions for advance taxpayer notification, except for Hungary and Slovenia, and the power, generally, to enter and search taxpayers' homes, which was a feature of the previous political system.

The taxpayer selection basis is an important consideration when a main audit objective is to maximize tax collections. This result is more likely to be achieved if taxpayers with a high probability of yielding significant audit results are targeted for an in-depth review rather than trying a broad brush approach over a wide field.

Fines and penalties, detailed in Table 15, tend to be severe and may, as in Bulgaria, be levied against company officers and the accountants rather than the company itself. The way that fines and penalties are assessed and calculated may be perceived as inequitable or somewhat illogical. Generally, there is concentration on form over substance regarding tax law violations. In Russia, for example, tax evasion activities of a fraudulent nature, such as overstating the size of the workforce in order to evade the excess earnings tax—which can be accommodated somehow within the confines of the tax laws—may escape heavier penalties levied on unwitting mistakes in recording transactions. Further, the calculation of the penalty is based on the value of the underlying transaction involved rather than on the avoided tax amount. While fear of retribution may constitute a strong motivation for accurate and timely tax liability reporting, a sense of fair play needs to permeate the institutional arrangements. In Poland, the function of ombudsman—similar to the Swedish model—was established a number of years ago to review and process citizens' complaints about officialdom, and its State audit service (NIK) is authorized to carry out appropriate reviews. Those who investigate taxpayer complaints would be useful members of trainee teams

involved in improving the fiscal auditing process. Because each transitioning country has its own value systems, local trainers should be the ones to provide guidance about optimizing auditor/taxpayer relations during the conduct of fiscal reviews.

#### 4.23 Government auditing

The accountability concept, that is, the obligation of officials and employees who manage public programmes to render an account of their activities to the public, has been an inherent feature of governing processes throughout much of recorded history (GAO, 1994, p.8). Indeed, in some advanced societies—such as Germany—governments are still required to be officially discharged by Parliament after the accounts have been audited by the State audit service (Berry, 1987). In the United States, the General Accounting Office (GAO), in defining what the accountability concept entails, also outlined the underlying objectives of State auditing (GAO, 1994, p. 8.):

“The need for accountability has caused a demand for more information about government programmes and services. Public officials, legislators, and citizens want and need to know whether government funds are handled properly and in compliance with laws and regulations. They also want and need to know whether government organizations, programmes, and services are achieving their purposes and whether these organizations, programmes, and services are operating economically and efficiently.”

This definition goes beyond the typical State audit procedures followed in the transitioning economies of assuring that the auditee's financial reports are fairly stated in compliance with applicable laws and regulations. It adds two additional objectives to the GAO's audit process, known as comprehensive auditing: determining that the entity is managing or utilizing its resources in an economical and efficient manner and promptly reporting instances of inefficiency or dis-economy; and determining whether the desired results or benefits of the governmental programme are being achieved, or whether the programme is effective. Throughout the community of governmental auditors, the concept of comprehensive auditing is becoming more and more universal.

For government auditors not trained in concepts of

external accountability, the notion that the main objective of government accounting and auditing is to aid government's main management functions, i.e. decision making, planning, and control (Most, 1991, p. 240), may take time and training to root. To some extent then, government accountants and auditors should be involved in public expenditure decisions and their evaluation after the fact. According to the Plowden Group in the United Kingdom, these decisions include (Most, 1991, 240):

- a. to determine what the country can afford over a period of years, and what part is properly the concern of government;
- b. to decide the relative importance of one kind of expenditure over another, and how each should be financed; and
- c. to introduce the greatest possible degree of stability into the incidence of government revenues and expenditures.

While some of these decisions, particularly the last, may be outside the province of the accountants and auditors, part of the auditor's responsibility would be to comment on them as a part of an after-the-fact audit report so as to provide some input to guide future plans.

Comprehensive auditing requires special training because it is a combination of a financial audit, a compliance audit and an operational audit. It is in the latter area that the closest correlation may be found to evaluating public expenditure decisions. This is because operational auditing examines the effectiveness of programmes, such as providing job skills to the unemployed, or responding quickly and efficiently to burglar or fire alarms, in both nonmonetary terms of whether desired results are being achieved, as well as in monetary terms of getting value for money. This special training is often allied to systems design and analysis as part of a series of general management courses. Often, examining the books and records may constitute a very small part of a public programme audit engagement. Consequently the government auditor has to develop new ways of analyzing and new audit tools. Much of this type of training is conducted by the State audit services of a number of countries including the GAO in Washington, DC and members of the European Union, among others.

Finding, training and retaining professional staff has long been a perennial problem in developing countries,

and the transitional economies are no exception. Because accountants and auditors should form the core group in government financial management (Gujurathy and Dean, 1993, p. 188), this is a particularly vexing problem: particularly, as in the case of transitioning economies, when the accounting and auditing functions do not enjoy high esteem.

As Gujurathy and Dean (1993) found, drastic salary differentials between the public and private sectors constitute one of the major reasons for the acute shortage of good staff. Others reasons include: poor working conditions, lack of appreciation for audit efforts by the government officials receiving reports and perceived limitations for career advancement. Attracting and training staff is a lengthy and costly process, but retaining staff can be even more challenging. For some, government service is viewed as a training exercise which provides a candidate with a good background for advancement in the corporate world. In countries where superior candidates are rare, disincentives to leave employment early, such as contracts, do not usually represent viable options. Under such conditions there may be no ready solutions except to subcontract services which do not involve confidentiality, or could otherwise be entrusted to certified public accountants—an approach taken in some countries, such as the United States. The situation could be expected to stabilize, gradually, as working conditions in the public sector start to gain the ascendancy over those in the private sector.

#### 4.24 Training in the role and practice of governance

The governments of transitioning economies have benefitted from an outpouring of assistance from many quarters in redefining the role and practice of governance. From the standpoint of financial management in government, considerable funding has been and still is made available, through such facilities as training centres, universities, lecture programmes and on-the-job training in host government departments. These efforts have been facilitated by the links which exist between various governmental organizations such as Voivodship Assemblies of Local Authorities, the National Assembly of Local Authorities, the Association of Polish Cities and the Union of Small Towns in Poland. Economies of scale can be achieved in joint training sessions with the added benefit of the sharing of experiences between participants.

The Polish Foundation in Support of Local Democracy, established in 1989, provides one example of an integrated system of training aimed at improving the general level of government. As a not-for-profit foundation, sponsored by such international groups as the United States' Agency for International Development (AID) and the European Union's PHARE, it has, with the assistance of universities and foreign local governments, among others, provided a variety of training facilities to literally thousands of local government employees and politicians in its brief history.

Professional accounting bodies, particularly those from member countries of the European Union, have also been very active in financial management training which has not been restricted to government employees. Private sector accountants from transitional economies, for example, have had the opportunity to participate in public sector audits overseas as part of temporary, on-the-job training exercises. One of the most valuable aspects of this approach has been the hands-on learning it provides in a real-world setting. This same appreciation has been expressed for the training provided by the GAO in Washington, DC as well as other State audit services elsewhere in the world. Training in ethical issues in government, which is an essential element of accountability, should be a domestic concern because it is culture-specific and, therefore, values-dependent.

#### 4.25 Future directions

Budgeting strategies are still generally dominated by emergency thinking in the CEE region, thus hampering continued improvement of financial management in government proper. This means that certain political, social and economic conditions—particularly inflation control and social safety net provisions—have to stabilize before refinement of budgeting techniques to diversify revenues, control expenditures, and adopt a programme approach, can start to fall into place.

Most of the structured efforts have been in the area of revenue diversification with the most success credited to the introduction of value-added tax. This is because VAT does not require identification and pursuit of the taxpayer, implementation is fast, and ease and speed of collection is more or less assured depending on the reliability of the tax base. It has, however, been blamed for adverse economic effects, particularly with respect to goods and services with higher VAT rates. Fiscal

reforms, on the other hand, have generally been criticized for their ambiguous and punitive aspects which work against increasing tax collections, as do the activities of some tax administrations.

Controlling expenditures, on the other hand, has received less analytic attention because across-the-board cuts avoid the need for reasoned and painful decisions, particularly political ones. Until more analysis is given to the structure of expenditures, introduction of a programme concept will have to wait.

The financial management aspects of central/local government relations find expression in the assignments of resources and responsibilities and the revenue-sharing arrangements that support them. Generally, transitional governments in the CEE region have perceived political decentralization as having a major financial advantage; that is, an opportunity to shift public service burdens and financing from the central to the local level. Leaving local authorities to fend for themselves financially, without start-up beginning funds, while at the same time assuming responsibility for such major outlays as public education, had the side benefit of speeding the privatization of locally-owned small enterprises and stores. This ground-up approach is, of course, the basis of a market economy; however, it did not necessarily lead to loss of central control, that is, putting real economic power in the hands of the local populations. In Lithuania, for example, local councils are freely elected and set their own budgets. However, the central government has the power to remove elected officials if it disapproves of their policies. Similar tensions over revenue-sharing exist in China.

Government accounting, a major service in government proper, cannot achieve greater potential until the planning and budgeting-function problems are resolved and a programme concept adopted. Although accounting has been included in training programmes for government, there has been too much attention to descriptions of government accounting in other countries rather than help in planning indigenous systems. The existing integrated system in Poland, for example, is very similar to the previous one even in the definition of government accounting objectives. To help remedy the situation, government planners and accountants in government proper should have some joint training sessions in system design and use in order to develop a wider appreciation of their respective functions and how they complement each other. As is true elsewhere in the world—particularly

in developing countries— developing qualified staff is a major problem for the traditional reasons of low pay, low status, and the perception of limited potential for advancement. This situation should gradually change as the financial management function itself matures.

The government audit service suffers from the same staffing problems as the accounting and financial service and there are general complaints about understaffing. As the concept of external accountability takes hold, the role of the State audit service should become more pronounced, offering an attractive career. The training programmes offered by various State audit services—notably the GAO in the United States—should be very beneficial in fostering professionalism among the trainees. They can then act as advocates for advancing the interests both of their own organizations and governmental activities in general.

