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Report to the Chairman, Committee on International Relations, House of Representatives

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FOREIGN ASSISTANCE

Harvard Institute for International Development's Work in Russia and Ukraine

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United States
General Accounting Office
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National Security and
International Affairs Division

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The Honorable Benjamin Gilman
Chairman, Committee on International Relations
House of Representatives

Dear Mr. Chairman:

This report responds to your Committee's request that we review the Harvard Institute for International Development's (HIID) work. Specifically, we assessed (1) how the U.S. Agency for International Development (USAID) awarded assistance agreements to HIID to carry out work in Russia and Ukraine and (2) HIID's role and accomplishments in implementing assistance agreements to (a) develop a Russian capital market and (b) devise a legal reform program. In connection with evaluating HIID's role, we also assessed the effectiveness of the Russian Privatization Center (RPC) in implementing USAID post-privatization and land reform projects.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. At that time, we will send copies to the Secretaries of State and the Treasury, the Administrator for USAID, and other interested parties.

This report was prepared under the direction of Benjamin F. Nelson, Director, International Relations and Trade Issues, who may be reached on (202) 512-4128 if you or your staff have any questions. Other major contributors are listed in appendix VII.

Sincerely yours,

Henry L. Hinton, Jr.

Henry L. Hinton, Jr.
Assistant Comptroller General

Executive Summary

Purpose

As the Soviet Union began to dissolve, the United States sought to assist Russia and the other newly independent states (NIS) in their transition to free market democracies. The transition taking place was unprecedented and touched all political, military, economic, and social institutions. Almost overnight, Russia and the other NIS were beginning the process of transforming from communist, state-controlled economic and political systems—systems that were for almost a half a century in competition with those espoused by the United States. However, the transformation was not without serious opposition, and different reformers pursued different approaches. The United States sought to consolidate the gains that could be made by assisting the NIS in their transformation and supporting the reformers that were thought to have the best chance to emerge as leaders in the new governments.

The U.S. goal was to support reforms that were considered to be critical to U.S. objectives: the development of democratic institutions, the privatization of state-owned property, the establishment of legal codes, and the creation of mechanisms to operate a private capital market. The success of the reforms in Russia potentially would have far-reaching military, economic, and geopolitical consequences for the United States.

The U.S. Agency for International Development (USAID) was the lead U.S. government agency to provide transition assistance. However, USAID did not have the established organization, contacts, and expertise to accomplish this unprecedented task. Therefore, it turned to U.S. private organizations, including the Harvard Institute for International Development (HIID), to provide direct technical assistance to Russian reformers. HIID was also expected to provide technical assistance and help oversee U.S. contractors in USAID's Russian economic restructuring project. HIID had preexisting relationships with Russian officials and had already helped establish several Russian institutions to sustain reforms, including the Russian Privatization Center (RPC).[1] The RPC assisted with the restructuring of business enterprises and facilitated land reform. USAID's privatization program in Russia amounted to about $325 million for fiscal years 1992-96, approximately $40.4 million of which went to HIID.

Concerned about the noncompetitive nature of the awards to HIID and HIID's effectiveness, the Chairman of the Committee on International Relations, House of Representatives, asked GAO to review HIID's work.

[1]The RPC is a nonprofit organization established by presidential decree in November 1992 to coordinate the mass privatization voucher process, provide ongoing advice to the Russian government in privatization, and coordinate foreign donor assistance in privatization and post-privatization enterprise restructuring with the assistance of eight local privatization centers (LPC).

Specifically, GAO assessed (1) how USAID awarded assistance agreements to HIID to carry out work in Russia and Ukraine and (2) HIID's role and accomplishments in implementing assistance agreements to (a) develop a Russian capital market[2] and (b) devise a legal reform program. In connection with evaluating HIID's role, GAO also assessed the effectiveness of the RPC in implementing USAID post-privatization and land reform projects.

Background

The U.S. government-supported activities covered in this report were conducted in a difficult and uncertain environment. First, there was no validated model to follow in trying to assist Russia's transition. Moreover, the view among the U.S. political leadership was that the provision of assistance to the reformers, particularly in Russia, was time critical.

In addition, the United States had to obtain the input, cooperation, and support of the new leaders, particularly in Russia and Ukraine, regarding the timing and nature of specific projects. Moreover, the assistance had to be delivered in an environment where there was much distrust of U.S. objectives and where the United States could not be viewed as being the actual implementor of reforms. Nevertheless, USAID believed that the establishment of capital markets, the reform of the legal system, and the privatization of Russian enterprises within a relatively short period were critical to U.S. foreign policy objectives.

Results in Brief

Russia has made progress in many areas where it received U.S assistance; however, some expectations have not been met. A significant portion of U.S. assistance to Russia was provided through cooperative agreements[3] involving oversight and strategic guidance from HIID and task execution by several U.S. contractors. This approach resulted in HIID's having substantial control over the U.S. assistance program.

The U.S. assistance program was driven by the desire to support reformers whose agenda was consistent with U.S. objectives. Between December 1992 and September 1995, USAID, through a noncompetitive cooperative

[2]Capital markets consist of private institutions, technology, and regulatory structures needed to facilitate the orderly and cost-effective execution of transactions for corporate securities such as stocks and bonds.

[3]A cooperative agreement is a funding mechanism used by a federal agency to transfer funds to an organization to support an agency program. Applicable laws and regulations impose only minimal requirements that agencies must follow when selecting recipients and awarding cooperative agreements.

agreement and amendments to the agreement, provided HIID with $40.4 million to undertake a number of activities in Russia. These activities included providing assistance in privatizing Russian companies, developing a capital market, instituting legal reform, and overseeing U.S. contractors' delivery of over $285 million of technical assistance to Russian institutions and private companies.

Prior to the 1992 award, HIID had worked extensively with certain Russian reformers and had developed a system of contacts within the Russian government. GAO found that the noncompetitive awards to HIID reflected its existing relationships with Russian reformers and that the awards were consistent with applicable laws and USAID guidelines. While USAID guidelines encourage competition in the award of cooperative agreements, they allow noncompetitive awards based on factors such as a recipient's relationship with a foreign country and the promotion of U.S. foreign policy.

In 1995, USAID held a competition for assistance in connection with four projects—two in Russia, one in Central Asia, and one in Ukraine. GAO found that, in conducting the 1995 competition, USAID used erroneous scores to select the winning proposal for one of the Russia projects. However, the winning proposal was later rejected by the Russians.

With the assistance of HIID and U.S. contractors, Russia has made significant progress in developing a capital market. To date, Russia has established (1) a Securities and Exchange Commission (SEC), (2) a national company for registering trades, (3) a Russian stock trading system, and (4) a self-regulatory organization for market participants. However, the goal of setting up fully functioning national clearing and settlement organizations (CSO) that handle stock trades had not been realized due to political resistance. Recent political maneuvering to downgrade the Russian SEC's status from ministry to state committee have to date proved unsuccessful; nevertheless, the SEC's status and autonomy may continue "to come under fire," according to the Department of State.

HIID's work has supported reformers' legislative agendas and contributed to the development of key commercial laws and the establishment of the Russian Institute for Law-Based Economy (ILBE) to carry out the legal reforms during and after USAID ends its assistance. HIID also assisted in the development of strategies that enabled Russia to obtain a loan from the World Bank to implement legal reform. However, due to the political situation that developed in Russia after the 1995 parliamentary elections,

most of the legal reforms that have taken place since then have been by executive decrees, rather than the passage of laws. Notwithstanding HIID's accomplishments, GAO found that USAID exercised minimal oversight of HIID.

With HIID support, the RPC has assisted with the privatization and restructuring of state-owned enterprises and promoting land reform. Since April 1993, HIID's responsibilities for the RPC and the LPC network have been focused mainly on providing macroeconomic policy advice and recruiting program and management specialists as needed. However, while efforts to provide policy advice and facilitate post-privatization were generally successful, USAID's land reform projects were less successful, and the RPC may not be sustainable without further donor assistance.

Principal Findings

Cooperative Agreement Awards Consistent With Applicable Guidelines,but Errors Occurred

In October 1992, HIID submitted a proposal to USAID seeking funding to provide technical assistance in support of Russia's transition to a market economy. Because HIID had already gained experience working in Russia and USAID's assistance program in that country was in its early stages, USAID decided to award HIID a cooperative agreement without competition. GAO found that the noncompetitive award of the agreement was consistent with USAID's guidelines. These guidelines allow such awards when the recipient has exclusive or predominant capability based on an existing relationship with a cooperating country.

USAID initially provided $2.1 million in funding for the agreement. USAID amended the agreement nine times by September 1995, five of which increased funding to a total of $40.4 million. The largest single increase was $20 million provided in 1994 for a legal reform project. USAID considered holding a competition for award of a separate agreement for the legal reform project because, by that time, at least one other U.S. organization was providing legal reform assistance in Russia. However, as allowed by its guidelines, USAID instead decided to amend HIID's 1992 agreement and included this project based on HIID's existing relationship with Russian reformers.

In March 1995, USAID issued a request for applications to provide "Impartial Oversight and Strategic Guidance for Privatization and Market Reform

Programs" in Russia, Ukraine, and Central Asia. USAID planned to award four separate agreements as a result of the competition—one for assistance to the RPC, one for assistance on capital markets to the Russian SEC, one for assistance in Central Asia, and one for assistance in Ukraine. USAID awarded only two agreements, one to HIID for $17.4 million for work with the RPC and one to the University of Wisconsin for work in Central Asia. While proposals were received for the Russian SEC project and being prepared for the Ukraine project, USAID canceled the portions of the request pertaining to those projects.

The portion of the request pertaining to the Russian SEC was canceled because the Director of that organization refused to accept the indicated winner of the competition. The Ukraine portion was canceled because funds were limited, and the Ukrainian government was not interested in receiving the technical assistance at that time.

GAO found that USAID used erroneous scores to select the winning proposal for the Russian SEC project. Ultimately, the Russian SEC rejected the selected proposal, and USAID did not award a cooperative agreement for the project. In September 1995, USAID/Moscow amended the existing cooperative agreement to provide $1.7 million to HIID. The amendment allowed HIID to pay the expenses of the Russian Resource Secretariat (the intellectual facility for the Russian SEC) that would have been covered in the rejected cooperative agreement.

The Ukraine portion of the request was withdrawn in May 1995 before proposals were submitted. In July 1995, HIID submitted an unsolicited proposal to USAID to provide macroeconomic policy advice to the government of Ukraine. This proposal was modified in August and October 1995 and at that time had an estimated budget of $6 million. After questions were raised by the House Committee on International Relations in April 1996, the proposal was again modified, and in May 1996 USAID awarded a cooperative agreement for $1.5 million to HIID. The award was for a scaled-back version of the $6-million October 1995 proposal. The noncompetitive award was made under the authority of USAID guidelines. These guidelines provide that competition is not required for "circumstances determined to be critical to the objectives of the foreign assistance program." Because high-level Ukrainian officials specifically requested HIID assistance, GAO has no legal basis to question USAID's determination that foreign policy considerations justified awarding HIID a cooperative agreement without competition. However, GAO observed that

some proposed HIID activities may duplicate work being performed by others.

Mixed Progress on Key Features of an Efficient Capital Market

Russia, with support and assistance from HIID and other U.S. entities, has made substantial progress in establishing some key features of a functioning, efficient capital market. These accomplishments include developing a Russian SEC and a Resource Secretariat for technical assistance, a stock trading system, and a self-regulating organization for market participants (dealers and brokers). However, implementation of some other aspects of the capital market infrastructure projects, such as CSOs, have met with considerable resistance. Most of USAID's infrastructure efforts will end in late 1996. USAID had hoped that by then the necessary laws and institutions would be substantially in place, but this now appears unlikely.