The widespread availability and use of computers in government has had many beneficial effects, particularly in the area of tax administration. So, computerization financing has been one of the more beneficial of the many investment opportunities offered to transitional governments by various international organizations. Where considerable efforts have yet to be attempted, however, lies outside the world of electronic technology. That is in the area of building bridges between the governing and the governed—particularly with respect to ethics, including conflicts of interest and accountability. Various opinion polls show that, generally, public trust in governments in the CEE region is low, suggesting that emphasis on external accountability should be foremost when considering the priorities to be given financial management issues in government.

## 5. Summary and conclusions

As experience all across the CEE region has shown, one of the principal deterrents to development and growth in the transitional economies is the general lack of financial liquidity. Until the banking sector becomes more efficient in opening up the existing bottlenecks to permit the free flow of funds, business will grow, but slowly, from its stagnating state. The economies where loan capital is made available at a reasonable price, and in Poland's "windows" programme, are those which show greater promise in reaching a more advanced stage of market transformation. The other significant lesson drawn

from the banking sector is the improved performance which results from hands-on learning on the job where the trainers understand the local business climate and work alongside the trainees to demonstrate by doing with learning by imitation. The banker's current use of financial information in the credit-granting approval process may well be one of the most important ways that an understanding of and appreciation for accounting-based financial information may be diffused throughout the host environment.

At the enterprise level, private businesses are, as might be expected, more familiar with the uses of accounting data, particularly in the larger firms. At the grass roots, however, accounts are likely to be very rudimentary in nature and on a cash basis. The sole owner-entrepreneur, as in most places in the world, has a good grasp of his or her affairs and tends to operate more or less by instinct. One of the hardest concepts to explain to those small businesses applying for loans is the nature of the term "equity", mainly because they have never seen a balance sheet and cannot guess its purpose.

Certain alternatives to larger-scale investment—such as leasing—and obtaining funds through borrowing on receivables, or selling them, are now becoming more available, particularly in the Czech Republic. However, the fact that the VAT, and other regulations, virtually destroyed the leasing momentum in Poland, points to the necessity for government officials to take a longer and wider view of the adverse economic effects of certain revenue-raising initiatives.

The beneficial effects of accounting on the development of stock markets is still in the future. For newly emerging democracies, the stock market resembles a lottery or game of chance where investors are only interested in short-term capital gains and follow each other like lemmings to purchase what are touted to be good buys. Virtually the only financial indicator that the general public is aware of is the price-earnings ratio; and it is that ratio that is featured prominently in prospectuses and other offers to buy securities. The heavy requirements of the Warsaw Stock Exchange concerning accounting disclosure were borrowed from the large markets in London and New York. Their use in nascent securities markets, although necessary for consumer protection, has proved of little value otherwise.

In the professional auditing field, certain countries—such as the Czech Republic, Poland, Hungary and, to some extent, China—have put new

institutional arrangements into place. However, audit quality has been severely criticized within the Polish accounting community. Thus, much remains to be done with respect to auditor training and raising public awareness of the value of the auditor's review and report. This will evidently be a long-term exercise.

As for government, some advances have been made in restructuring the budgeting, accounting, and auditing functions but, once again, much more remains to be done. As in the private sector, government auditors need to be completely retrained in the comprehensive audit and programme approach. It goes without saying, that the non-finance government officials still have very limited understanding of government financial management. Consequently, cross-training

programmes need to be put in place where closer associations develop between the different functions in government so that each enriches the other.

Considering the relatively short space of time which has elapsed, one could claim that significant progress has been made, even though it may not be too apparent. It must be kept in mind, that all these activities have been taking place against a backdrop of, at times, considerable chaos. For all the participants, it has required tremendous effort to understand what a market economy is all about and to select the best possible approaches under the circumstances.

## TABLES

**TABLE 1. SOME ESSENTIAL DIFFERENCES BETWEEN INSTITUTIONAL ARRANGEMENTS  
IN PLANNED VERSUS MARKET ECONOMIES**

<b>INSTITUTIONAL FEATURES</b>	<b>PLANNED ECONOMIES</b>	<b>MARKET ECONOMIES</b>
Integration of economic activities	State economic planning	Market mechanism
Resource allocations and investment decisions	Political considerations	Economic considerations
Dimensions of industrial	Technical	Commercial and technical
Main enterprise objective	Output expansion	Profit maximization
Price determination	Centrally controlled	Economic considerations
Principal (basic) means of production	Socially owned	Privately owned

SOURCE: Derek T Bailey, ed. (1988). *Accounting in Socialist Countries*. London, Routledge, pp. 2-8.

TABLE 2. COMPARATIVE CHARTS OF ACCOUNTS FOR BANKS

Western European Standardized			
Group	Chart of Accounts <sup>b</sup>	Group	Poland-BPK 93 <sup>a</sup>
0	Vacant	0	Fixed assets
10	Cash and bank accounts	1	Operations with monetary asset and with financial entities
15	Time-limited investments/deposits		
20	Credits/loans	2	Operations with non-financial entities
30	Investments (in trade turnover)	3	Operations with budgetary entities
35	Investments (own domestic shares-non-trade)		
40	Fixed assets	4	Securities
50	Other clearings	5	Various operations
60	Capital and own resources	6	own and assimilated resources
65	Profit and loss accounts		
70	Bank accounts and investments	7	Cost accounts
75	Clients' accounts and investments		
78	Credits received		
79	Accruals		

80	Other clearings	8	Income accounts
90	Off-balance sheet accounts	9	Off-balance sheet obligations granted and received

SOURCES: Alicja Jarugowa et al and others, 1994. *Rachunkowość Banków Komercyjnych*. Warsaw, Centrum Edukacji I Rozwoju Biznesu, (a) pp. 176-189, (b) pp. 190-192.



**TABLE 3. MAIN CHART OF ACCOUNTS SECTIONS AND OFF-BALANCE SHEET ACCOUNTS FOR THE RUSSIAN FEDERATION COMMERCIAL BANKS**

<b>Chart of Accounts Section Number*</b>	<b>Chart of Accounts Section Title</b>
I	Bank Funds
III	Monetary Resources
V	Foreign Transactions
VI	Budget-Sponsored Institutions
VII	Investment Finance
IX	Securities
X	Credit and Clearing Transactions
XIII	Public Organizations
XIV	Citizens' Savings, Deposits and Bank Accounts
XVI	Long-Term Investments
XVII	Other Long-Term Investments
XVIII	Settlements with Banks and Other Outside Resources
XIX	Centralized Accounts for Pension Settlements
XX	Interdivisional Clearing
XXI	Debtors and Creditors
XXII	Bank Fixed Assets and Operational Expenses
XXIII	Diverted Resources
XXIV	Bank Revenues and Expenses
<b>Section Number*</b>	<b>Off-Balance Sheet Accounts Section Title</b>
II	Collaterals
III	Leasing Transactions
IV	Clearing Documents

V	Documents and Values Covering Foreign Transactions
VI	Long-Term Crediting Documents
VII	Sundry Values and Documents
IX	Debts Written Off as a Loss
X	Securities

\*Sections applicable only to central banks omitted.

SOURCE: A. Androsov and A. Golubovich, (1993). *Financial Reporting and Accounting in Russia*. Moscow, ARGO Financial Services, pp. 117-185

TABLE 4. EXAMPLE OF COMMERCIAL BANK BALANCE SHEET IN THE RUSSIAN FEDERATION

BALANCE OF ACCOUNT (thousand roubles)			
Account		Assets	Liabilities
Number	Name of Account		
1	2	3	4
010	Authorized Fund .....		555886
011	Reserve Fund .....		92448
012	Special Funds .....		230
016	Economic Incentives Funds .....		894
31	Cash .....	5030	
050	Precious Metals .....	71	
060	Foreign Currencies in Cash .....	391	
070	Current Accounts in Foreign Currencies .....		9452
072	Accounts with Foreign Banks .....	11356	
073	Accounts of Foreign Banks, Companies .....		4
075	Deposits in Foreign Banks .....	15042	
076	Other Foreign Transactions .....	6804	20609
78	Creditors (Letter of Credit—Foreign Operations .....		7238
161	Correspondence Account in the State Bank .....	371168	
191	Investments in Shares of Joint-Stock Companies .....	103335	
199	Marketable Liabilities .....		12939
345	Clearing Account of State Enterprises and Organizations .....		434700
355	Loan Account of State Enterprises and Organizations .....	962417	
417	Loan Account of Collective Fisheries .....	1500	
461	Clearing Account of Co-Operatives Producing Consumer .....		3081
465	Goods Clearing Account of Youth Technical Development Centres .....		716
466	(NTTM) .....		52
467	Clearing Account Alliances of Co-Operatives		

	Joint-Stock and Limited-Liability Companies—Clearing . . . . .	579519
468	Accounts	
	Small Companies Arranged by Individual Persons—Clearing . . . . .	35982
471	Accounts	
	Loan Accounts of Co-Operatives Producing Consumption . .	95107
475	Goods	
	Loan Accounts of Youth Technical Development Centres . . . .	430

continued

continued

477	(NTTM) .....	1042349
478	Joint-Stock and Limited-Liability Companies—Loan Accounts Small Companies Arranged by Individual Persons—Loan .....	39468
603	Accounts .....	447
619	Current Account of Foreign Companies .....	4667
620	Loan Accounts of Other Enterprises .....	5998
644	Overdue Debts .....	541
652	Current Account of Individual Enterprises .....	6224
654	Loan Accounts for Joint and Individual Leasing Contracts ....	200
695	Loan Accounts for Individual Enterprises .....	108
700	Current Accounts of Trade Unions .....	26868
711	Current Accounts of Public Organizations .....	95
712	Savings of Citizens .....	360
713	Credits Granted to Citizens Involved in Individual Labour .....	365180
714	Holdings and Deposits of State Enterprises .....	330
715	Holdings and Deposits of Co-Operatives .....	38
716	Current Accounts of Citizens Involved in Individual Labour ..	744
720	Loans to Individual Persons .....	685
722	Letters of Credit .....	52747
822	Limited Check-Books .....	120500
823	Loans Granted to Other Banks	
824	Loans Received from Other Banks Resources Available on Reserve Account in the USSR State .....	239693

825	Bank		
	Resources Transferred to Enterprises, Participation		
	In Their Economic Activities . . . . .	2504	
890	Settlements Between Branches of the Bank . . . . .	5397	5397
904	Other Debtors and Creditors . . . . .	92589	170367
940	Operational Materials . . . . .	3	
941	Anticipated Expenses . . . . .	3	
942	Low-Value and Quick-Depreciation Items . . . . .	3	
950	Resources Diverted out of Profit . . . . .	153160	
980	Profit and Losses . . . . .		153160
	<b>TOTAL . . . . .</b>	<b>3286651 . . . . .</b>	<b>3286651</b>

continued

TABLE 4. EXAMPLE OF COMMERCIAL BANK BALANCE SHEET IN THE RUSSIAN FEDERATION  
(continued)

<b>OFF-BALANCE SHEET ACCOUNTS (roubles)</b>		
<b>Account Number</b>	<b>Name of Account</b>	<b>Amounts</b>
9921	Liabilities under Short-Term Loans (1) .....	1158337763-00
99211	Liabilities under Short-Term Loans (2) .....	208600-00
9925	Warranties, Securities Issued by Bank .....	122500000-00
9945	Part of Authorized Fund Unpaid by Bank Shareholders .....	43413710-58
9959	Strict-Reporting Forms .....	584599969-40
9960	Sundry Values and Documents (Shares, Bonds) .....	135804950-00
9961	Sundry Values and Documents Handed out on Accountability Terms .....	5880000-00
99731	Forms of Shares, Bonds, Savings Certificates of Commercial Banks Intended for Release (1) .....	56890300-00
99732	Forms of Shares, Bonds, Savings Certificates of Commercial Banks Intended for Release (2) .....	8603000-00
9983	Received Permits to Issue Shares .....	990000000-00
<b>TRANSITION TO A WESTERN SYSTEM OF PRESENTING BALANCE SHEET</b>		
<b>Assets</b>		<b>Liabilities</b>
Cash 5421 .....	Due from banks	
Due from Banks		Total .....
Total	518066	756804
		Sight
		4

Sight .....	397566	Time .....	765800
Time .....	120500	Clients' Deposits	
Advances and Loans .....	2159464	Total .....	1509856
Overdue Depts .....	120500	Sight .....	1144350
Securities .....	103335	Time .....	365510
Long-term Holding .....	2504	Other Creditors .....	203757
Reserve Deposit at		Other Liabilities .....	13624
The State Bank .....	239693	Share Capital .....	555886
Other Debtors .....	104928	8 Reserve & Special Funds ...	93564
Other Assets .....	153240	Profit & Loss Account .....	153160
<b>Total .....</b>	<b>3286651</b>	<b>Total .....</b>	<b>3286651</b>

SOURCE: A. Androsov and A. Golubovich (1993). *Financial Reporting and Accounting in Russia*. Moscow, ARGO Financial Services, pp. 203-205.



**TABLE 5. BALANCE SHEET FORMAT FOR POLISH COMMERCIAL BANKS**

ASSETS	LIABILITIES
<p><b>I. Monetary resources and financial subjects:</b></p> <ol style="list-style-type: none"> <li>1. Cash</li> <li>2. Central Bank</li> <li>3. International financial organizations</li> <li>4. Bank foreign departments and branches</li> <li>5. Operations with participation by banks and other financial subjects</li> <li>6. Operations with foreign exchange offices</li> <li>7. Operations with post office institutions</li> </ol> <p><b>II. Non-financial subjects</b></p> <ol style="list-style-type: none"> <li>8. Credits for basic non-financial subjects</li> <li>9. Credits for private persons</li> <li>10. Credits for other subjects</li> </ol> <p><b>III. Budgetary and nonbudgetary units:</b></p> <ol style="list-style-type: none"> <li>11. Credits for the State Budget</li> <li>12. Credits for community budgets</li> <li>13. Operations with nonbudgetary administrations and funds</li> <li>14. Operations with community funds</li> </ol> <p><b>IV. Securities</b> (transferable, nontransferable, constituting guarantees)</p> <p><b>V. Various operations</b></p> <ol style="list-style-type: none"> <li>15. Cashing and receivables collections accounts</li> <li>16. Temporary accounts</li> <li>17. Regulating accounts (interperiod clearings)</li> <li>18. Various debtors</li> </ol>	<p><b>I. Financial resources and deposits of financial subjects:</b></p> <ol style="list-style-type: none"> <li>1. Bank issued travelers checks and notes</li> <li>2. Central Bank</li> <li>3. International finance organizations (debts)</li> <li>4. Departments and branches</li> <li>5. Operations with participation by banks</li> <li>6. Operations with participation by foreign exchange offices</li> <li>7. Operations with post office institutions</li> </ol> <p><b>II. Deposits of nonfinancial subjects</b></p> <ol style="list-style-type: none"> <li>8. Deposits of basic nonfinancial subjects</li> <li>9. Deposits of private persons</li> <li>10. Deposits of other subjects</li> <li>11. Special purpose funds</li> </ol> <p><b>III. Deposits of budgetary and nonbudgetary units</b></p> <ol style="list-style-type: none"> <li>12. State budget</li> <li>13. Community budgets</li> <li>14. Operations with nonbudgetary administrations and funds</li> <li>15. Operations with community funds</li> </ol> <p><b>V. Bank issued securities</b></p> <p><b>VI. Various operations</b></p> <ol style="list-style-type: none"> <li>16. Internal clearing accounts</li> <li>17. Inter-bank clearing accounts</li> <li>18. Income of future periods</li> </ol>

SOURCE: Alicja Jarugowa and others (1994). *Rachunkowość Banków Komercyjnych*. Warsaw, Centrum Edukacji i Rozwoju Biznesu, pp. 108-109.

TABLE 6. INCOME STATEMENT FORMAT FOR POLISH COMMERCIAL BANKS

COSTS	REVENUES
<p><b>A. Costs of operations with financial subjects:</b></p> <p>Interest</p> <ul style="list-style-type: none"> <li>from operations with the National Bank</li> <li>from operations with international organizations</li> <li>from operations with other financial subjects</li> </ul> <p>Provisions</p> <p><b>Costs of operations with clients:</b></p> <p>Interest</p> <ul style="list-style-type: none"> <li>from operations with enterprises</li> <li>from operations with private persons</li> <li>from operations with other nonfinancial subjects</li> </ul> <p>Interest on deposits</p> <p>Provisions and other costs</p> <p><b>Costs of operations with budgetary and non-budgetary units:</b></p> <ul style="list-style-type: none"> <li>Costs of operations with the State budget</li> <li>Costs of operations with community budgets</li> <li>Costs of operations with nonbudgetary units</li> <li>Costs of operations with securities:</li> <ul style="list-style-type: none"> <li>Other operating costs</li> </ul> </ul>	<p><b>A. Revenues from operations with financial subjects</b></p> <p>Interest</p> <ul style="list-style-type: none"> <li>from operations with the National Bank</li> <li>from operations with international organizations</li> <li>from operations with other financial subjects</li> </ul> <p>Provisions</p> <p><b>Revenues from operations with clients:</b></p> <p>Interest</p> <ul style="list-style-type: none"> <li>from operations with enterprises</li> <li>from operations with private persons</li> <li>from operations with other nonfinancial subjects</li> </ul> <p>Provisions</p> <p><b>Revenues from operations with budgetary and nonbudgetary units:</b></p> <ul style="list-style-type: none"> <li>Revenues from operations with the State budget</li> <li>Revenues from operations with community budgets</li> <li>Revenues from operations with nonbudgetary units</li> <li>Revenues from Operations with Securities on Bank's Own Account</li> <li>Other operating revenues</li> </ul>
<b>B. NET BANK PROFIT</b>	<b>B. NET BANK LOSS</b>
<p><b>C. General costs:</b></p> <ul style="list-style-type: none"> <li>Personal outlays</li> <li>Operating costs</li> <li>Costs of non-operating activities</li> <li>Taxes and fees</li> </ul>	<b>C. Collateral revenues</b>

**continued**

continued

<b>COSTS</b>	<b>REVENUES</b>
<b>D. GROSS OPERATING PROFIT</b>	<b>D. GROSS OPERATING LOSS</b>
<b>E. Write-offs for amortization and provisions:</b> Write-offs for amortization Provisions for receivables from financial subjects for unpaid receivables for difficult receivables for doubtful and litigious receivables Provisions for receivables from non-financial subjects: for unpaid receivables for difficult receivables for doubtful and litigious receivables Write-downs for financial depreciation of securities Write-offs to funds	<b>E. Resolutions of provisions:</b> Resolutions of provisions for receivables from financial subjects: for unpaid receivables for difficult receivables for doubtful and litigious receivables Resolutions of provisions for receivables from nonfinancial subjects: for unpaid receivables for difficult receivables for doubtful and litigious receivables Resolutions of provisions for the financial depreciation of securities Provisions of reserves for funds
<b>F. NET OPERATING PROFIT</b>	<b>F. NET OPERATING LOSS</b>
<b>G. Extraordinary costs:</b> Bad debts written off Decrease in securities' values in connection with waiver of other extraordinary costs	<b>G. Extraordinary revenues</b> Increases in securities' values in connection with waiver of other extraordinary revenues
<b>H. GROSS PROFIT</b>	<b>H. GROSS LOSS</b>
<b>I. Profit taxes</b>	
<b>J. NET LOSS</b>	<b>J. NET PROFIT</b>

SOURCE: Alicja Jarugowa and others (1994). *Rachunkowość Banków Komercyjnych*. Warsaw, Centrum Edukacji i Rozwoju Biznesu, pp. 102-103.