HIID's Role in Establishing a Capital Market

The cooperative agreement between HIID and USAID gave HIID responsibility for guiding the effort to develop a capital market. This included working with the newly created Russian SEC to establish its independence and to devise the necessary capital market infrastructure, including a self-regulatory organization, independent stock registers, and CSOs.

Under the HIID cooperative agreement, HIID worked with the Russian SEC on its regulatory and infrastructure projects. In addition, HIID long-term advisors and short-term specialists assisted with monitoring the performance of U.S. contractors to identify and implement capital market activities.

Development of the Russian Resource Secretariat

During the summer of 1994, in anticipation of the creation of the Russian SEC, USAID began to fund a Resource Secretariat. The idea was to consolidate all technical assistance to the Russian capital market development effort under a single organization led by experienced professionals. The Resource Secretariat was created through the assistance of HIID and USAID contractors. Specifically, HIID provided executives, coordinated the work of U.S. contractors and their subcontractors—who created the administrative and organizational component of the Resource Secretariat—and implemented various infrastructure projects. USAID has provided about $15.6 million in support of the Resource Secretariat and the establishment of the Russian SEC,

including $13.9 million to U.S. contractors and $1.7 million to HIID, as of May 1996.[4]

Progress in Organizing the Russian Trading System

U.S. consultants assisting in the development of a Russian capital market proposed to USAID in December 1993 that the market's evolution might best be advanced by organizing dealers into self-regulatory organizations largely patterned on the U.S. market. The task orders issued by USAID for implementing this Russian trading system amounted to approximately $15 million.

As of October 1996, there were 328 members of the broker self-regulating organization that owns the trading system, of which 215 have trading system terminals in their offices. The broker organization now has members in 39 cities, and in 24 of these cities, members have access to the trading system. According to HIID, most of the 15 cities where brokers do not have access will be connected by the end of the year by U.S. consulting firm Klynveld, Peat, Marwick, Goerdeler (KPMG)/Barents under its task order. Over 100 company stock issues are listed on the system, and roughly 40 to 50 percent of the over-the-counter trading in Moscow flows through it. The Russian trading system no longer receives assistance and is operated by the market participants on a self-financing basis.

Efforts to Develop CSOs Were Disappointing

Market participants generally believed that a national registry company and a CSO were needed. The CSO project was to be the centerpiece of HIID's infrastructure effort, with a potential impact on stock registrars, dealers and brokers, the Russian central bank, foreign and domestic banks, the tax inspectorate, and others. USAID's cost for this effort was estimated at $14 million. In mid-1993, a project under HIID's direction got under way to create five CSOs. By late 1994, CSO in Moscow, Ekaterinburg, Novorsibirsk, St. Petersburg, and Vladivostok had emerged. Each CSO evolved from an existing stock exchange and was owned and controlled by the exchange and the market participant. As of mid-1996, only the Vladivostok stock exchange was active. However, trading was limited to 30 transactions a day, and the CSO for Moscow was disintegrating. USAID, HIID, U.S. contractors, and market participants cited unfavorable market conditions, discouraging tax laws, and political power struggles as reasons for the disappointing outcome.

[4]The $1.7 million was approved in September 1995 to pay the cost of Russians working for the Resource Secretariat. The amount does not include the cost of the executive management positions paid through HIID's cooperative agreement that were categorized as "policy advice."

Status of the Russian SEC

The following events highlight the ongoing nature of the struggle for lasting reform. On April 22, 1996, Russian President Boris Yeltsin signed a comprehensive law "On the Securities Market" that established a structure for market regulation by the Russian SEC. The underlying concepts and the vision for the regulated capital market contained in the law are a direct result of HIID's support of the Resource Secretariat and the Russian SEC.[5] Although the Russian SEC seemed to be progressing as planned, in August 1996, President Yeltsin signed a decree that downgraded the status of the Russian SEC from a ministry to a state committee with an unclear mandate and no appointed Chairman. Reports from Moscow indicated that Russian stock market participants were surprised and dismayed by this move. Less than 1 month later, the action taken in the August 14 decree was at least partially reversed in a decree of the President "On the System of Federal Executive Agencies," dated September 6, 1996. The Russian SEC was upgraded but moved from subordination to the Ministry of Finance to the presidential structure.

It is unclear whether the Russian SEC has the resources to fulfill its responsibilities. Market participants told us that fulfilling the Russian SEC's considerable responsibilities will require a significant enlargement of its staff and budget.

HIID's Role in Legal Reform

Since 1992, Russia has privatized 15,000 medium and large-scale state-owned enterprises and allowed private ventures but has lacked economic and commercial laws to underpin these developments. Under a cooperative agreement, HIID provided expert advice and drafting assistance on legislation; established a core group of long- and short-term resident legal advisors; helped create ILBE to carry out a legal reform project after USAID ends its assistance; and helped Russia obtain funding from the World Bank for continued legal reform, among other accomplishments.

HIID's work plan for the legal reform effort states that, among other things, it was to provide commentary, expert advice, and drafting assistance on 19 pieces of legislation. Of the nine laws that were passed, HIID was the principal drafter of three; for three others, it served either as co-drafter or provided comments.[6] These laws are significant accomplishments and include rules on securities, joint stock companies, and advertising.

[5]The reform of the capital markets has involved not only HIID, but also substantial input by the New York Stock Exchange, the U.S. SEC, and the Federal Reserve.

[6]HIID participated in work on seven additional laws that were passed but were not part of HIID's original work plan.

The majority of laws USAID hoped that the parliament would have passed by the end of 1996 have not been enacted. Confronted with the possibility that none of the remaining legislation would come to fruition because of political opposition to reform legislation, HIID began to place more emphasis on working with the executive branch to have decrees promulgated rather than on the enactment of legislation.

HIID conducted this project with minimal oversight from USAID. GAO found that USAID did not always enforce the reporting requirements contained in the cooperative agreement, did not set measurable goals, and was not aware of decisions HIID was making that could have resulted in added cost to the government or significantly affected U.S. strategy. HIID at first submitted quarterly reports rather than the monthly reviews that were specified. USAID officials in Washington, D.C., questioned the completeness of the data in the reports that were submitted. For example, no information was provided on how specific HIID projects were related to the overall goals of the legal reform program. HIID started work on part of the legal reform effort before it received USAID approval, and in so doing became involved in work being performed by another USAID-funded organization. This may have resulted in some unnecessary costs being incurred.

Sustainability of Privatization Centers Questionable

HIID helped establish the RPC and oversaw the work of the contractors who developed the RPC accounting system, located its office space, and recruited its personnel. After September 1994, the responsibility for RPC financial oversight shifted from HIID to the USAID mission in Moscow. Although USAID then gave a direct grant to the RPC to cover its operating expenses, HIID remained engaged by recruiting and paying the salaries of expatriates who held important positions such as the Chief Financial Officer, the Chief Procurement Officer, the Press Secretary, and a number of project associates.

Following the completion of Russia's privatization of most state-owned enterprises in June 1994, USAID focused on using the RPC and LPCs to help (1) USAID work with newly privatized firms on the difficult process of restructuring and (2) devise procedures for land reform. U.S. contractors working with the RPC helped some Russian firms successfully complete enterprise restructuring. For example, some of the enterprises reduced labor costs by streamlining operations and lowered other expenditures by revising procurement procedures.

The largest USAID-sponsored land reform project was to create a real estate information system in selected municipalities. Five of the nine cities in which the project was implemented rejected the system offered by the contractors and worked on developing another version. The RPC was responsible for facilitating negotiations among local agencies to unify into a single database the information each was maintaining, such as data on land, structures on the land, and housing. However, in a number of cases, because the negotiations became protracted, this project did not meet its objectives.

USAID informed GAO in November 1996 that the RPC had successfully implemented on a fee basis a series of consulting seminars using materials developed by the Financial Management Assistance program and Program for Intensive Enterprise Support contractors. However, according to USAID, the development of LPC staff skills has been uneven, and it is not clear whether all LPCs could successfully offer the existing consulting materials. Moreover, U.S. contractors also were unsure to what extent the RPC could provide consulting services without support from private expatriates and independent contractors. While financial support from the World Bank will be provided, Bank funds are not expected to fully meet the RPC network's operating costs.

HIID and Agency Comments

USAID and HIID generally agreed with GAO's findings related to the award of the cooperative agreement to HIID and GAO's assessment of HIID's role and accomplishments. USAID noted that although GAO had no recommendations in this report, it planned to review existing policy regarding amendments to noncompetitive agreements and improve the management and oversight of the grantee with respect to reporting requirements, establishment of measurable goals, performance monitoring, and results evaluation. Officials from the Department of the Treasury said that they had no comments on the report. The Department of State commented that HIID's preexisting relationship with Russian reformers may have been adequate reason for the selection of HIID in the past, but given the large number of specialists with substantial experience in the Russian market who are currently available, this will be a less likely rationale for sole-source selection in the future. State also commented that GAO's report generally appears to give a good deal of credit to HIID for endeavors that had a number of contributors.

Contents

Tables

Abbreviations

CSFB	Credit Suisse First Boston Bank
CSO	clearing and settlement organization
DCC	Depository Clearance Company
ELS	Enterprise Land Sales project
FMA	Financial Management Assistance program
FSU	former Soviet Union
GKI	State Committee of the Russian Federation for the Management of the State Property
GPU	State Legal Administration of the Office of the President of the Russian Federation
HIID	Harvard Institute for International Development
ILBE	Institute for Law-Based Economy
IRIS	Institutional Reform and the Informal Sector (University of Maryland Center)
KPMG	Klynveld, Peat, Marwick, Goerdeler
LPC	local privatization center
NAUFOR	National Association of Professional Market Participants
Nasdaq	National Association of Securities Dealers Automated Quotation system
NBU	National Bank of Ukraine
NIS	newly independent states (of the former Soviet Union)
NSC	National Security Council
NRC	National Registry Company
OTC	over the counter
PAUFOR	Professional Association of Market Participants
PIES	Program for Intensive Enterprise Support
REIS	Real Estate Information Systems
RDI	Rural Development Institute
RPC	Russian Privatization Center
SEC	Securities and Exchange Commission
SRI	Stanford Research Institute
USAID	U.S. Agency for International Development

Introduction

The changes that swept the Soviet Union starting in 1989 were enormous, unprecedented, and unexpected. Almost overnight, Russia and the other newly independent states (NIS) began the process of transforming from communist, state-controlled economic and political systems—systems that were for almost a century in competition with those espoused by the United States—into market systems.

In December 1990, the United States began providing limited assistance to the Soviet Union to support its reform effort; after the Soviet Union dissolved in December 1991, the United States increased this aid. In October 1992, Congress enacted the Freedom for Russia and the Emerging Eurasian Democracies and Open Market Support Act of 1992, commonly known as the "Freedom Support Act." This act set forth the broad policy outline for helping the NIS that were part of the former Soviet Union (FSU) carry out both political and economic reforms. It authorized a bilateral assistance program that is being implemented primarily by the U.S. Agency for International Development (USAID). As of September 1996, USAID reported obligations of $1.6 billion and expenditures of $1.2 billion for programs and projects in Russia.

The act also established a coordinator within the State Department who, among other things, was responsible for developing a strategic plan for providing such assistance. The core objectives of the approved strategy for Russia were to (1) help Russia make the transition to a market economy, (2) support the conversion to a democratic political system, and (3) ease the human cost associated with the transition. The strategy document recognized that only Russian reformers could make Russia's transition a success but that the United States could support the effort. It also recognized that the success of the reforms within Russia would have far-reaching consequences for the United States. A democratic, market-oriented, stable Russia could be a constructive partner on a wide range of global issues. The benefits to the United States could include reduced defense requirements as well as expanded opportunities to market U.S. goods and services to a country of 150 million people. Conversely, a Russia in political and economic turmoil would have the potential to destabilize the region and adversely affect a variety of U.S. interests.