TABLE 7. LISTING OF OFF-BALANCE SHEET ACCOUNTS FOR POLISH COMMERCIAL BANKS

	Domestic Currency		Foreign Currency	
	Resident	Non-resident	Resident	Non-resident
<p><b>I. 1. OBLIGATIONS TO FINANCIAL SUBJECTS</b></p> <p>2. OBLIGATIONS FURNISHED FINANCIAL SUBJECTS</p> <p>3. Short-term lines of credit</p> <p>4. Guaranteed documental credits</p> <p>5. Credits incumbent on other institutions</p> <p>6. Guaranteed checks</p> <p>7. Other obligations</p> <p>8. OBLIGATIONS RECEIVED FROM FINANCIAL SUBJECTS</p> <p>9. Short-term lines of credit</p> <p>10. Guaranteed documental credits</p> <p>11. Credits guaranteed by other institutions</p> <p>12. Other obligations</p> <p><b>II. 13. OBLIGATIONS FURNISHED NONFINANCIAL SUBJECTS</b></p> <p>14. Open guaranteed credits</p> <p>15. Open documental credits - export</p> <p>16. Open documental credits - import</p> <p>17. Receipt for payment</p> <p>18. Other obligations</p> <p><b>III. 19. BUDGET-RELATED OBLIGATIONS</b></p> <p>20. OBLIGATIONS FURNISHED</p> <p>21. OBLIGATIONS RECEIVED</p> <p>22. Credits for housing construction guaranteed by the State budget</p> <p>23. Budget-guaranteed central investments</p> <p>24. Other State-budget guarantees</p> <p><b>IV. 25. FOREIGN CURRENCY OPERATIONS</b></p> <p>26. CASH-EXCHANGE OPERATIONS</p> <p>27. Purchased domestic currency to be received</p> <p>28. Purchased or borrowed foreign currency to be received</p> <p>29. Sold domestic currency to be disbursed</p> <p>30. Sold or loaned foreign currency to be disbursed</p> <p><b>V. 31. SECURITIES OPERATIONS</b></p> <p>32. Securities to be received</p> <p>33. Securities to be disbursed</p> <p>34. Receipt for issuance</p> <p><b>VI. 35. TECHNICAL ACCOUNTS</b></p> <p>36. Exchange items (foreign currency accounts)</p> <p>37. Equivalent value of exchange items (domestic currency accounts)</p>				

SOURCE: Alicja Jarugowa and others (1994). *Rachunkowość Banków Komercyjnych*. Warsaw, Centrum Edukacji i Rozwoju Biznesu, pp. 108-109.



TABLE 8. CHARTS OF ACCOUNTS FOR FIVE COUNTRIES WITH TRANSITIONAL ECONOMIES

GROUP	BULGARIA	CZECH REP. AND SLOVAKIA	HUNGARY	RUSSIAN FEDERATION
0	Vacant	Non-current tangible, intangible, and financial investments	Vacant	Off-balance sheet accounts
1	Capital (equity and and long-term debt)	Inventories intangible and	Non-current tangible, other investments financial investments	Long-term assets
2	Non-current tangible, intangible, and financial investments	Financial accounts	Purchased and self-manufactured inventories	Production reserves (inventories and pre paid expenses)
3	Inventories	Clearing (receivables and payables)	Current assets other than inventories	Production expenses (inventories and pre paid expenses)
4	Third parties (receivables and payables)	Capital (equity and long-term debt)	Equity accounts, short-and long-term debt	Finished products, goods, and sales
5.	Financial assets	Expenses by nature	Costs by nature	Monetary assets
6	Expenses by nature	Revenues	Internal accounting	Settlements (receivables and payables)
7	Revenues	Closing and sub-ledger accounts	Internal accounting	Financial results and profit utilization
8	Vacant	Internal accounting	Cost of sales and other expenses	Funds and reserves
9	Off-balance sheet accounts	Internal accounting	Revenues	Bank credits and financing

## SOURCES:

Bulgaria: Republic of Bulgaria, Ministry of Finance (1992). *Accountancy Act and National Chart of Accounts*. Sofia.

Czech Republic and Slovakia: Czech and Slovak Federal Republic (1991). *Law on Accounting No. 563/1991 of 12 December*.

Prague. (English translation by Arthur Andersen & Co. SC.) Hungary: Act XVIII of 1991 on Accounting (1994), in *Hungarian Rules of Law in Force, Nr. V/9-10*. Budapest, Verzal Co. Ltd.

Russian Federation: A.J.H. Enthoven and others (1994).

*Doing Business in Russia and the other Former Soviet Republics: Accounting and Financial Management Issues*. Montvale, The Institute of Management Accountants, pp. 36-50.

TABLE 9. FORMAT OF RUSSIAN BALANCE SHEET

ACTIVE	PASSIVE
<p><b>I. Capital assets and other non-liquid assets</b></p> <p>Intangible assets:</p> <p style="padding-left: 20px;">historical costs* (04)</p> <p style="padding-left: 20px;">amortization* (05)</p> <p style="padding-left: 20px;">net</p> <p>Property, plant and equipment:</p> <p style="padding-left: 20px;">historical cost* (01,03)</p> <p style="padding-left: 20px;">depreciation* (02)</p> <p style="padding-left: 20px;">net</p> <p>Equipment for installation (07)</p> <p>Capital investments-in-progress (08)</p> <p>Long-term investments in securities (06)</p> <p>Transactions with owners (75)</p> <p>Other non-liquid assets</p> <p style="text-align: right;"><b>Subtotal I</b></p>	<p><b>I. Source of enterprise's own assets</b></p> <p>Stock capital (85)</p> <p>Reserve fund (86)</p> <p>Special fund (88)</p> <p>Project financing and investments (96)</p> <p>Lease obligation (97)</p> <p>Transactions with owners (75)</p> <p>Unused profit of previous years (87)</p> <p>Profit:</p> <p style="padding-left: 20px;">current year* (80)</p> <p style="padding-left: 20px;">used* (81)</p> <p style="padding-left: 20px;">unused profit of the current year</p> <p style="text-align: right;"><b>Subtotal I</b></p>
<p><b>II. Current assets</b></p> <p>Raw materials (10, 15)</p> <p>Animals growing and on feed (11)</p> <p>Small value short-lived assets:</p> <p style="padding-left: 20px;">historical costs* (12)</p> <p style="padding-left: 20px;">depreciation* (13)</p> <p style="padding-left: 20px;">net</p> <p>Work-in-progress (20,21,23,29,30)</p> <p>Prepaid expenses (31)</p> <p>Finished goods (40)</p> <p>Inventory:</p> <p style="padding-left: 20px;">sales price* (41)</p> <p style="padding-left: 20px;">mark up* (42)</p> <p style="padding-left: 20px;">purchase price</p> <p>Distribution expense (44)</p> <p>Added value tax for acquired goods (19)</p> <p>Other current assets</p> <p style="text-align: right;"><b>Subtotal II</b></p>	<p><b>II. Long-term liabilities</b></p> <p>Long-term bank credit (92)</p> <p>Long-term borrowings (95)</p> <p style="text-align: right;"><b>Subtotal II</b></p>

continued

continued

ACTIVE	PASSIVE
<p><b>III. Monetary assets, transactions, other assets</b></p> <p>Transactions with debtors:</p> <p style="padding-left: 20px;">for goods, projects and services (45,62,76)</p> <p style="padding-left: 20px;">notes receivable (62)</p> <p style="padding-left: 20px;">with subsidiaries (78)</p> <p style="padding-left: 20px;">with federal budget (68)</p> <p style="padding-left: 20px;">with employees (73)</p> <p style="padding-left: 20px;">with other debtors</p> <p style="padding-left: 20px;">Advances to vendors and contractors (61)</p> <p>Short-term investments in securities (58)</p> <p>Cash:</p> <p style="padding-left: 20px;">cash-on-hand (50)</p> <p style="padding-left: 20px;">bank account (51)</p> <p style="padding-left: 20px;">hard currency account (52)</p> <p style="padding-left: 20px;">other cash accounts (55,56,57)</p> <p>Other circulation assets</p> <p style="text-align: right;"><b>Subtotal III</b></p> <p>Losses: previous years (87)</p> <p><b>Total balance</b> (sum of 080, 330, 340, 350)</p>	<p><b>III. Payments and other liabilities</b></p> <p>Short-term bank credit (90)</p> <p>Bank credits for employees (93)</p> <p>Short-term borrowing (94)</p> <p>Transactions with creditors:</p> <p style="padding-left: 20px;">for goods, projects and services (60)</p> <p style="padding-left: 20px;">notes payable (60)</p> <p style="padding-left: 20px;">wages (70)</p> <p style="padding-left: 20px;">social security (69)</p> <p style="padding-left: 20px;">property and personal insurance (65)</p> <p style="padding-left: 20px;">with subsidiaries (78)</p> <p style="padding-left: 20px;">non-budget payments (67)</p> <p style="padding-left: 20px;">with federal budget (68)</p> <p style="padding-left: 20px;">with other creditors</p> <p>Advances from customers (64)</p> <p>Unearned revenue (83)</p> <p>Reserves for future payments and expenses (89)</p> <p>Reserves for doubtful accounts (82)</p> <p>Other short-term liabilities</p> <p style="text-align: right;"><b>Subtotal III</b></p> <p><b>Total balance</b> (sum of 480, 520, 770)</p>

\* These numbers are not included in the totals.

SOURCE: Russian Federation, Ministry of Finance (1993). *The Supplement and Changes to the Regulation on Accounting and Reporting in the Russian Federation*, June 4. Moscow, the Accounting Library.

TABLE 10. CORE ACCOUNTING COURSES OFFERED AT SELECTED POLISH UNIVERSITIES

	Introductory Accounting		Financial Accounting		Management Accounting			Cost Accounting	
	Lect.	Prac.	Lect.	Prac.	Lect.	Prac.	Lect./Disc.	Lect.	Prac.
University of Gdańsk	30	30	45	45	30	30		45	45
University of Łódź	30	30	30	45			60	30	30
Katowice Economics Academy	30	30	45	45	45			30	30
Poznań Economics Academy									
Dept. of Economics			30	30	30	30			
Dept. of Management			30	45	45	45			
University of Szczecin	30	30			15	30		30	30
University of Torun	15	30	15	30	30			15	
Warsaw Main School of Commerce:			30	30					
Finance and Banking					15	15		30	30
University of Warsaw									
Dept. of Management					30	30		30	30

KEY: Lect.—Lecture; Prac.—Practice; Disc—Discussion

SOURCE: Alicja Jarugowa and Jerzy Marcinkowski (1994). Nauczania Rachunkowości w Polskich Ekonomicznych Uczelniach Wyższych, *Rachunkowość*, February, p. 20.

TABLE 11. EXAMPLES OF ACCOUNTING COURSE LISTINGS  
AT THE UNIVERSITIES OF GDA SK AND ŁÓD

	Lect.	Prac.	Lect./Disc.	Various
<b>UNIVERSITY OF GDA SK</b>				
<b>Department of Production Economics</b>				
Accounting area: 15 faculty				
Economic analysis area: 8 faculty				
Accounting majors: 45				
<b>Additional basic accounting courses:</b>				
Financial Management .....	60	30		
<b>Specialized elective courses:</b>				
Bank accounting .....	30	30		
Auditing accounting records and financial statements .....			30	
Legal bases of accounting .....	30			
International accounting standards .....			45	
Financial auditing .....				X
Financial analysis .....			60	
Microcomputer utilization in accounting .....				X
<b>UNIVERSITY OF ŁÓD</b>				
<b>Department of Economics and Sociology</b>				
Areas of Specialization:				
Economic Cybernetics and Informatics;				
Management and Marketing.				
Teaching faculty: 8 plus 3 technical personnel				
Accounting majors: 60				
<b>Economic Cybernetics and Informatics:</b>				
<i>Basic courses:</i>				
Accounting information systems design .....		30	30	
Financial analysis-I .....			30	
Financial analysis-II computer assisted .....			30	
International accounting .....			30	
Auditing .....			30	
Auditing in a computerized environment .....			30	

continued

TABLE 11. EXAMPLES OF ACCOUNTING COURSE LISTINGS  
AT THE UNIVERSITIES OF GDA SK AND ŁÓD  
(continued)

	Lect.	Prac.	Lect./Disc.	Various
<i>Elective courses:</i>				
Budgetary accounting			30	
Bank accounting			30	
Accounting for insurance institutions			30	
Tax accounting			30	
Modern accounting theory			30	
Computer-assisted financial decisions lab			30	
<b>Management and Marketing</b>				
<i>Core courses:</i>				
Introduction to accounting	30	45		
Financial accounting-I	15	15		
Management accounting-I	15	15		
<i>Required Courses for Accounting Majors:</i>				
Accounting for costs and results			30	
Financial accounting-II			30	
Management Accounting-II			30	
Financial reporting and analysis	30	30		
Financial management	30			
Accounting information systems			30	
Auditing-I				X
Utilization of microcomputer techniques in accounting			30	Lab
International accounting	30			
Auditing-II			30	
Lec./Prac.				
<i>Elective Courses for Accounting Majors:</i>				
<i>Seminar 7: (limited to 120 hours)</i>				
Market valuation of an enterprise			30	
Modern accounting theory		30		
Tax accounting			30	
Accounting system organization			30	
Computerized analysis of statistical data			30	Lab

continued

continued

.....	Lect. ....	Prac. ....	Lect./Disc.	Various
Cybernetics .....	30			
Information systems in enterprise management .....			30	
Structural and ownership transformation .....	30			
Enterprise reform and bankruptcy proceedings .....			30	
Joint ventures in Poland and internationally .....			30	
The securities market .....			30	
Bank accounting .....			30	
<i>Seminar 8: (limited to 190 hours)</i>				
Governmental accounting .....			30	
Inflation accounting .....			30	
Financial accounting and reporting in concerns .....			30	
Computer-assisted financial statement analysis .....			30	Lab
Computerized accounting systems design .....			30	Lab
Useful microcomputer systems .....			30	Lab
Data protection .....			30	Lab
Negotiation procedures .....			15	
New forms of work organization .....			15	
Marketing tasks .....			30	
<i>Seminar 9: (limited to 60 hours)</i>				
Accounting for small firms .....			30	
Decision games .....			30	
Optimizing enterprise management decisions .....			30	
Foreign currency and customs policies .....			30	
International trade law .....		30		
Computer-assisted decisions under uncertainty .....				30 Lab

SOURCE: Alicja Jarugowa and Jerzy marcinkowski (1994). Nauczania Rachunkowości a Polskich Ekonomicznych Uczelniach Wyższych, *Rachunkowość*, February, pp. 20-21.

TABLE 12. EVOLUTIONARY STAGES OF GOVERNMENTAL FINANCIAL MANAGEMENT SYSTEMS

	<b>REGULARITY AND CONTROL</b>	<b>FINANCIAL MANAGEMENT</b>	<b>STRATEGIC CHOICE</b>
<b>ACCOUNTING EMPHASIS</b>	<p>Accounting records</p> <p>Efficient procedures for disbursements and revenue collection</p> <p>Accurate recording and documentation of transactions</p> <p>Proofs of accuracy</p> <p>Timely updating of accounting records</p> <p>Classification schemes to supply accounting data for various purposes</p>	<p>More frequent financial reporting to improve monitoring</p> <p>Improved asset management: e.g., liquidity, receivables, inventories, fixed assets subsystems</p> <p>Subsystems integrated with managerial review and action</p> <p>Accounting system used to track larger range of transaction types</p> <p>Multiple-stage recording of transactions for expenditure forecasting and liquidity management</p>	<p>Interfaces with other processes, e.g., investment appraisal, procurement, debt management, planning</p> <p>More elaborate data generation, e.g., economic costs</p> <p>Integrated management information systems</p> <p>Satisfying needs of external users of financial information</p>
<b>BUDGETING EMPHASIS</b>	<p>Installation of basic procedure systems: e.g., line itemization, budget calendar, forms</p> <p>Integration of accounting and budgeting for budgetary control purposes</p>	<p>Improved expenditure and revenue forecasting</p> <p>Clearer, better justified, and more understandable budget presentations, including some programming and narrative statements and accurate estimation of special types of expenditure</p> <p>Preliminary moves to integrate development budget with planning mechanism and measure performance</p>	<p>Further integration of plans and budgets: in particular, project classification schemes and price bases used</p> <p>Performance measurement and reporting</p> <p>Study of budgetary alternatives (costs and benefits of different methods of achieving policy goals)</p> <p>Evaluation of budget outcomes</p>
<b>AUDITING EMPHASIS</b>	<p>Verification of accounting and related records</p> <p>Investigation of compliance with budgetary and other procedural rules</p> <p>Ensuring correct financial reporting</p>	<p>Internal controls systems testing</p> <p>Articulation of financial management processes and their use to save money or improve efficiency</p>	<p>Separate performance audits, starting with economy and efficiency focus and progressing to effectiveness</p> <p>Gradual emergence of multi-disciplinary approach</p>

SOURCE: Adapted from Peter N. Dean (1988). "Governmental Financial Management in Development Countries", in *Governmental Accounting and Auditing: International Comparisons*, James L. Chan and Rowan H. Jones, eds. Buckenham, Croom Helm, pp. 149-174.



TABLE 13. POLISH PUBLIC SECTOR CHARTS OF ACCOUNTS

<b>A. Chart of Accounts for Local Governments</b>	
<b>Account Numbers</b>	
	<b>Balance sheet accounts</b>
133	Current budget account
134	Bank credits
140	Other monetary assets
222	Budgetary revenues clearings
223	Budgetary expenditures clearings
224	Settlements with the State budget
901	Budgetary revenues
902	Budgetary expenditures
	<b>Off-balance sheet accounts</b>
991	Planned budgetary expenditures
992	Planned budgetary expenditures
993	Clearings with other budgets
<b>B. Chart of Accounts for other Budgetary Units, Budgetary Institutions and Auxiliary Activities</b>	
<b>Group</b>	
0	Fixed assets
1	Monetary assets and bank accounts
2	Clearings and claims
3	Materials and merchandise
4	Costs by nature and their clearings
5	Costs by type of activity and their clearings
6	Products
7	Revenues, Taxes and Subsidies
8	Funds, reserves and financial results

SOURCE: Barbara Bakalarska (1993). *Rachunkowość Jednostek i Zakładów Budżetowych oraz Gospodarstw Pomocniczych*. Warsaw, Fundacja Rozwoju Rachunkowości w Polsce, pp. 21-23.

TABLE 14. AUDIT POWERS OF TAX ADMINISTRATION

Country	Selection basis	Taxpayer notification	Period auditors can look back	Power of auditors to:		
				Enter and search business premises	Enter and search taxpayers' homes	Audit third parties
<b>Bulgaria</b>	Random	Not necessary	Not restricted. However, tax obligations lapse after five years	Yes	No	Yes
<b>Czech Republic</b>	Discretion of tax administration	Not necessary	Three years	Yes	Yes, if dwelling used for business purposes	Yes
<b>Hungary</b>	Discretion of tax administration. Generally all taxpayers audited every five years	Notified in advance unless threat of records being destroyed	Five years	Yes under certain conditions	Yes	Yes
<b>Poland</b>	Random	Yes, but may be given on day of audit	Five years	Yes	Yes, under	Yes
<b>Romania</b>	Random	Not necessary	Three years. Court can extend to 10 years	Yes	No, unless warrant held by auditors	Yes
<b>Russia</b>	Discretion of tax administration	Not necessary	Six years	Yes	Yes, if dwelling used for business purposes	Yes
<b>Slovak Republic</b>	Random plus discretionary basis	Not necessary	Five years, but can be extended to 20 years	Yes	Yes, if dwelling used for business purposes information	No, but third parties have to disclose
<b>Slovenia</b>	Discretion of tax administration	Yes, in practice	Five years	Yes	No	Yes