Although USAID is the lead U.S. agency for providing transition assistance to Russia, its approach to providing aid is to seek out U.S. private firms or organizations to provide most of the economic, business, and financial advice. The United States had to reach agreement with Russian and

Ukrainian officials on the timing and nature of the assistance. Given their assessment of the situation, U.S. executive branch officials believed that they had a narrow window of opportunity to provide assistance to Russia. This was reiterated in the U.S. strategy for assistance to Russia, which set a goal of accomplishing several major reforms by the end of 1996. These included establishing capital markets, developing a free market legal system, and privatizing Russian enterprises.

USAID's Use of the Harvard Institute for International Development

The aforementioned conditions presented the United States with a major set of challenges. USAID admittedly did not have the in-house capacity to accomplish the task at hand owing to the political-strategic confrontation of the past decades and the uniqueness of the transitioning command economies to market basis. Before USAID's program began, the Harvard Institute for International Development (HIID) had been working with the top echelon of Russian President Boris Yeltsin's key economic reformers. HIID's ongoing work in Russia offered USAID an opportunity to support the economic reform work already under way and to have access to reformers within the Yeltsin government.

USAID decided to fund HIID through a cooperative agreement[1] for support of reformers' efforts in privatization, legal reform, and capital markets. This led to an oversight and management structure that did not follow the traditional pattern. The approach that was settled on resulted in HIID's having substantial control over the U.S. assistance program. In particular, the traditional project management approach that USAID normally employs was not in place for Russia's economic restructuring activities. Instead, HIID served in an oversight role for a substantial portion of the Russian assistance program. Appendix I graphically depicts this structure.

Since 1992, USAID has amended its initial cooperative agreement with HIID nine times, the completion date has been extended to August 1997, and the value of the agreement has grown from $2.1 million to $40.4 million. These amendments have expanded HIID's role from providing strategic policy oversight, primarily to the State Committee of the Russian Federation for the Management of the State Property (GKI), to establishing the Russian Privatization Center (RPC), assisting in drafting commercial laws channeled through the State Legal Administration of the Office of the President of the Russian Federation (the Russian President's Legal Advisor [GPU]), and

[1]A cooperative agreement is a funding mechanism used by a federal agency to transfer funds to an organization to support an agency program. Applicable laws and regulations impose only minimal requirements that agencies must follow when selecting recipients and awarding cooperative agreements.

providing support to the Russian Securities and Exchange Commission (SEC). In each of these areas, HIID helped establish Russian institutions to participate in the reform process and managed enterprise restructuring and land reform projects implemented by other U.S. contractors. The reformers associated with HIID have had a leadership role in these new institutes. In addition to the cooperative agreement with HIID, USAID made a direct grant of $16.5 million to RPC to support its work.

To foster competition for work in the FSU, on March 17, 1995, USAID requested proposals from applicants to provide impartial oversight and strategic guidance for privatization and market reform programs. USAID intended to award four cooperative agreements under the proposals: one for western NIS countries, including Ukraine, one for the Central Asian republics, and two for work in Russia—one to assist the RPC and another to assist the Russian SEC. The University of Wisconsin was awarded the cooperative agreement for Central Asia, and HIID was awarded a cooperative agreement for work to assist the RPC and to assist USAID with the overall coordination, management, and monitoring of different contractors and initiatives. Awards were not made for assistance to the Russian SEC or to Ukraine. HIID subsequently submitted an unsolicited proposal to provide assistance to Ukraine and was awarded a $1.5-million noncompetitive cooperative agreement for this purpose.

USAID Used HIID to Help Manage Other Contractors

In addition to assistance provided to Russia directly by HIID, HIID also helped USAID to manage and oversee contractors such as Arthur Andersen; Deloitte & Touche; Price Waterhouse; Klynveld, Peat, Marwick, Goerdeler (KPMG)/Peat Marwick; and several other consulting firms. The U.S. contractors were paid by USAID, not HIID. This arrangement required strong managerial skill and a high level of coordination. As shown in table 1.1, the total value of USAID's obligations for 1992-96 for the Russian privatization program as of May 10, 1996, amounted to about $325 million, including approximately $40 million for HIID.

Table 1.1: Summary of USAID's Russian Privatization Program Funding Obligations, Fiscal Years 1992-96 (as of May 10, 1996)

Program	USAID obligations
Mass privatization	$58,324,607
Land and real estate reform	62,626,116
Capital market development	77,189,912
Post-privatization activities	71,559,346
Policy, legal, and regulatory reforms[a]	39,103,676
Other[b]	16,436,643
Total	**$325,240,300**

[a]HIID received $36.1 million of its funding through this line item.

[b]"Other" consists of miscellaneous privatization projects.

Source: USAID.

Objectives, Scope, and Methodology

Concerned about the noncompetitive nature of the awards made to HIID and HIID's effectiveness, the Chairman of the House Committee on International Relations asked us to review HIID's work. Specifically, we assessed (1) how USAID awarded assistance agreements to HIID to carry out work in Russia and Ukraine and (2) HIID's role and accomplishments in implementing assistance agreements to (a) develop a Russian capital market[2] and (b) devise a legal reform program. We also assessed the effectiveness of the RPC in implementing USAID post-privatization and land reform projects. Finally, in response to the specific questions by the Committee, we provide a chronology of events regarding the noncompetitive award to HIID for work in Ukraine and a summary of what knowledge Ukrainian officials had about the project. This information is provided in appendix II of this report.

To review the basis for noncompetitively awarding HIID's first cooperative agreement in Russia, a subsequent $20-million legal reform amendment, and the noncompetitive award for work in Ukraine to HIID, we analyzed USAID guidelines, relevant files, and documents; interviewed USAID, Department of State, Department of the Treasury, and National Security Council officials; and officials representing the University of Maryland, the Russian Research Center for Private Law, HIID, and the government of Russia.

[2]Capital markets consist of private institutions, technology, and regulatory structures needed to facilitate the orderly and cost-effective execution of transactions for corporate securities such as stocks and bonds.

To evaluate whether the HIID proposal for work in Ukraine duplicated the work of other assistance providers, we reviewed files of the USAID mission in Ukraine; analyzed the HIID proposals; and interviewed officials from Ukrainian ministries, U.S. contractors, the International Monetary Fund, the U.S. Department of the Treasury, and other international assistance providers.

In reviewing USAID's management of the 1995 competition, we analyzed the competition files and other relevant documents; and interviewed members of the evaluation panel, the USAID Procurement Officer, other USAID officials, and government of Russia officials responsible for the rejection of the winning proposal for the Russian SEC portion of the request for proposals.

To assess HIID's role and accomplishments in the development of the capital market, we focused on the effort to establish an independent Russian SEC and the necessary capital market infrastructure. We interviewed officials from HIID, USAID, the Institute for Law-Based Economy (ILBE), USAID's implementing contractors, capital market participants, U.S. embassy economic section staff in Moscow, the New York Stock Exchange, the U.S. SEC, and international financial institutions, including the World Bank. We reviewed USAID, HIID, and contractor files, including task orders and work plans.

To assess HIID's role and accomplishments in the legal reform program, we reviewed USAID and Department of State justification documents to establish the goals of the program; discussed the program with the U.S. Ambassador to Russia, the USAID/Moscow Director, and HIID/Russia's General Manager, the HIID/Moscow General Manager, law firms specializing in commercial reform in Moscow, World Bank representatives, other contractors working in the legal reform area, the Director of the Russian Research Center for Private Law, officials from the University of Maryland who had worked on the Russian Civil Code, members of the Russian parliament, and other relevant officials; and reviewed work plans, HIID progress reports, HIID reports prepared specifically for our review, and other USAID documents.

To determine the results of HIID's and USAID's assistance to the RPC, we interviewed representatives from the RPC's Moscow office, including the Chief Executive Officer, the HIID-supported Chief Financial Officer, the Chief Legal Advisor, the Press Secretary, and project associates. We also interviewed USAID contractors responsible for implementing USAID-funded

technical assistance projects in enterprise restructuring and land reform and the USAID representatives responsible for overseeing these projects. We also reviewed project status and completion reports prepared by USAID contractors and USAID.

In addition to our work in Moscow, we performed site visits to St. Petersburg, Tver, and Vladimir. At each location, we interviewed representatives of the local privatization centers (LPC), local government administrations, and recipients of USAID-funded technical assistance. Also, we interviewed representatives from HIID's headquarters in Cambridge, Massachusetts.

The Rural Development Institute (RDI), a HIID contractor working in the area of land reform, did not allow us to interview its Russian contacts; consequently, we were limited in our evaluation of RDI's contribution to the process of developing land reform legislation in Russia in that we could not obtain a Russian perspective on RDI's activities. HIID stated that RDI's contacts were sensitive, because they had been developed with a commitment to confidentiality.

The information on foreign laws in this report does not reflect our independent legal analysis but is based on interviews and secondary sources.

We conducted our work from March 1996 to October 1996 in accordance with generally accepted government auditing standards.

The Departments of State and the Treasury, USAID, and HIID were provided an opportunity to comment on this report. Treasury officials told us that they had no comments on the report. USAID, HIID, and the Department of State provided detailed comments that are discussed in the appropriate chapters of this report. Their comments are reprinted in appendixes IV, V, and VI, respectively.

USAID's Award of Cooperative Agreements

USAID used noncompetitively as well as competitively awarded cooperative agreements to fund HIID activities in Russia and Ukraine. We looked at a December 1992 noncompetitive award for work in Russia, a competition held under a request for applications issued in March 1995, and a May 1996 noncompetitive award for work in Ukraine.

By virtue of its early and extensive work in advising the Russian reformers, HIID had developed experience, expertise, and a system of contacts within the Russian government. We found that USAID's awards to HIID reflected the relationship it had established with Russian officials and that the awards were consistent with applicable laws and USAID guidelines. While USAID guidelines encourage competition, they recognize several broad exceptions to the competition requirement, allowing noncompetitive awards based on factors such as a recipient's relationship with a foreign country and the promotion of foreign policy objectives.

We found that, in conducting the 1995 competition, USAID used erroneous scores to select one of the winning proposals. With respect to the 1996 award for work in Ukraine, we found no legal basis to question USAID's decision to award HIID a cooperative agreement without competition for foreign policy reasons. However, we observed that some of HIID's activities may duplicate work being performed by other assistance providers.

Minimal Requirements for Award of Cooperative Agreements

A cooperative agreement is a funding mechanism that a federal agency uses to transfer funds to a public or private organization to support an agency program. Agencies often use cooperative agreements when they plan on being substantially involved in the management of the project being funded. The agreement defines the agency's relationship with the recipient. Unlike acquisition of goods or services by contract, cooperative agreements are often used to define project goals and determine the best approach for achieving them. Because of the need for flexibility, applicable laws and regulations impose only minimal requirements with respect to the procedures agencies must follow when selecting recipients and awarding cooperative agreements.

The Federal Grant and Cooperative Agreement Act of 1977 (31 U.S.C. 6301) establishes criteria for selecting the appropriate funding instrument—procurement contract, grant, or cooperative agreement—for a particular activity. The act requires agencies, in awarding cooperative agreements, to "encourage competition, where deemed appropriate."[1]

[1]31 U.S.C. 6301(3).