 SOURCE: *Business Central Europe, September 1994, p. 69.*

TABLE 15. PENALTIES FOR VARIOUS TAX OFFENCES

Country	Non-registration for tax purposes	Failure to file annual tax return	Late submission of tax return	Submission of incorrect tax return	Fraud
<b>Bulgaria</b>	A tenth of non-registered investment. Carrying out unregistered economic activity: twice the realised profit (min: Lev 1,000)	Five times overdue tax	Five times overdue tax	No specific penalty. If deemed an attempt to conceal income; treated as fraud	Five times overdue tax
<b>Czech Republic</b>	Up to Kč2m. If offence persists may be prohibited from carrying out activities	Up to Kč2m. If offence persists may be prohibited from carrying out activities	10% of tax due	0.15-0.9% of tax evaded per day	Fine plus imprisonment (six months to 12 years)
<b>Hungary</b>	Ft10,000 to Ft100,000. Penalty can be doubled	5-30% of tax due (max: Ft100,000)	5-30% of tax due (max: Ft100,000)	5% of tax difference (min: Ft5,000; max: Ft100,000)	50% of tax evaded plus late interest
<b>Poland</b>	Up to three years prison and/or Zł500m fine	Up to Zł250m plus late interest	Up to Zł250m plus late interest	Up to Zł250m	Up to Zł500m
<b>Romania</b>	Lei1m	Lei30,000	Lei30,000	Lei25,000	Up to Lei4m plus prison
<b>Russia</b>	Administrative fine plus 10% of tax due	10% of tax due	10% of tax due	Up to twice tax evaded	One to five times concealed income or profits
<b>Slovak Republic</b>	Up to Sk2m. If offence persists, may be prohibited from carrying out activities	Up to Sk2m. If offence persists, may be prohibited from carrying out activities	10% of tax due	0.15-0.3% of tax evaded per day plus interest	Fine of up to Sk1m and/or prison (six months to 12 years) plus tax duty
<b>Slovenia</b>	Not applicable; no general obligation to register for tax purposes	Minimum TL400,000	Minimum TL400,000	Minimum: TL1.5m; maximum: five times tax due	Maximum: five times tax due

*All penalties relate to corporate income tax for companies with foreign participation. In most cases, penalties are the same for local companies.*

SOURCE: *Business Central Europe*, September 1994, p.69.

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### III. OVERVIEW AND CONCLUSION

The previous chapters provide a detailed picture of the context in which financial management takes place in transitional economies, factors in the economic and policy environment which have hindered or hastened the development of financial management, and insights into current institutional aspects. This overview and conclusion will reiterate significant themes with regard to the government role in financial reform and in accounting reform, and to the key role of the banking system and of banking reform.

Financial management is a service primarily to the financial stakeholders—owners, creditors and the tax authorities, who need to know what their “agents” are doing with their money. This is as true in a centrally-planned economy as in a market-oriented economy. The development of financial management is driven by the requirements of the financial stakeholders, whose identity changes in the transition from central planning to market-oriented planning. In economies moving toward the market, and with a higher private share of productive activity, the need is for entrepreneurs and for entrepreneurial information, so financial management is progressively recast to serve their needs.

An inhibiting factor has been the spread of the so-called “grey economy”—unregistered, non-taxpaying and not subject to accounting norms and standards. The growing size of the grey economy is an issue, for instance in Hungary, where it is estimated to be responsible for 33 per cent of GDP.

The growth of entrepreneurship, and hence of financial management, is easier in countries in which some sectors of the economy remained in private hands, since this provides a core of entrepreneurs who move into the “new” sectors opened up for entrepreneurship. In other countries, the suppression of entrepreneurship was so complete, and cultural values had for so long discouraged private entrepreneurial activity, that the re-emergence of the entrepreneurial function has naturally been slower, and financial management will develop at a corresponding pace.

In the latter case, the government has to take a stronger lead. The government cannot itself establish a market-only buyers and sellers can do that—but it can (a) create the minimum legal and regulatory infrastructure, (b) decontrol prices and the free flow of goods so that prices can respond to supply and demand, and (c) lead opinion, not least by showing its own commitment to the market by privatizing its own assets and activities.

Transitional economies have made uneven progress in

establishing legal support for their emerging market economies. New property laws have been introduced, but they are still subject to restrictions, and implementation lags, particularly with regard to the establishment of reliable land registration as a basis for transfers of title and security for loans. Most countries have reformed their contract law and introduced new commercial codes, but there is a general paucity of remedies for breach of contract due to lack of a commercially-trained judiciary. Similarly, laws have been introduced covering bankruptcy and competition in several countries, but are rarely applied or enforced. Company laws exist but are often unclear.

Most transitional-economy governments have decontrolled the majority of wholesale and retail prices. However, the emergence of economic prices which equate supply and demand depends also on managers’ knowledge of markets. Lack of experience, as well as lack of regulation of monopolies, have often resulted in supply/demand imbalances and wide dispersion of prices, so resource allocations are not yet determined by accurate price signals. In some countries, subsidies are retained on key items, such as food, medical care, rent, education, transport or fuel, as is the case in the Russian Federation, Ukraine, Uzbekistan, Turkmenistan and Mongolia. However, these administered prices are subject to continuous adjustment, and thus are moving toward economic pricing.

With regard to privatization, in most of the transitional economies the level of State ownership and control has been brought down to typical levels of the rich market economies. The EBRD (1994) study of 25 transitional economies in Eastern Europe and the former Soviet Union showed that the private sector generated 40 per cent or more of GDP of 12 countries by mid-1994. As Prodhan and Kaser point out (chapter I), this is a rate of change paralleled only by the dynamic Asian economies.

According to Berry (Chapter II), reform has been eased by tapping financial know-how from the Western countries, in particular the international accounting and consulting firms, and by collaborations of various kinds (joint ventures, “twinning”) with Western banks.

This was least difficult in the East German *Länder*, which had access to know-how in their own country and language. In other transitional economies, there are continuing problems of assimilation or adaptation of concepts and practices from other cultures. In Russia, for instance, initial bank accounting reforms preserved many features of the old State system; this facilitated training,

but reduced—or delayed—the benefits of a more radical change. The political urgency of the transformation process has made it tempting to adopt foreign practices wholesale, and this is sometimes welcomed by foreign consultants who find it much easier to recommend what they know and are familiar with than to work with their hosts in finding viable local solutions. There is some concern that a wholesale approach is not practical—effective policies are always country-specific.

The most difficult part of the process comes after policies have been promulgated and laws passed. The benefits of greater efficiency then depend on the responses of entrepreneurs and enterprise managers. Much restructuring turns on the introduction of management incentives, whether by corporate bankruptcy or takeover following inefficient operation, or individual rewards and penalties linked to performance; China, for instance, has concentrated on the latter. There has been a series of experimental reforms in enterprise management, which have tried to retain the residual powers of the State while giving managers more autonomy and rewards for good performance and/or penalties for bad performance. In 1979, a system of profitsharing was introduced, which allowed firms to retain a fixed proportion of their profits and pay the rest to the State. The proportion rose gradually from 8 per cent to 22 per cent<sup>15</sup>. From 1985, the State stopped collecting depreciation funds and allowed these to be retained and reinvested by the enterprise at the discretion of the management.

How to reconcile equity with efficiency remains a leading issue in most transitional economies. Equity calls for the distribution of public assets to the people at large, not to those who are most able to pay for them as a consequence of their-illegal-amassing of wealth in an earlier regime. This implies free or near-free distribution of shares, as in several voucher schemes. Efficiency, however, requires that effective control of assets be in the hands of those who have entrepreneurial vision of how they can be most productively used. For this to take place, enterprises must be offered to the highest bidders and potential entrepreneurs must be able to borrow. In voucher schemes, ownership is too dispersed for effective governance, which leaves power in the hands of the managers. However, if vouchers are tradeable-at the risk

of adding to inflation-and the trading machinery is in place, it can be expected that property rights will eventually gravitate to those who value them highest. The equity goal is still served as the initial holders of vouchers sell them at higher prices which final holders are willing to pay; so, in theory, everyone gains.

In the initial phase of privatization, it was expected that capital markets would discipline managers who failed to maximize the market values of their enterprises by the threat of takeover. Pending their development, corporate governance would be exercised by holders of majority shares such as banks, investment funds and parent enterprises, all of which would have the necessary business expertise. They would monitor the performance of enterprises, provide strategic inputs, and replace managers who were ineffective or corrupt.

In practice in many countries, managers and other employees have taken advantage of the interval between the breakdown of State control and the emergence of new market-oriented controls to capture corporate decision-making for themselves, and to block the issue of shares to outside interests. In some cases, enterprise assets have been sold off at low prices to new companies owned by the managers, a form of “spontaneous privatization”. Even where the central privatization agency tries to introduce competitive bidding for the enterprise, the incumbent managers have a major information advantage over other potential buyers, which they can reinforce by selective release of information and by “cooking the books”—i.e. using accounting methods which undervalue profits and assets—and/or outright fraud. Mejstrik and Burger (1994, p. 210) say that, in the Czech Republic, the privatization process has been more or less controlled by managers, following the dismantling of State controls. Most managers are said to be operating without contact with their new owners.

This is one of the more worrying tendencies in several transitional economies. While managers are gaining control of their enterprises, the countervailing power of shareholders is not being established or is even being reduced. In some cases, minority shareholders, even institutional shareholders like investment funds which were set up to provide professional backstopping of the management team, are being excluded from the management process. In Slovenia, for instance, some managements are said to get perpetual proxies from presumably ignorant small shareholders so as to maintain their dominance at annual general meetings. One might expect that equity-holding managers would try to maximize the value of the firm, and that shareholder/manager agency problems would be reduced. On the contrary, managers maximize the benefits to themselves, of which a share in the bottom line may not be the most

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<sup>15</sup>Not all of this was personal reward—some of the retentions were provisions for research and development, but these still added to the discretionary power of the managers.

significant.

The more pressing problem is with the exploitation of minority shareholders by insiders. Investment fiends, even if they have adequate equity, do not have the analytical and managerial resources to participate in the board meetings of large numbers of companies. In Slovakia, for instance, a survey of investment fiends found that two thirds of them aimed to establish control in not more than ten enterprises (Schmognerova, 1994, p. 229). One answer lies in better company law and capital market regulation for the protection of investors, and in stronger enforcement.

## 1. Accounting reform

The authors of both papers describe the role of accounting in pre-transitional economies. In general, enterprises aimed to meet the State-planned physical production quotas: accounting was used mainly to record cash flows between enterprises and the non-State sector, that is, the payment of wages, and purchases from households. Accounting was nothing more than book-keeping. All transfers of goods and services between State-owned firms were recorded by debits and credits in the respective accounts at administratively-determined prices, based on estimates of their labour cost (omitting the opportunity cost of land and natural resources<sup>16</sup> and actual import costs (which were at multiple artificial exchange rates). Firms could expect to be provided with whatever cash might be needed to cover any deficits, while any cash surpluses were siphoned back to the State which controlled the bank account of the enterprise and handled certain transactions itself. Not being allowed to hold cash or a bank balance from one accounting period to the next, enterprises accumulated what they did have control over—physical assets and inventories—and falsely reported inputs and outputs. When production was above the quota, it was under-reported not only to hide the surplus and hold it against future under-production (or for sale on the black market), but also to avoid targets being raised. Vice versa, under-production was over-reported

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<sup>16</sup>The cost of capital was, in principle, included through depreciation of the capital expenditure. However, capital expenditure consisted only of the labour costs incorporated in the asset. There was no concept of opportunity cost of capital.

so as to show that targets were achieved. Alternatively, the firm could claim a quality increase (Prodhan and Kaser).

The prestige and power of accountants in the market economies<sup>17</sup> may be contrasted with the low status of accountants in the centrally-planned economies, which is, however, rapidly rising in the transitional era. The enterprise chief bookkeeper (the term “financial manager” overstated the role) was effectively a State comptroller, operating according to State rules, and not part of the management team, as in market economies.

Accounting standards were set centrally and in great detail to meet planning needs; they were generally followed meticulously—although not necessarily honestly. Accounts were kept typically on double entry principles, and this added to the self-checking accuracy of accounting summaries. The accounting year usually coincided with the calendar year, and accounts were rendered to the State at the end of each year. Accounts were kept mainly on a cash basis, though Poland was an early user of accrual accounting (Berry). Apart from this outstanding example, there was no matching of revenues (including accrued revenues) with expenses (including accrued expenses), so there was no measurement of profit.

Profit measurement has three purposes: to guide decisions on profit distribution, on output prices, and on

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<sup>17</sup>**Accountants...stand to the world of corporate business much as the lawyer stood to the 19th century world of rich men's property. They are the priesthood of industry: the more fragmented and diversified a company becomes, the more important becomes the man [sic] who can disentangle the threads of profitability that holds it together. Few people in a vast company are in a position to see over the tops of the trees. An able accountant can, and from his knowledge comes his power.”** (Anthony Sampson, *Anatomy of Britain*, 1962, p. 466). This was written before the information revolution, but the latter has not affected the importance attached to those responsible for financial management.



investment. None of these purposes applied in a centrally-planned economy. Distributions (to the sole stakeholder) were not based on profit but on cash availability. Prices were based on technical coefficients, which were only loosely founded on actual costs or profits. The other potential use of profit measures—to guide resource allocations—also did not apply, since allocations were made on grounds of physical “needs” as estimated by the central planners. Similarly, there was no need for consolidated accounts of groups of companies. Within enterprise groups there was no elimination of intra-group transfers, and it is unlikely that this could have been done effectively at higher levels of aggregation.

A feature of Soviet-style enterprise accounting was the use of separate funds, each with its own assets and liabilities. The rules on what should be paid into each fund, and what could or should be paid out, were set by the State. This is similar to government accounting in most countries. In the market economies, the typical enterprise operates as a single fund, into which all receipts flow and from which all payments are made. Segregated funds reflect the limited autonomy of their managers and, more particularly, the diversity of functions of the Soviet-type enterprise, e.g. the social welfare functions required a separate social fund.

Assets were recorded at their historical cost and depreciated on the straight-line basis, as prevails in accounting in market economies. The main difference was that asset lives were assumed to be longer, partly because Soviet planners were not subject to the principle of conservatism—they were not concerned with the dangers of overstating profit. Certain assets, such as land, mineral rights, intellectual property and goodwill were not paid for, and accordingly they did not appear in Soviet-style balance sheets.

There was no practical distinction between equity capital and loans, since nothing was repayable unless cash flows allowed it. Banks had no credit intelligence and very little experience in credit-risk evaluation or loan monitoring. Downstream, there was no bankruptcy or the recycling of resources to other managers; the only possibility was internal restructuring.

There was a failure to deal with inflation at the enterprise accounting level. The evidence from those countries which have applied current cost accounting indicates the highly distorting effects of GAAP<sup>18</sup> historical cost accounting at even low rates of inflation maintained over a period of years. The impact of this distortion in terms

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<sup>18</sup>Generally accepted accounting principles

of misguided resource allocations is not known—nor could it be known unless all alternative allocations were reflected in inflation-adjusted accounts. However, if economies rich in accountants such as the United Kingdom and the United States balked at the introduction of inflation-adjusted external financial reports, this cannot be recommended for the transitional economies, which are struggling with a lack of accounting and auditing skills.

The lack of a competitive environment and the loss of CMEA markets precipitated a plummeting demand for goods and services and loss of government revenue. “Managers lost their twin anchors of sellers’ markets and guaranteed financial support” (Berry). The transitional stage began with enterprise illiquidity, layoffs, debt default, tax evasion and high instability in the political and economic environment. Personal opportunism and corruption flourished in an environment in which law and order appeared to have broken down. The old rules no longer applied, and the new rules had not been set or were not understood or were not enforced.

During the transition, inflation produced artificial profits<sup>19</sup>, which were often masked by declining sales. In many cases, profits were not matched by cash balances as cash flows were recycled into higher-cost working capital even if inventory and receivables had been kept at the same physical levels. This might in some cases have been offset by reductions in physical inventory as managers found that their material inputs were more available and stockpiles could be reduced. On the other hand, the liquidity crunch and high interest rates led to mounting accounts receivable.

The transfer of social responsibilities to government—even if, in a context of mounting fiscal deficits, the responsibilities are not met’—has been widely completed, and has thus eliminated the need for enterprises to

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<sup>19</sup>Artificial profits arise wherever outputs are sold at current price levels, while inputs are charged at the (lower) price levels at the time they were acquired. The overstatement of profit is greater in proportion to the asset-intensity of the firm and the amount of inflation of prices over the periods since acquisition. This is offset by the inflationary gain on (non-indexed) net credit to the firm.

maintain non-commercial funds. This is reflected in the new charts of accounts officially promulgated in several transitional economies. Funds may still be of importance where enterprises continue to hold monies assigned to employee pensions, but these may be taken off enterprise balance sheets and re-registered in the names of appointed trustees.

Accounting reform has been driven primarily by (a) the desire of transition economy governments to bring their accounting standards into line with the rest of the world, where the needs of private investors and creditors are paramount, and (b) new needs for State revenue. All transitional economies have shifted from direct taxation of enterprises as the main source of State revenue to indirect taxes—VAT in particular—and individual income taxes. In Hungary and Poland, monthly accounts were introduced, principally to report turnover tax payable (Prodhan and Kaser). Poland, which had a long experience of accrual accounting, introduced in 1989 a compulsory dividend—in other words, a tax—on State-owned enterprises, calculated on the basis of the amount of State investment (Berry).

“Western-style” accounting was introduced in joint ventures and in privatized enterprises to meet the needs of foreign investors. Since investors expect their capital to be maintained, and that dividends should come only out of genuine profit, accrual accounting is a necessity. A special feature of joint venture accounting was the recording of foreign exchange transactions—apart from their conversion to domestic currency for inclusion in the ordinary accounts—because profit repatriation was commonly limited to a proportion of the joint venture’s foreign exchange earnings (Prodhan and Kaser).

The main tool in the economic transformation is the application of modern techniques of financial analysis based on accrual accounting. Neither the cash basis nor cameral accounting provide owners and their managers with measures of profit, its breakdown over product lines, or meaningful analysis of variances between budget data and actual results. Full accrual accounting is the only basis for executive decision-making where economic efficiency is an important objective. However, its introduction is resisted by business where it results in higher tax liability due to profits from sales which are not yet collected, or even collectible. Generally accepted accounting principles require loanloss provisions to be charged against profit—the fiscal code should allow these expenses to be correspondingly deducted from assessable profit. Czech businesses, for example, face tax assessments which make no allowance for doubtful debts—they are seeking tax relief from this anomaly.

The mobilization of resources is also dependent on

financial standards. The supply of external resources for investment is a function of risks and returns, as seen by investors. Perceived risk is substantially reduced by transparent access to information, in a meaningfully standardized form in which it can be read and used by investors. The widespread adoption of GAAP and internationally recognized standards of reporting and disclosure are key factors in the attraction of foreign investment and the development of capital markets.

## 2. Banking reform

Both papers highlight the importance of financial management in enterprises in the financial sector, principally the commercial banks, because of (a) their role, *inter alia*, as intermediaries between suppliers of savings and users of investment funds, and (b) their no less important role as intermediaries and apostles in the dissemination of market philosophy.

According to surveys, entrepreneurs repeatedly rank lack of access to capital as their foremost problem. Despite the tendency of entrepreneurs to “monetize” their problems, and the consequent need to interpret survey results with care, there appears to be no doubt that the emergence and the growth of enterprises—especially small and medium-sized firms—is significantly constrained by lack of credit at a price that the entrepreneur can afford to pay. Berry comments that market economies are built up through the main mechanism of small entrepreneurs, but that this cannot happen until they can get adequate access to working capital. In the early stages, some entrepreneurs get credit from informal sources such as families and friends—as in the early development of Hong Kong—but this is not available to all potential entrepreneurs and is liable to be inappropriately allocated on non-commercial criteria. Even if credit is formally available, it must be accessible to the entrepreneur and on terms that can be met from cash flows: in the transitional economies, interest rates were, initially, often impossibly high.