Likewise, USAID's guidelines "encourage" competition in the selection process. However, the guidelines describe a number of circumstances where competition is not required.[2] For example, competition is not required for (1) unsolicited proposals, (2) awards where one recipient has exclusive or predominant capability based on an existing relationship with the cooperating country, (3) follow-on awards that continue an existing assistance relationship, or (4) such other circumstances determined to be critical to the objectives of the foreign assistance program (the "foreign policy" exception).[3]

1992 Noncompetitive Award of First HIID Cooperative Agreement

In October 1992, HIID submitted a proposal to USAID seeking funding to provide technical assistance to Russia. The proposal focused primarily on support for Russia's privatization efforts. At the time, USAID's assistance program in Russia was in its early stages. HIID officials already had experience working with Russian reformers and had provided substantial technical assistance in establishing Russian institutions designed to sustain economic reforms.

Since USAID believed there was an urgent need to begin U.S. support for Russia's privatization efforts and to coordinate western donors and contractors, it decided to award HIID a cooperative agreement without competition based on the expertise and relationships HIID had developed in Russia. Under USAID guidelines, competition is not required when the recipient is considered to have exclusive or predominant capability based on an existing relationship with the cooperating country.[4] Therefore, in our view, the award was consistent with USAID guidelines.

USAID initially provided $2.1 million in funding for the agreement. The agreement was amended nine times; five of the amendments increased funding for the agreement with HIID. By September 1995, funding for the agreement totaled $40.4 million. The largest single increase in funding was a noncompetitive amendment executed in July 1994 that provided $20 million for a legal reform project. The purpose of the project was to support a newly formed coordinating committee on law drafting, chaired by the head of GPU and composed of representatives from GPU, the Duma (the lower house of the Russian parliament), and the Federation Council (the upper house of parliament). The amendment increased funding for

[2]USAID Handbook 13, chapter 2, "Selection of Recipients."

[3]USAID Handbook 13, chapter 2B(3).

[4]USAID Handbook 13, chapter 2B(3)(b).

HIID's agreement from $15.6 million to $35.6 million and extended the completion date from August 1995 to August 1997.[5]

By the time of the amendment, USAID's legal reform efforts in Russia were expanding and other USAID recipients were providing technical assistance to Russian institutions. For example, the University of Maryland's Center for Institutional Reform and the Informal Sector (IRIS), another organization that had received USAID funding, was also doing legal reform work in Russia.

In view of the fact that another organization was by now providing this type of assistance to Russia, USAID considered conducting a competition. Nevertheless, USAID decided to amend HIID's existing agreement, justifying the amendment based on HIID's having an exclusive or predominant capability due to its existing relationship with Russian officials. The USAID/Moscow Director also noted that the decision to continue HIID's work was supported by foreign policy considerations and endorsed by the State Department's NIS Coordinator's Office, the National Security Council, the Department of the Treasury, the Office of Management and Budget, and the USAID Assistant Administrator for Management.

In support of its determination to award the amendment, USAID explained that HIID had a unique advantage to carry out the legal reform program because HIID's assistance had been requested by GPU as a direct outgrowth of its ongoing program. Specifically, USAID found that HIID had developed a "deep relationship of trust" with the Russian reformers involved in the project and that it had a unique track record in providing policy advice in Russian reform efforts. USAID characterized GPU as the primary legal counsel to the Russian President.

According to IRIS documentation, IRIS challenged USAID's characterization of GPU as the Russian President's chief legal advisor. According to IRIS, President Yeltsin also sought legal advice from a broad group of individuals and entities, including other members of the Presidential Council, the Ministry of Justice, and the Chairman of the Research Center for Private Law. In fact, according to IRIS, the Research Center was primarily responsible for developing an important portion of Russia's new Civil Code, with assistance from representatives of the Office of the President and Prime Minister, the Ministry of Justice, the judiciary, the

[5]The other amendments that USAID made to the cooperative agreement were smaller. Under USAID Handbook 13, chapter 2B(3)(c), competition is not required for amendments to existing assistance agreements.

parliament, and the academic community. According to IRIS, this work was accomplished despite initial opposition from GPU.

Whether or not GPU was the President's primary legal advisor, it is clear that GPU was an important force in Russia's legal reform efforts and that it was to play a significant role in the project that formed the basis for the amendment to HIID's agreement. Therefore, we believe that USAID's decision to amend HIID's agreement was reasonably based on HIID's existing relationship with Russian reformers.

1995 Competition Under Request for Applications

On March 17, 1995, USAID issued a request for applications for "Impartial Oversight and Strategic Guidance for Privatization and Market Reform Programs in Russia, West NIS [Ukraine, Moldova, and Belarus], and Central Asia of the Former Soviet Union." USAID planned to award two agreements for assistance to Russia—one for work related to the RPC and one for assistance to the Russian SEC—and one agreement each for work in Ukraine and Central Asia. HIID submitted two proposals—one for assistance related to the RPC and one for assistance related to the Russian SEC.

USAID awarded only two agreements, one to HIID, valued at $17.4 million, for work with the RPC and one to the University of Wisconsin for work in Central Asia. While proposals were received for the Russian SEC project and were being prepared for the Ukraine project, USAID canceled the portions of the request pertaining to those projects.

We found that USAID used erroneous scores to select the winning proposal for the Russian SEC project. Ultimately, the Russian SEC refused to accept the projected winner, and USAID did not award a cooperative agreement for the project. In the meantime, USAID amended HIID's original cooperative agreement and added $1.7 million to cover certain Russian SEC costs through September 1996.

The Ukraine portion of the request was withdrawn before proposals were submitted, based on USAID's determination that funds were limited and that Ukrainian officials were not interested in oversight assistance. In May 1996, USAID awarded HIID a cooperative agreement for work in Ukraine. Because high-level Ukrainian officials specifically requested HIID assistance, we had no basis to question USAID's decision to award HIID a cooperative agreement without competition for foreign policy reasons.

Selection Process for Russian SEC Work

USAID established a committee and developed criteria for evaluating proposals for the RPC, the Russian SEC, and the Central Asia projects. USAID instructed panel members to use the following criteria and weights to evaluate proposals (see table 2.1).

Table 2.1: Criteria and Weights for Proposal Evaluation

Criteria	Weights (percent)
Qualifications and experience of personnel	50
Prior case study	30
Institutional qualifications and experience	20
Total	**100**

USAID also specified that it would "look favorably on applications that minimize the number of expatriate person months, maximize the participation of local indigenous staff and provide the best overall value to the Government, cost and other factors considered."

The evaluation committee was composed of five individuals, including three USAID officials, an RPC representative, and a Russian SEC representative. The committee Chairman was from the USAID project office. Both the RPC and the SEC had been given an invitation to nominate representatives to the selection panel. In late June 1995, the Assistant Administrator for European and NIS Affairs communicated a second invitation to the Russian SEC director. According to USAID and State Department officials involved in this decision, the Russian institutions were allowed to place representatives on the committee because they would be working closely with the winners of the competition. The officials wanted to ensure that the Russian institutions would have a say in and ultimately accept the selection of the organization with which they would be working.

The Director of the RPC nominated a high-level RPC employee. The employee was approved by USAID and named to the committee. The Russian SEC initially nominated an individual employed by Price Waterhouse, but USAID rejected this individual because Price Waterhouse was subject to HIID oversight. The Russian SEC then nominated an individual from the World Bank's International Finance Corporation who had extensive experience working in the Russian capital markets. The Executive Director of the Russian SEC stated that the nominee was very familiar with the content and organization of his programs and plans for the future. USAID approved the nominee. However, because the Russian SEC's second nomination of a representative did not occur until after the

other committee members had completed their evaluations, USAID had to formally reopen the process to allow the Russian SEC representative to conduct her evaluation.[6]

According to the USAID Procurement Officer responsible for conducting the competition, the Russian SEC representative did not follow the instructions for evaluating proposals based on the USAID-developed criteria. Instead, she ranked the eight applicants in descending order, with eight being the highest rating and one the lowest. USAID's Procurement Officer reconciled the Russian SEC representative's ranking with the other committee members' numerical ratings by multiplying each proposal's ranking by the weighted value of the category. For example, he gave the top-ranked proposal an 80 (0.8 x 100 percent). Because most of the panel members had departed Washington, D.C., where the scoring had taken place, the USAID Procurement Officer said he made no effort to reconvene the panel for group analysis or to have the Russian SEC representative correct her scores.

Mathematical Errors in Calculation of Final Scores

We found that the USAID Procurement Officer made several mathematical errors when calculating the final panel's scores for the Russian SEC proposals. According to the official, he made the errors when he transferred committee members' individual scores to his final worksheet. Based on his tally of individual scores, the Procurement Officer calculated that the panel had rated a proposal submitted by the Stanford Research Institute (SRI) the highest. He calculated an average score of 76.7 percent for SRI and 76.4 percent for HIID. Our discussions with the panelists and our review of their individual evaluations disclosed several discrepancies between the panel members' ratings and the ratings recorded by the Procurement Officer. Based on our calculations, the panel members actually gave HIID an average rating of 77.1 and SRI an average rating of 76.08.

The Procurement Officer said that he recommended SRI for award of the Russian SEC cooperative agreement based on the committee ratings, which he acknowledges were incorrect. According to USAID officials, when USAID informed the Director of the Russian SEC that SRI had been selected for the cooperative agreement to work with his organization, he refused to accept

[6]Because of HIID's close involvement in establishing and operating the RPC and the Russian SEC, questions have been raised concerning the ability of the individuals representing these organizations to fairly and independently evaluate the proposals. For both of these organizations, HIID had provided personnel for key managerial positions, and each organization strongly supported HIID's work. However, each representative certified in writing that he or she had no conflicts of interest.

SRI. Consequently, USAID chose not to award a cooperative agreement for the Russian SEC work.

In September 1995, before SRI was notified that the Russian SEC portion of the competition had been canceled, USAID/Moscow amended HIID's existing cooperative agreement to provide $1.7 million to HIID to finance 20 Russian professionals for the Russian Resource Secretariat (the Resource Secretariat provided professional advice to the new SEC). The amendment allowed HIID to fund these personnel through September 1996; the cost of operating the Russian Resource Secretariat would have been covered in the rejected cooperative agreement.

1996 Noncompetitive Award of Cooperative Agreement for Ukraine

The March 17, 1995, request for applications covered assistance in the western NIS, including Ukraine, Moldova, and Belarus. The request was for impartial oversight and strategic advice for privatization and market reform programs. On May 23, 1995, USAID decided not to award a cooperative agreement for assistance to Ukraine and withdrew that portion of the request.[7] According to the USAID/Kiev Director, the decision to withdraw the request was made because of limited funds and because Ukrainian officials had indicated they were not interested in oversight assistance.

In July 1995, HIID submitted an unsolicited proposal to USAID for a project to provide macroeconomic policy advice to the government of Ukraine. The proposal was modified in August and October 1995 and at that time had an estimated budget of $6 million. In April 1996, after the House Committee on International Relations raised concerns about the proposed agreement, HIID submitted a scaled-back proposal that had three components: advice on macroeconomic and monetary policies, tax and budget assistance, and advice on reforming Ukraine's pension program. In May 1996, USAID decided to award without competition a cooperative agreement for $1.5 million, based on HIID's scaled-back proposal. The noncompetitive award was made under the authority provided in USAID Handbook 13, chapter 2, paragraph 2B3e, which states that competition is not required for "circumstances determined to be critical to the objectives of the foreign assistance program by the cognizant [Assistant Administrator]." According to USAID, earlier attempts to provide policy advice to Ukraine through the competitive process had been rejected by the Ukrainian government, which had a generally negative view of foreign

[7]HIID had decided not to submit a proposal for Ukraine pursuant to the March 17, 1995, request.

advisors. However, Ukrainian officials subsequently specifically requested assistance and macroeconomic advice from HIID.