This is very relevant to the question of sequencing of reforms. Some minimum package of financial sector reform is necessary at an early stage of transition to set the framework for credit allocations based on prospective profit (Roe, 1992; Borish, 1995).

The importance of the banking sector is also implicit in Berry’s opinion that “the bankers’ current use of financial information in the credit-granting approval process may well be one of the most important ways that an understanding and appreciation for accounting-based financial information may be diffused throughout the host environment”. The supply of reliable financial

information is driven by demand, and a principal source of demand is from credit-granting agencies which are themselves constrained to make a profit.

The reform of banking in the transitional economies has a number of common elements as follows:

- a. The separation of commercial banking functions (deposit-taking, lending, foreign trade facilitation, etc.) from central monetary authority functions (monetary management, clearing mechanisms, serving as banker to the government and to other banks, refinancing other banks, supervising financial institutions, and research), i.e. the creation of a two-tier structure, as in China (1984), Hungary (1987), USSR (1988), Poland (1989) and Czechoslovakia (1990);
- b. The introduction of the “winds” of competition by deregulating commercial banking, licensing new entrants subject to capital adequacy and other requirements, and admitting foreign banks, as in the Russian Federation from mid-1994;
- c. The restructuring of banks, including the appraisal of inherited portfolios of loans and investments, and loss provisioning;
- d. Privatization of State-owned commercial banks, e.g. on a regional basis, as in Poland, and greater autonomy given to the central bank;
- e. Training and professionalization of bank staff, e.g. by the introduction of banking diploma programmes;
- f. The introduction of strategic planning into commercial banks, and their reorganization to reflect the marketing function, as well as assets management, liabilities management, risk management and information support systems;
- g. Central supervision of bank liquidity and solvency, based on law, standardized reporting and early-warning systems;
- h. the introduction and mandatory use of new market-oriented charts of accounts, based in most cases on the EU amended Fourth Directive (1986) and/or the International Accounting Standard No. 30;
- i. computerization and networking, subject to the limitations imposed by the telecommunication infrastructure;
- j. The spread of branch banking, inter-bank payment systems to speed the transfer of money (which took several weeks in the former USSR), and a widening range of services;
- k. The emergence of capital and money markets.

Bank accounting reform in Poland from 1991 has been contrasted with that of the Russian Federation. Poland, like other countries seeking entry to the EU, adopted most of the requirements of the Fourth Directive (1986) and International Accounting Standard No. 30. The forms have been adopted and the concepts translated, but much training is still needed. Russian bank accounting reform, though it started in the Soviet era (1988), has been criticized (e.g. by Enthoven and others, 1994) for its failure to present a fair picture of solvency, liquidity and profitability. Russia is considering the German/Japanese model of banking. A four-stage plan of reform has been launched.

Accounting reform provides a good opportunity for computerization and several transitional economies are engaged in computerizing their operations. Large banks in Central Europe are installing integrated systems by which head office databases are continuously updated for branch operations. This facilitates overall liquidity management, decentralization of services, and supervision of customers having accounts with several branches. Problems include poor telecommunications and frequent changes in regulatory regimes, as well as the logistical problems of training large numbers of staff.

The transfer of responsibility for financial viability from the State to the individual bank cannot be successful without a strategy for eliminating from the bank's balance sheet the dead weight of non-performing loans, mainly to SOEs. These bad loans are estimated to account for between 4 per cent (in Estonia) to 50 per cent (in Albania and Bulgaria) of total loans (Borish 1995). The debtor enterprises cannot be privatized while they have so much outstanding debt, while the bank cannot write off loans before the firm has been assessed for possible turnaround; nor can it show a good balance sheet and raise fresh capital for lending.

There is no consensus on how to deal with non-performing loans: transitional economies have used various approaches (Dhar and Selowsky, 1994). One approach is to do nothing. This allows inflation to reduce the real burden of debt (which is almost always a fixed monetary amount)—the bank loses and the enterprise gains. If the enterprise finds a viable line of business, it can start repaying past loans. However, doing nothing may not be the best option for the economy if the enterprise fails to turn around. A second option is to recapitalize the banks, but it is argued that doing this before they have incentives to allocate the new capital on a commercial basis compounds the error, or even rewards the error. The government can protect the depositors by taking over (“carving out”) all the bad loans at their face value and replacing them by treasury bonds, guarantees or cash. The government then sells off the loans for whatever they

fetch. This is equivalent to recapitalization, and may do nothing to make bank managers more commercial, unless the bank is privatized.

A third option is to undertake bank and enterprise restructuring simultaneously. This may be led by the government (the centralized approach) or by the banks themselves (the decentralized approach). In the centralized approach—as in Romania—the government selects enterprises in critical financial condition, isolates them from the banking system, and transfers the responsibility for their management to a central restructuring agency. The agency examines the possible future viability of each enterprise, and makes recommendations on liquidation or privatization. The government supports restructuring by allowing an interest rate policy which provides an adequate margin, as in the Czech Republic, where the Komerční Bank was able to build up loan loss reserves, and eventually be privatized.

The decentralized approach attempts to solve the problem by offering incentives to the banks to restructure their troubled clients. In Poland, for example, banks are recapitalized by the Government and managers are given equity stakes. This motivates them to maximize debt recoveries and to move toward their own privatization. Debt-equity conversions give the bank managers control over the debtor enterprises. The bank then solicits reorganization proposals from other creditors, from outside investors or from the enterprise managers—the so-called conciliation process. Nonviable enterprises are wound up or, if they are politically sensitive, temporarily kept afloat by subsidies from a Government Intervention Fund. The main danger in this approach is that of collusion between the bank and the enterprise at the expense of the Government. The incentive design is critical. All restructuring is difficult and lengthy, and requires commercial acumen and skills which are in short supply. Nevertheless, the alternative is unselective liquidation, or worse—a domino collapse. The superiority of a decentralized approach is predicated on the rationale that incentives are easier to apply and more effective at the bank level than at the government agency level.

Loan hospitals and work-out departments have similar objectives—to maximize the return from bad loans—whether by foreclosure, which is rare, by selling the loan at a discount, or by working to turn around the debtor firm and enable it to restart loan service. Berry points out that the preoccupation with problem loans prevents other developments such as small and medium-size enterprise business. Work-outs also suffer from the usual constraints of high administrative cost and high risk attaching to small undiversified firms. Government interest policy and inflation are also important

constraints.

Liquidation of irretrievably nonviable enterprises remains problematic. In the transition period, while the State still owns most enterprises, it is difficult to implement bankruptcy reform. Prodhon and Kaser contrast the approaches of Poland and Hungary. In Poland, as mentioned above, nine State banks were given responsibility for restructuring 2,000 enterprises which were illiquid. If this was resisted by the enterprises, or proved impossible, liquidation was the final resort. In Hungary, a strict procedure was initiated in 1992, which required an enterprise to file for bankruptcy or liquidation if it defaulted on any debt for more than 90 days. Out-of-court settlements with creditors parallel the Polish conciliation process. Except in Hungary, bankruptcy laws remain weak and unenforced, due to the social implications as well as to the lack of capacity for the process.

The prudential regulation and corporate governance of banking activities are treated separately from those of non-banking activities. New laws and accounting regulations underpin bank supervision, which is being stepped up in the Czech Republic, Hungary, Poland and Slovenia. Berry emphasizes the importance of independent and expert supervision with no conflicts of interest.

An issue highlighted by Prodhon and Kaser is that of capital adequacy. The international standard defined by the Basle Committee of the Bank of International Settlements has been adopted by some countries—such as Hungary and Latvia—but they warn that the calculation of regulatory ratios depends on the underlying accounting classifications, such as the categorization of assets according to their risk characteristics, and the loan-by-loan assessment of loss provisions. Moreover, the conventional capital adequacy ratio does not cover other kinds of risk such as interest rate risk, risk attaching to off-balance sheet items and portfolio concentration risk. It is important, for instance, to limit exposure on individual accounts—this improves diversification and reduces risk.

Another common issue is whether some bank functions could be performed by non-bank firms, or by firms under the control of non-bank firms. In the Russian Federation, many banks are set up and controlled by industrial firms which use them as conduits for relatively cheap finance from interbank currency markets. Conversely, banks take equity stakes in industry; though this has worked well in Germany and Japan, these cases may be exceptional. Cross-ownership complicates the supervision of bank liquidity and solvency, and is not recommended in the transitional economies. It is concluded that they should generally aim for an arm's length relationship between banks and non-banks.

Another issue is the depoliticization of banking. Despite the success of some Asian economies with highly interventionist governments—such as South Korea—the prevailing orthodoxy is that the transition to the market implies that banks should be allowed to make lending decisions according to their perception of market risks and returns, without subordination to political direction. However, in the aggregate, bank decisions have important macro-effects for which politicians are held responsible; they are, of course, also blamed for the micro-effects. The issue of shared responsibility is most prominent at the central bank level: while many Western countries have achieved separate autonomy for their central banks, the transitional economies are still subject to an instability which requires strong central control over the banking sector, but not a control which is subject to populist pressures.

### 3. Conclusion

Financial restructuring and the development of new financial management institutions and practices have been driven by the political urgency of economic trans-

formation under deteriorating social conditions and, in the Visegrád countries, by the desire to meet the admission requirements of the European Union. The State aimed to create a market economy through stabilization, liberalization, deregulation, privatization, banking reform and enterprise restructuring. Since price liberalization resulted in rapid inflation, the “big bang” reform required simultaneous price stabilization. According to Prodhan and Kaser, the shock therapy of massive State disinvestment was intended, *inter alia*, to pre-empt the political backlash engendered by the initial hardships of transition. The counter-argument is that a gradualist approach allowing more time for the development of financial, banking, legal and accounting services, and more time for training, retraining and natural attrition, might have pre-empted much of the hardship (see, for instance, Metcalf and AmbrusLakatos, 1992). Akyuz (1994, p. 22) comments that, while serious economic macroeconomic disorder, such as hyperinflation, may require shock therapy, the same approach to structural and institutional change causes more shock than therapy. On the ideal pace of financial reform and institution-building, the jury is still out.

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