On March 26, 1996, the Assistant Administrator determined that the award would be made without competition based on foreign policy considerations.[8] The award was also approved by a representative from the State Department's Coordinator for Assistance to the FSU, a representative from the Treasury Department, and a representative from the National Security Council. The justification for the award provided the following:

"It is squarely in the interest of the United States for Ukraine to implement its reform programs successfully, and high-level strategic advice will clearly serve as a critical catalyst at this juncture. Thus, it behooves USAID to be responsive to the [government of Ukraine] request for HIID's assistance, which will enable strategic policy advisors, who specialize in transition economies, to help shore up the [government of Ukraine's] political will and provide them with the technical expertise to formulate and implement appropriate policies. Earlier attempts to provide economic policy advice through a competitive Request for Applications process was specifically rejected by the [government of Ukraine] because at the time, they did not perceive the need for technical assistance that they now acknowledge."

Because high-level Ukrainian officials specifically requested HIID assistance, we have no legal basis to question USAID's determination that foreign policy considerations justified awarding HIID a cooperative agreement without competition.

Potential Duplication of Ongoing Work

The USAID mission in Kiev observed that the tax components of HIID's proposal would largely duplicate and quite possibly delay work already being done by a U.S. Treasury advisor and others. The mission also noted that HIID's proposal would likely duplicate work being done by the International Monetary Fund for the National Bank of Ukraine in areas of foreign exchange and credit policies. This concern was also raised by the Fund representative in Kiev in July 1996. The USAID mission also concluded that despite some deficiencies with a German-sponsored program in the area of pension reform, HIID's proposal would be counterproductive to this effort and the project would have to begin all over again.

[8]The head of USAID's privatization/economic reform office noted that the HIID proposal might in some respects duplicate work under the request for applications, and we note that both HIID and the request sought to provide advice and assistance in reforming Ukraine's tax law. While the USAID official believes that the work should have been competed, she recognized that the Assistant Administrator had authority to make an award to HIID based on foreign policy considerations.

The May 24, 1996, cooperative agreement with HIID awarded on the basis of foreign policy considerations recognized these potential areas of duplication and made reference to the need for HIID to coordinate with other assistance providers.

Agency Comments

In commenting on this report, USAID generally agreed with our findings that these awards were consistent with applicable laws and its guidelines. USAID also stated that although we made no recommendations, it planned to review existing policy regarding amendments to noncompetitive agreements.

The Department of State noted that while HIID's preexisting relationship with Russian reformers may have been adequate for the selection of HIID in the past, "an explosion in the numbers of economic specialists and of Americans, with business and academic backgrounds with substantial experience in the Russian market, would make this a less likely rationale for 'sole source' selection in the future."

Russian Progress Toward Developing an Efficient Capital Market

USAID and HIID agreed early on that a well-functioning, efficient capital market was critical to Russia's successful transition to a market economy. Russia needed an efficient system to (1) raise capital; (2) facilitate the selling and registration of shares; and (3) provide reliable information to potential investors, among other things. Between fiscal years 1992 and 1996, USAID provided $77.2 million for the capital market development effort, mostly through consultant organizations such as Booz Allen, Burson Marsteller, Arthur Andersen, KPMG/Peat Marwick, Ian Freed Consulting, Price Waterhouse, and Deloitte & Touche. HIID's role was to provide strategic guidance to the capital market development effort, including helping to coordinate and provide impartial oversight over the consultant contractors that gave technical assistance to Russian institutions.

With the assistance of HIID and other U.S. contractors, Russia has made significant progress in developing a capital market. A key factor in this progress was HIID's assistance in creating an organization to consolidate technical aid to the Russian capital market. To date, Russia has established (1) an SEC, (2) a national company for registering trades, (3) a stock trading system, and (4) a self-regulatory organization for market participants. However, the goal of establishing an efficient, well-functioning capital market has encountered a number of problems, including recent political maneuvering to downgrade the Russian SEC's status and autonomy. These efforts, although ultimately unsuccessful, created uncertainty about its future role. Furthermore, plans for a national system of clearing and settlement organizations (CSO) needed to facilitate the settlement of transactions have not been fully realized.

According to HIID, the threats to capital market development have been real and serious. HIID's resident General Director stated that over the last 2 years, many parties have been interested in an aggressive bureaucratic intervention to prevent market mechanisms from functioning normally. Thus, the future of the Russian capital market is uncertain at this time.

Condition of Russia's Capital Market When Assistance Began

At the time when USAID began to support this capital market development, Russia was suffering from many of the ills typically associated with the transformation from a state-controlled economy to a market economy. First, the Russian securities market was created by the mass privatization of thousands of state-owned enterprises, which eventually resulted in millions of new shares and share owners.

In addition, the lack of an organized, efficient, and controlled environment for trading securities presented a huge obstacle to the development of a secondary market in Russia.[1] In the absence of a modern trading apparatus, brokers had to physically travel to a company's registrar to ensure that the change in share ownership was entered in the books correctly. Brokers then had the option of carrying suitcases full of cash to close the deal or transferring money through the banking system. This could take weeks or even months—exposing the broker to additional risk. In the interim, the price of the shares purchased could fall or, in the case of a price increase, the seller could decide to back out of the deal in order to retain the gain.

The existing capital market was also highly fragmented and opaque. There was no mandatory listing of shares. Trading occurred principally through informal arrangements among brokers and was conducted almost entirely in the over-the-counter (OTC) markets. Brokers relied on their connections with enterprises to find shares and then set their own prices, which could differ by a huge margin from other sellers'. Most often, information on transactions and prices was not disclosed and, when it was revealed, it was not trustworthy. In most cases, stock certificates were not issued. Instead, ownership was recorded in company ledgers that were not necessarily independent of the actual company they served. These factors encouraged trading activities that were nonstandardized, fragmented, costly, time-consuming and, from an investor's perspective, unreliable.

The absence of organized trading markets also meant that enterprises had few avenues for raising capital through the issuance of shares. Broker syndicates that placed shares in the capital markets were only just beginning to emerge. Moreover, a number of logistical and practical difficulties impeded the sale of shares, particularly on an interregional basis. Therefore, enterprises had to devise their own method of attracting share buyers. Moreover, in the absence of organized capital markets, these enterprises generally found it unnecessary to engage in practices designed to ensure investor confidence. Enterprises did not disclose detailed financial information on a regular basis. Their boards rarely included truly independent directors. And some enterprises deliberately tried to thwart the rights of outside investors.

[1]The marketplace for buyers and sellers of existing securities is called a "secondary market." The most frequently cited example of a secondary market is the New York Stock Exchange, where equities of large U.S. corporations are traded. Secondary markets are often contrasted with primary markets, where newly issued securities are sold to investors.

HIID's Role in Establishing a Capital Market

With the award of the cooperative agreement in December 1992, HIID basically became responsible for guiding the capital market development effort. This included working with the newly created Russian SEC to establish its independence and to develop the necessary capital market infrastructure, including self-regulatory organizations, independent stock registers, and CSOs.

Under the cooperative agreement, HIID was to work with the Russian SEC on its regulatory and infrastructure projects. HIID was to assist in the development of institutional capabilities with respect to regulatory requirements and infrastructure needs and then participate in project design and implementation by helping to (1) design and execute information-gathering tasks, (2) analyze existing needs, (3) determine key concepts for the project, (4) articulate the vision for the projects, and (5) define and carry out the projects. In addition, HIID's long-term advisors and short-term specialists also were responsible for assisting with monitoring contractor performance.

In 1994, HIID, with the assistance of a representative of a senior investment officer from the World Bank's International Finance Corporation, prepared a memorandum on developing a Russian capital market. The memorandum presented some of the choices about the structure of the capital market and made recommendations about possible courses of action to follow. For example, it recommended that the capital market should be regulated through a combination of a self-regulatory organization and a centralized bureaucracy. It also recommended that the market participants be left to choose the trading system that best met their needs. In addition, the memorandum discussed shareholding and settlement structures, share deposits, and custodial services but did not make any recommendations in these areas.

USAID also used "omnibus" contracts[2] to retain the services of U.S. contractors that had the ability to mobilize the resources and expertise needed to identify and implement capital market activities. These contracts required the subsequent approval of task orders and work plans for the purpose of further defining the role the contractor was to perform.

[2]USAID's Europe and NIS Bureau often procured U.S. technical assistance through multipurpose contracts, commonly referred to as "omnibus" contracts. These contracts provided for the performance of activities, many of which needed to be further defined. USAID used the omnibus contracts to retain the services of U.S. companies to mobilize, either in-house or through subcontractors, the resources and expertise needed to identify and implement project activities. The description of work in these contracts was very general.

HIID (working with Russian reformers, contractors, and USAID) helped write these task orders.

Development of the Russian SEC

During the summer of 1994, in anticipation of the creation of a Russian SEC, USAID began to fund a Resource Secretariat through HIID and USAID contractors. The idea was to consolidate all technical assistance to the Russian capital market under a single managerial and coordination structure led by experienced professionals. The objectives of the Resource Secretariat and the Russian SEC were

- to develop the institutions and infrastructure of the Russian securities market,
- to foster self-regulation by market participants, and
- to provide regulatory oversight of the market through self-regulatory organizations.

The Resource Secretariat was created through the assistance of HIID and USAID contractors. Specifically, HIID recruited and, using funds provided by USAID, paid for the salaries of executives in the Resource Secretariat. HIID also coordinated the work of USAID contractors, including consultant and accounting firms, and of their subcontractors. These subcontractors created the administrative and organizational component of the Resource Secretariat and implemented various infrastructure projects. USAID had provided about $15.6 million in support of the Resource Secretariat and the establishment of the Russian SEC, including payments of $13.9 million to U.S. contractors and $1.7 million to HIID, as of May 1996.[3]

In addition to the work performed by the Resource Secretariat, HIID assisted the Russian SEC through HIID's legal reform project. Among other efforts, the legal reform project worked on a draft securities law and provided amendments and refinements to the draft. On April 22, 1996, President Yeltsin signed a comprehensive law "On the Securities Market" that established a structure for market regulation by the Russian SEC. Market participants said that the adoption of this law was a significant milestone. According to USAID and HIID officials, the concepts of the law and the vision of the capital market regulation contained in the law are a direct result of HIID's support of the Resource Secretariat and the Russian SEC.

[3]The $1.7 million was provided by USAID in September 1995 to pay the cost of Russians working for the Resource Secretariat. However, this does not include the funding for the executive management positions funded through HIID's cooperative agreement that HIID accounted for as "policy advice."

Progress on Other Features of an Efficient Capital Market

Russia, with support and assistance from HIID and others,[4] has made substantial progress on some of the key features of a functioning, efficient capital market infrastructure. These accomplishments include developing a Russian SEC, a stock trading system, and a self-regulatory organization for market participants (dealers and brokers). Efforts to establish other infrastructure elements, however, have encountered obstacles. Most of USAID's infrastructure efforts will end in late 1996, by which time USAID had hoped that the necessary laws and institutions would be substantially in place. This now appears unlikely.

The Russian Trading System

HIID provided oversight over the development of the Russian stock trading system. Barents, an economic consulting unit of the accounting firm KPMG/Peat Marwick, was responsible for implementation of the project.

In December 1993, KPMG/Barents proposed to USAID and in February 1994 to the western staff (Resource Secretariat) of the Russian SEC that the market's evolution might best be advanced by organizing dealers in a National Association of Securities Dealers Automated Quotation system (Nasdaq)-style self-regulatory organization. This would be an evolutionary step from their present activities in an informal OTC market. In mid-1994, KPMG/Barents, the Russian SEC, and USAID began to create a national electronic OTC market largely patterned on the U.S. market. The KPMG/Barents' task orders for implementing the Russian trading system and the associated institutional development, paid by USAID, amounted to approximately $15 million from 1992 through 1996.

The project covered the operational costs to "jump-start" the trading system. For example, the contract task order included funds to pay for the salaries of expatriate advisors that provided technical assistance to the self-regulatory organization, covered the operational cost of this organization, and provided computers and software along with the training to establish a telecommunications network that connected Moscow brokers and regional brokers to the trading network. One of the Russian trading system's primary contributions has been in increasing the quality of pricing information.

As of October 1996, there were 328 members of the broker self-regulating organization that owns the trading system, of which 215 have trading system terminals in their offices. The broker organization now has members in 39 cities, and in 24 of these cities, members have access to the

[4]The reform of the capital markets has involved not only HIID but also substantial input by the New York Stock Exchange, the U.S. SEC, and the Federal Reserve.

trading system. According to HIID, most of the 15 cities where brokers do not have access will be connected by the end of the year by KPMG/Barents under its task order. Over 100 company stock issues are listed on the system, and roughly 40 to 50 percent of the OTC trading in Moscow flows through it.[5] The Russian trading system no longer receives assistance and is operated by the market participants on a self-financing basis.

Development of Self-Regulatory Dealer/Broker Organizations

The Russian trading system initiative served as a springboard for the effort to promote professional associations and self-regulatory organizations for brokers and dealers. According to a KPMG/Barents official, KPMG/Barents presented to the State Department Coordinator a proposal to assist in organizing a self-regulatory dealer/broker organization. The KPMG/Barents official believed that there was a need for uniform practices and codes of ethical conduct in the Russian market. Without organized discipline, liquidity and costs suffer, and market activity is impeded. HIID provided general oversight over KPMG/Barents' work as part of its cooperative agreement responsibilities.

As a result of KPMG/Barents' work, a Professional Association of Market Participants (PAUFOR) was established. PAUFOR is the Moscow association of brokers and dealers. A nationwide organization called the National Association of Professional Market Participants (NAUFOR) was also established. It is essentially an umbrella organization of local broker organizations, including PAUFOR, in six regions of the country. The associations are self-regulatory organizations of market participants that develop governance, fair practice rules, trading rules, and compliance and enforcement procedures to help promote fair and trustworthy markets that earn the confidence of investors in Russia and overseas. As of July 1996, the umbrella organization had been active for approximately 1 year.

Market participants, both Russian and foreign, stated that PAUFOR, while still in its infancy, has had a positive effect on market practices and has helped to improve the conditions in Russian capital markets. While the organization is not yet as strong or effective as many would like to see it, market participants we interviewed were generally quite impressed with the progress to date. They said that PAUFOR is gaining members on a fairly steady basis. According to contractor and U.S. officials we interviewed in Moscow, as more and more market participants adhere to PAUFOR's codes and practices, it will become increasingly difficult for "rogue" traders or firms to conduct business in the Russian market.

[5]These statistics were provided by HIID in October 1996.

PAUFOR is operating at close to a break-even level and is increasing in membership at a promising rate, according to KPMG/Barents officials and market participants. Compliance with financial and disclosure requirements is improving, and disciplinary measures are being taken against transgressing firms.

National Registry Company Established to Address Register Problems

HIID recognized that the establishment of reliable stock registrars must be one of the highest priority areas of the Russian SEC. The specific goals of the task order HIID helped prepare for KPMG/Barents were to (1) play a catalytic role in stimulating the creation of one or more third-party registrars capable of providing quality services, on an interregional basis, to large issuers and (2) provide guidance to the registrar industry on legal, regulatory, and operational issues involving such areas as shareholders' entitlements and processing of distributed share transfers.

According to a senior Resource Secretariat official, the concept behind the National Registry Company (NRC) was that Russian companies seeking foreign capital would be compelled to use NRC or a similarly well-conceived and -operated registrar. A centerpiece of the proposal was the participation of very large and visible Russian companies, such as Lukoil, that would serve as examples of significant companies willing to place their company's stock registration with NRC. This was intended to induce other companies to move their registries to the new, or similar, registrars.

Large issuers particularly present problems in the areas of shareholder communications, exercise of voting rights, payment of dividends, rights offerings,[6] and other shareholder entitlements. This is partly because large issuers often have their shares broadly distributed across a number of regions, with transfers occurring in more than one principal location. This introduces significant organizational, processing, and legal and regulatory questions, such as the role of subregistrars and multiple transfer agents.

In February 1994, USAID developed a task order for Deloitte & Touche to assist in the development of a large stock issuer registrar for recording stock ownership. The task order noted that for large issuers (defined as those companies having in excess of 100,000 shareholders) the challenge of obtaining quality services from an independent registrar is considerably greater than for smaller companies.

[6]Rights offerings are the sale of new shares of common stock by distributing stock purchase rights to a firm's existing shareholders.

NRC, a large-issue shareholders' registry designed to conform to international standards for registry activities, was initially capitalized at $10 million by the Bank of New York International Stock Registry Corporation, Nikoil Investment Company (Russia), United Export-Import Bank (Russia), the World Bank's International Finance Corporation, and the European Bank for Reconstruction and Development.

However, as of October 1996, the transfer of the Lukoil register had not been executed. This, among other factors, has led to a certain amount of skepticism on the part of market participants. While they do not doubt that NRC itself will be a responsible and worthwhile organization, the delay in Lukoil's executing the arrangement lowered hopes in the broker community by giving the appearance, at least to some, that the project did not have the momentum necessary to succeed.[7]

However, according to HIID, progress has been made in solidifying the NRC's position. HIID said in October 1996 that NRC has now taken over the registers of 17 Russian companies, all of whom have more than 1,000 shareholders. Five of these companies have more than 10,000 shareholders. HIID said that in September 1996, NRC became the registrar for Norilsk Nickel, the world's largest nickel producer, and that NRC was in the final stages of negotiation for client agreements with an additional five Russian companies, including Lukoil. It said that although the transfer of the Lukoil register has been delayed, Lukoil has publicly reconfirmed its intention to transfer its company register to NRC as soon as its internal corporate reorganization is complete. This should occur by April 1, 1997. Lukoil and NRC are currently finalizing the contract for such a transfer. We have not verified the recent information provided by HIID.

Efforts to Develop CSOs Encountered Obstacles

There was consensus among market participants that a central depository was needed to facilitate the clearing and settlement of transactions. In mid-1993, a project under HIID's direction got under way to create five CSOs. By late 1994, CSOs in Moscow, Ekaterinburg, Novosibirsk, St. Petersburg, and Vladivostok had emerged. Each CSO evolved from an existing stock exchange and was owned and controlled by the exchange and the market participant.

[7]While certain decrees and regulations have been passed in an attempt to improve industrywide registrar practices, many companies are serviced by "pocket" registrars, that is, registrars that they control. This has proven to be a major impediment to secondary trading. Company management is often able to use its relationship with the pocket registrars to get them to refuse to record changes in ownership of shares in order to lessen outsider participation in the firm.

The CSO project was to be a key element of HIID's infrastructure effort, with a potential impact on stock registrars, dealers and brokers, the Russian central bank, foreign and domestic banks, the tax inspectorate, and others. USAID's cost for this effort was $14 million for fiscal years 1992-96.

HIID, through its support of the Resource Secretariat, took an active role in designing and implementing the Moscow CSO, known as the Depository Clearance Company (DCC). The original concept was for DCC to hold stock shares in either the stock owner's name or a nominee's name. It was also to settle stock transactions. The Resource Secretariat's former Executive Director, an HIID employee, devoted considerable time to develop DCC. Moreover, HIID, using USAID-provided funds, paid the salary of the DCC's second President. In addition, U.S. contractors, under HIID oversight, (1) identified potential institutions with which it hoped to work to develop CSOs, (2) determined the level of assistance required and developed a work plan, (3) provided financial support to these institutions to cover operating expenses, (4) gave policy and organizational advice, and (5) trained staff to perform the activities required for a self-regulatory organization.

According to the contractor, as of mid-1996, only the Vladivostok stock exchange was active, executing about 30 transactions a day, and as of mid-1996, DCC was disintegrating. USAID, HIID, U.S. contractors, and market participants cited a number of reasons for the CSOs' current status. These included unfavorable market conditions, discouraging tax laws, and political power struggles.

Unfavorable Market Conditions

According to HIID and a U.S. contractor, DCC is not yet fully operational in part because the market was not ready for such an organization. In 1994, the dealers in Moscow and to a lesser extent in St. Petersburg were buying and selling shares mainly to accumulate share packages for large buyers. The dominant force in this market was foreign buyers purchasing through Credit Suisse First Boston Bank (CSFB). The Moscow dealers were providing CSFB shares they bought from small regional dealers.

By mid-1995, however, foreign interest in Russian shares declined, and market activity then centered on domestic buyers who were consolidating their purchases of shares. Dealers were buying from small customers and selling to larger customers, usually Russian enterprises, banks, and voucher funds.[8] These activities did not involve a settlement between dealers. Moreover, high inflation and political uncertainty continued to

[8]During voucher privatization, a number of funds containing vouchers, or shares, for many companies were established by Russian organizations.

reduce the demand for shares to a few dozen large, well-known companies, mainly traded by 20 or 30 Moscow dealers.

Taxes and Registrar Fees

According to foreign banks and other market participants, even if DCC had the capacity to settle trades, it would not be in their interest to trade using domestic organizations because of the Russian tax structure. Russian law makes no distinctions between beneficial (the investor) and nominee (generally the custodian) holders in offshore custody arrangements.[9] This creates uncertainty as to whether the investor or the nominee will be required to pay taxes. One contractor noted that in late 1993, the long-awaited decree on nominee ownership was published but without elaboration and specificity that might have created confidence among investors and market participants in using DCC.

The amount of taxes on domestic transactions also works against the goal of getting foreign companies to trade through domestic CSOs. If a foreign company sells property in Russia (for example, shares), it is liable for a 20-percent withholding tax on the profits. (Capital gains are taxed as ordinary income in Russia, at a rate of 35 to 38 percent.) In contrast, market participants stated they did not have to pay taxes on Russian trades going through offshore trading companies.

International bankers also stated that to transfer their present holdings to DCC was currently not in their clients' interest. They explained that to move the shares that are currently under their custodial care would require the shares to be registered in the nominee name of DCC. Such a transaction would incur a significant registration fee. On the other hand, the President of DCC stated that the banks were making money by acting as depositories and were therefore not interested in using DCC as a depository.

Political Power Struggles

According to HIID, U.S. contractors, and market participants, politics has been a ubiquitous factor in the history of market reforms and, in particular, the effort to develop effective clearing and settlement mechanisms throughout Russia. The early history of the project was affected by the political struggle between the Russian central bank and the Russian SEC over issues such as market regulation and structure.

A 1994 task order directed the contractors to attempt to obtain some level of commitment to and input from the Russian central bank on the general

[9]An offshore custody arrangement is a type of arrangement in which the custodian has an obligation to preserve and safekeep the property entrusted to him for his principal.

concept of a CSO along with a legal, regulatory, and operational analysis of such a project. The task order recognized that a key step in organizing the intraregional and interregional movement of funds was to obtain the cooperation of the Russian central bank.

Unfortunately, the Russian central bank and the Russian SEC did not have a good relationship until early 1996. This relationship directly affected the DCC's development. For example, DCC could not obtain a general banking license without the Russian central bank's approval and, as of July 1996, had not implemented a fully functioning funds settlement capability.

Another threat to the DCC's future was the installation of a new DCC President in October 1995 who had ties to President Yeltsin's Legal Advisor. According to one contractor, the installation of a government bureaucrat as the President of what market participants had thought was their own organization substantially diminished their support for DCC. As of June 1996, DCC was not operating as either a depository or a CSO but was generating revenue by providing registration services.

Future of the Russian SEC

The following events highlight the nature of the ongoing struggle for lasting reform. Although the Russian SEC seemed to be progressing as planned, in August 1996 President Yeltsin signed a decree that downgraded the status of the Russian SEC from a ministry to a state committee with an unclear mandate and no appointed Chairman. Reports from Moscow indicated that Russian stock market participants were surprised and dismayed by this move. The Chairman of the Russian central bank stated that it was unclear why this decree was adopted.

Less than 1 month later, the action taken in the August 14 decree was at least partially reversed by a decree of the President—"On the System of Federal Executive Agencies," dated September 6, 1996. This decree upgraded the Russian SEC but moved it from subordination to the Ministry of Finance to the presidential apparatus.

It is unclear whether the Russian SEC has the resources to fulfill its considerable responsibilities without a significant enlargement of its staff and budget. Market participants told us that fulfilling the Russian SEC's considerable responsibilities will require a significant enlargement of its staff and budget. For example, under Russian law, salaries to federal employees are capped at levels that are not competitive with the private sector, according to the Director of the Russian SEC. The Russian central

bank has a waiver from the cap and can pay higher salaries. However, the Russian SEC has not been granted such a waiver.

HIID and Agency Comments and Our Evaluation

HIID and USAID generally agreed with our evaluation of HIID's role and accomplishments in developing a capital market; however, HIID disagreed with some specific points. HIID said that in 1994, when the Russian CSO project was initially designed, each CSO was paired with a developing floor-based exchange in each respective city. HIID said that because the floor-based exchange was never a viable equities trading platform—although it initially supported this approach—the floor-based exchanges have not survived. HIID and USAID noted that the DCC board of directors was changed and a new management team elected. Furthermore, HIID said that the World Bank's International Finance Corporation had repeated its pledge to assist in raising capital to support the DCC's gradual assumption of guarantees for reregistration, settlement, and depository activities.

According to HIID, additional capital will now have to be raised to support a reorganized DCC. While HIID provided no estimate of the capital requirements necessary to guarantee clearing and settlement activity, one expert close to DCC told us that it will require capital in excess of what either the International Finance Corporation, the Russian government, or the U.S. government are likely to provide.

Russian Progress on Legal Reform

In December 1993, USAID/Moscow received a request from the Russian President's legal office for help in carrying out a critical and ambitious program of legal reform. USAID and the U.S. embassy in Russia expressed the view that U.S. government support in the drafting of legislation should be provided only in areas in which the Duma and the executive branch of the Russian government agreed to a collaborative approach. The approach would involve using either joint drafting teams or having one or the other body take the lead in certain areas. The 1995 U.S. strategic plan for Russia stated that the passage of specific laws by late 1996 would be the benchmark of success for the legal reform program.

On May 7, 1994, USAID/Moscow was informed that GPU and the Duma had reached an agreement to establish a coordinating committee for law drafting, chaired by the head of GPU and composed of representatives from GPU, the Duma, and the Federation Council. The coordinating committee agreed on 19 core laws that it saw as necessary for providing a sound legal basis for a market economy. USAID's legal reform project was initiated in August 1994. Under the $20 million program, HIID, through an existing cooperative agreement with USAID, supported the coordinating committee by setting up working groups and hiring consultants to advise, comment on, and recommend legislation needed to develop these and other laws.

The legal reform project resulted in the development of many draft laws and the establishment of a Russian organization, ILBE, to carry out the legal reforms during and after USAID ends its assistance. Of the nine core laws that were passed, HIID was the principal drafter of three, served as either the co-drafter or provided comments on another three, but had a minimal role in the development of three sections of the Civil Code. The sections of the Civil Code were primarily the work of another USAID-funded contractor. With assistance from HIID, Russia obtained a loan from the World Bank to expand its legal reforms. However, due to events that occurred after initial optimism regarding Russia's political environment, such as the changes that followed the 1995 parliamentary election, more of the legal reform took place through presidential decrees than through the passing of laws.

Consistent with the cooperative agreement, USAID gave HIID great latitude in implementing the legal reform program; nonetheless, we found USAID's management and oversight over HIID to be lax.

HIID's Role in the Legal Reform Project

HIID's November 1994 work plan stated that it was to

- provide commentary, expert advice, and drafting assistance on commercial legislation as directed by the coordinating committee (see app. III for the status of these laws);
- establish a core group of long-term resident advisors and short-term western experts who would be available to assist the working groups in preparing draft legislation;
- develop an institutional structure for continued legal reform work after USAID funding ends; and
- promote closer coordination between the Russian executive branch and the Duma.

HIID's Approach to Drafting Legislation

HIID provided commentary, expert advice, and drafting assistance in many general areas of law related to economic activity. If HIID was the principal drafter of a law, it would often begin the process through the development of concept papers. These papers outlined the relevant issues to be addressed in a particular subject of legislation and explained how the legislation should be dealt with in the Duma. This required lengthy consultations with foreign experts and extensive meetings within the relevant government ministries, Duma committees, working groups, and the Russian private sector. Once a consensus had developed, the legislation would be introduced to the Duma, and the legislative process would begin. The initial hurdle was to get the Duma to approve the first reading of the draft law; the draft legislation would then go through two more readings, where it would be revised and amended before final approval. If passed by the Duma, the draft legislation would be sent to the Federation Council and, if passed, would then go to the President's office for consideration. There is no official record or formal reporting on this legislative process.

HIID identified nine laws that were passed as of June 1996 related to the 19 areas of basic legislation identified by the coordinating committee in 1994 as important to supporting a market economy. These laws were the (1) Law on Joint Stock Companies, (2) Law on Securities, (3) Law on Taxation of Small Business, (4) Law on Advertisements, (5) Federal Law on Noncommercial Organizations, and (6) Law on Holding Companies and Financial Industrial Groups. HIID indicated that three of the nine laws were covered in the Civil Code. These included (1) Contract Law (title II of the Civil Code), (2) Insurance Law (title II of the Civil Code), and (3) Law on Pledges (title II of the Civil Code).

We noted that HIID had begun work on the first two laws 1 year before the start of the legal reform project. USAID had funded work on the first two laws in April 1993 as part of HIID's Russian privatization effort. These two laws were enacted in December 1995 and April 1996, respectively. HIID was the principal drafter of the first three laws, co-drafted the fourth law, and participated in the drafting of the fifth and sixth laws. However, the core laws related to the Civil Code—contract law, insurance law, and the law on pledges—were primarily the work of the University of Maryland's IRIS Center and the Russian Research Center for Private Law. According to IRIS officials, it had worked with other reformers in the Research Center to develop parts I and II of the Civil Code, and HIID had had virtually no role in developing or drafting these three sections of the Civil Code.

HIID noted that in 4 of the 19 areas of law, it had discouraged any effort to propose or pass laws. HIID believed that passage of laws in these four areas would be detrimental to a free market economy.[1]

HIID also noted that it had had a role in drafting other laws that were signed by the President. These laws covered such areas as condominiums, agriculture cooperatives, and banking activities.

The USAID/Moscow Mission Director, the ILBE Director, HIID's Moscow General Manager and its former project manager, the GPU Director, and a member of the coordinating committee all indicated that HIID had performed well in the legal reform project and offered several explanations about why more laws were not passed. For example, the former HIID project manager in Moscow said that USAID and HIID were too optimistic about the number of laws that could be passed within 2 years. She said the number of laws listed in HIID's work plan indicated how overly optimistic the project was, especially considering that they now know it usually takes about 2 years to pass a law in Russia. She also said that factors within the Duma slowed legal reform. For example, she pointed out that the Duma was new and did not know how to work as a legislative body, had to develop an agenda, spent most of the year trying to pass a budget, and was distracted by the Chechenya secession crisis. In addition, she said it lacked such basic systems as a database for members to

[1]According to HIID, these areas included (1) Fundamentals of Pricing Policy, which involved the government's setting rules for pricing and thus inviting bureaucratic control instead of market forces; (2) Delivery of Products for State Needs, which raised problems of expanding the government's role in setting standards for goods and services; (3) Management of State Property, which raised the same problem; and (4) Movement of Capital, which raised the problem of the government, instead of the market forces, allocating capital.

identify what bills had been introduced, their status, or their location within various committees.

The coordinating committee members had varying recollections of HIID's input to the legislative process. One member was unable to remember which of the thousands of amendments offered from many participants had come from HIID staff. Another member said that HIID lawyers had great expertise and were highly qualified and skilled and that HIID had provided the organizational and financial support needed.

Legal Reform Increasingly in the Form of Decrees

The 1994 establishment of the coordinating committee to draft laws was a major step toward improving cooperation between the executive and legislative branches of the Russian government and in rationalizing the legislative process.[2] However, much of HIID's work has contributed to executive decrees rather than legislation. Although presidential decrees bypass the coordinating committee and the Duma, they are legally binding unless they contradict preexisting laws. HIID believed that taking this approach was necessary to advance reform, particularly after the 1995 parliamentary elections.

According to USAID, HIID drafted hundreds of decrees during the first 2 years of the project. HIID provided documentation showing that HIID-drafted decrees were issued in most of the areas identified by the coordinating committee. HIID supported the use of decrees because it believed that they advanced reforms and, if supported by the market participants, pressured the Duma to pass similar legislation. HIID accepted the use of decrees because those members of the Duma and officials in the ministries opposed to reform could stall or kill reform legislation through outright objection, proposing antireform amendments, or applying delaying tactics. HIID believed that this had been the case with many pieces of reform legislation.

According to HIID, those members of the Duma and officials in the ministries who opposed reform stalled or prevented (1) banking and payments legislation, where the Russian central bank had been an impediment; (2) bankruptcy legislation, where the Russian federal bankruptcy agency had not wanted any such legislation passed and the many state-owned enterprises that were technically bankrupt opposed the legislation; and (3) tax legislation, where the Ministry of Finance and the

[2]Before the project, Duma committees had no staff or resources to help develop, evaluate, or consolidate various legislative drafts.

tax inspectorate, for a variety of reasons, opposed serious tax reform. Although the legal reform project had prepared draft legislation in these and other areas, it increasingly relied on presidential decrees because of the political opposition to reform legislation.

HIID contracted with the U.S. RDI[3] to do work in land reform. RDI stated that its most significant accomplishments involved issuance of two presidential decrees. One laid the groundwork for transformation of rural and urban land ownership and agricultural reform, and another strengthened private ownership rights of individuals to agricultural land. Additionally, RDI was instrumental in calling attention, through newspaper articles and meeting with U.S. government officials, to a section of a presidential decree prepared by another donor organization that RDI assessed could have sabotaged land reform in Russia. About 1 year later, according to RDI, this decree was rescinded through its efforts.

HIID Initiated ILBE

HIID initially set up the legal reform project by hiring a team of about 20 Russian specialists to begin support of the coordinating committee. According to HIID/Moscow's General Manager, these specialists included Russian lawyers and economists experienced in western commercial law. However, because it was not politically acceptable for HIID or other foreign organizations to be directly associated with the Russian legislative process, Russian officials and HIID proposed the establishment of ILBE. ILBE was staffed with Russian specialists who were able to interact with Russians involved in the legislative process.

In April 1995, ILBE was formally chartered as a nonprofit organization. ILBE's roughly 40 Russian specialists are mostly paid through HIID's cooperative agreement with USAID. Although HIID and USAID officials said that ILBE currently relies on USAID for about 80 percent of its funding, they are optimistic about ILBE's long-term sustainability as USAID assistance is completed in early 1997.

According to HIID/Moscow's General Manager, ILBE has established itself as the leading Russian group with expertise in commercial law development and has a very high reputation with the range of Russian interests. For example, the World Bank representative who has worked with ILBE staff, another USAID contractor who participated in ILBE's drafting of land reform

[3]RDI's contracts with HIID have totaled about $3 million. HIID said that in addition to commenting on drafts of decrees and land reform legislation, RDI has advised Russian officials on land reform issues such as real estate registration, mortgages, land use planning, and state management of land.

legislation, and a private Russian lawyer who worked with ILBE lawyers, all endorsed the competence of the ILBE staff.

World Bank Loan May Help Sustain ILBE

Although not part of HIID's work plan, HIID played a critical role in helping the Russian executive branch secure a $58-million World Bank legal reform loan. The loan could have long-term ramifications for Russian legal reform efforts and may possibly help fund ILBE activities after USAID assistance ends. According to HIID, the idea of promoting a loan for legal reform was conceived by the staff of the legal reform project. The staff prepared background papers for Russian government officials whose approval was a prerequisite for the borrowing of funds and held many discussions and negotiations to build support for the loan in the Duma, the executive branch, the judiciary, and other organizations. The staff also worked closely with GPU to design the legal reform loan and to identify the highest priority components for loan financing. Throughout this process, HIID advised the Russian executive branch on its negotiations with the World Bank.

A World Bank official told us that HIID played a significant role in the Bank's decision to add a legislative drafting component to the loan. She said that HIID's work in legal drafting gave the World Bank confidence to include legislative drafting in its program, citing HIID's work on the law on joint stock companies and its capital markets legislation and regulations. She said that HIID demonstrated that assistance in legal drafting, if done at the right time, could significantly improve the quality of legislation.

USAID's Oversight of HIID

Despite favorable comments from Russian and World Bank officials regarding HIID's work and notable accomplishments, we believe that USAID's management and oversight of HIID was lax. In particular, USAID did not enforce specific reporting requirements, did not set measurable goals, and was not aware of decisions HIID was making that could have resulted in costs to the U.S. government or that could significantly affect U.S. strategy.

USAID Did Not Require HIID to Meet All of Its Reporting Requirements

According to the cooperative agreement, HIID was required to provide semiannual work plans that detailed program objectives and the main anticipated results or targets. HIID was also to supply monthly progress reports. The progress reports were to include such information as an evaluation of the effectiveness of the assistance, proposals by HIID's

Russian counterparts (such as the coordinating committee) for improving the delivery of assistance under the program, an outline of any decisions that the Russian counterparts must make, and a description of upcoming activities for the next month. In addition, USAID's Handbook 13 states that progress reports are to contain a comparison of actual accomplishments with the goals established for that period.

HIID provided quarterly progress reports from July 1994 until December 1994 instead of monthly progress reports as called for in the agreement. In addition, these reports generally highlighted only inputs, and there was no comparison of accomplishments with the goals. Moreover, the progress reports did not include Russian proposals to improve project operations.

USAID/Washington officials raised several questions concerning the lack of information in the progress reports. For example, according to a USAID/Washington analysis in late 1995, it noted that (1) HIID never explained why new projects started or how they tied in with the overall work, (2) accomplishments were not easy to discern, (3) progress reports did not explain the purpose of projects, and (4) no information was provided about projects that were completed. According to the USAID/Moscow project officer, these suggestions were discussed at USAID/Moscow, but it was decided they were unnecessary. As a result, few in USAID/Washington knew the accomplishments or methods of HIID's legal reform efforts.

USAID Did Not Set Measurable Goals

USAID did not incorporate measurable goals into HIID's work plan. USAID policy states that each project should identify specific goals and measure progress toward meeting those goals. While USAID/Moscow has made 32 submissions for other reform activities, it has supplied none for HIID's work. HIID was not averse to the establishment of program goals. For example, on September 23, 1994, HIID's Project Manager sent USAID/Moscow 10 suggested measurements of success for the first 6-month work plan. However, these suggestions were never incorporated into HIID's work plan.

Lack of USAID Oversight May Have Resulted in Unnecessary Costs

The Civil Code is the foundation for all civil and commercial relations in Russia, and all commercial laws must conform to the code. Although the USAID/Washington Office of Democracy in Russia had already begun funding a U.S. contractor—the University of Maryland's IRIS Center—to

help to draft the Civil Code, HIID independently began work on part I of the code without formal USAID authorization and before USAID approved HIID's legal reform project. In January 1994, HIID began developing what it believed to be a more market-oriented part I of the Civil Code. This effort was not formally approved by either USAID/Moscow or USAID/Washington, and the work was begun 6 months before the HIID legal reform project was approved. HIID spent $500,000 on this effort, using U.S. and Dutch experts to develop the competing code. HIID paid these expenses in September and November 1994 with money from the legal reform project that was authorized in August 1994. HIID's version of the Civil Code was rejected by the President's office, and the original version drafted by the Russian Research Center for Private Law, with the assistance and support of the University of Maryland's IRIS Center, went into effect January 1, 1995. Greater oversight by USAID may have precluded this duplication of effort or ensured that HIID's work complemented that of IRIS.

HIID Modified Its Approach Without USAID's Approval

HIID altered the USAID/Department of State legal reform strategy by deciding to emphasize the use of presidential decrees without receiving prior approval from USAID. The U.S. strategy was to foster closer executive-legislative working relationships that could lead to passage of critically needed commercial legislation. One member of the 1994 coordinating committee stated that the use of decrees was becoming more common and he was concerned that this was a negative development. The USAID/Washington Office of Democracy for Russia also opposed using decrees because it believed decrees did not support the democratic processes envisioned by the project. HIID did not raise this issue in its progress reports, and we found no USAID approval for this change in strategy. Both are required by HIID's cooperative agreement with USAID.

HIID stated that its work on decrees did not alter the legal reform project's strategy and that decrees were widely used during the initial effort. We agree that decrees were used extensively during the privatization program and that HIID contributed to their drafting. However, we disagree with HIID's assertion that the use of decrees was an integral part of the legal reform project's strategy. None of the USAID or Department of State documents authorizing the program discuss accomplishing legal reform through the issuance of decrees, only the passage of legislation.

The U.S. Ambassador to Russia told us that the issuance of decrees was not part of the legal reform strategy and that it was this very use of decrees during privatization that led him to push for the coordinating

committee to gain legislative involvement. Furthermore, USAID justified the project based on the need to pass legislation and the need to "foster a new pattern of executive-legislative cooperation. . .necessary to adopt and implement the new laws."

HIID and Agency Comments and Our Evaluation

In commenting on this report, USAID generally agreed with our assessment and stated that it planned to improve management and oversight of the grantee with respect to reporting requirements, establishment of measurable goals, performance monitoring, and results evaluation.

Nonetheless, USAID and HIID disagreed with our reporting of events surrounding the development of part I of the Civil Code. USAID and HIID stated that HIID's work had USAID approval and did not duplicate IRIS work. However, our review showed that HIID began work on the Civil Code 6 months before the legal reform project was authorized. HIID also stated that its work contributed to the passage of part I of the Civil Code. The USAID/Washington official in charge of the IRIS program, as well as IRIS documents, indicated that the HIID draft did not expedite the Research Center's draft but held up passage of part I for several months. According to the Russian Research Center and IRIS representatives, none of HIID's work was used in part I. On June 20, 1996, HIID stated to us that "the legal reform project had little involvement with part I of the Code. . . . [HIID] provided comments . . . to the Research Center . . . although it was never very clear how the Research Center dealt with such comments."

HIID said that our report overstated its role in the creation of ILBE. HIID stated that ILBE was conceived and formed by Russians on their own initiative. We believe that HIID's response understated its role because Russian officials and HIID jointly proposed to USAID the establishment of ILBE. Moreover, HIID and its contractor developed the legal reform project's management structure; identified, hired, and paid Russian, U.S., and foreign legal experts; developed the working groups used to support the Duma; developed the administrative functions; and created the support structures that were all transferred to ILBE.

Assistance to the RPC

The RPC is a nonprofit organization established by presidential decree in November 1992 to, among other things, help businesses that had been privatized restructure their operations; that is, to downsize their work forces and modernize corporate governance, accounting systems, and marketing approaches, all of which were intended to improve their profitability and make them attractive investments. The RPC also had a role in land reform and privatization of real estate. Since April 1993, HIID allotted about $13 million of its cooperative agreement resources from USAID to support the RPC, primarily to pay for personnel costs and some initial operating expenses. In addition, USAID made a direct grant of about $16.5 million to the RPC to pay for its operations and provided another $16 million indirectly to the RPC through other U.S. contractors to help create the LPC network.[1]

During this period, HIID's role was to give policy advice to Russian reformers through its association with the RPC, whereas USAID helped implement enterprise restructuring and land reform projects. USAID did so through contractors and through the RPC's assistance. These projects involved providing financial management advice and improving the performance and management of some newly privatized enterprises. HIID also paid the salaries of project managers and high-level administrators. These efforts largely achieved their goals.

In the area of land reform, the RPC and LPCs played a role in designing a number of projects, including a real estate information and titling system, and in assisting enterprises to acquire municipal land. The real estate information and titling system experienced difficulties in meeting its objectives. This can partly be attributed to the RPC network's difficulties in resolving differences among the project participants. The land acquisition project has encountered fewer problems.

Because the RPC relied almost completely on USAID funds, the RPC's sustainability is in question once USAID assistance ends in 1997. The RPC has not submitted work plans and program reports. Also, the RPC may not be able to support itself with fees earned for providing advice to Russian enterprises. A World Bank project may help with the RPC's administrative overhead costs, but the Bank's loan will not cover all RPC expenses.

[1]This funding also supported the creation of a Business Information System, a database that contains information about large- and medium-sized privatized enterprises in the eight regions supported by the LPC network.

Support for Privatization and Enterprise Restructuring

During Russia's initial privatization efforts, HIID provided policy advice and personnel to assist with the RPC's and State Committee of the Russian Federation for the Management of the State Property's (GKI) organization and supervision of the mass privatization process. During this process, nearly 15,000 medium- and large-scale state-owned enterprises were transferred to private ownership. By June 1994, ownership in Russia moved from the ministries of the Soviet state to millions of Russian citizens; for example, over 70 percent of the industrial sector was in private hands.

With HIID support, the RPC provides ongoing policy advice to government agencies, including comments on draft laws on natural monopolies, competition, antitrust policies, and tax reform. For example, during 1995, HIID's General Director and the RPC's Chief Executive Officer worked with senior reformers in the Russian government to help the government negotiate a stabilization loan from the International Monetary Fund. According to the senior HIID representative, this policy dialogue will continue while HIID remains engaged with the RPC.

Following the completion of Russia's privatization of most state-owned enterprises by June 1994, USAID focused on using the RPC network to help USAID work with newly privatized firms on the difficult process of restructuring. USAID funded two targeted enterprise restructuring efforts—the Financial Management Assistance (FMA) and Program for Intensive Enterprise Support (PIES) projects.[2] The FMA project objectives were narrowly focused on providing financial management advice, while the PIES objectives were geared to improving the overall management and performance of some newly privatized enterprises. These projects directly reached 23 enterprises and, to varying degrees, these enterprises have cut costs and improved their management operations. For example, one of the enterprises we visited cut its workforce by half and revised its accounting procedures as a result of the restructuring advice and assistance it received.

According to project reports, consultants, and USAID and RPC officials, the project objectives of FMA and PIES were largely achieved. For example, 32 consultants were trained, some of whom are currently working for the LPC network, to continue to provide financial management advice to enterprises. In addition, participating enterprises have changed their operations by doing all or some of the following that are required to restructure and cut costs:

[2]These projects cost about $18 million.

- downsized labor forces,
- improved accounting and financial management,
- revised procurement procedures, and
- identified more profitable product lines.

To implement FMA and PIES, USAID used U.S. management consulting companies and the RPC and LPC network to assist in program delivery. HIID did not have a direct role in these activities. The project task orders called for the RPC to

- publicize the projects at the federal level through the RPC and the local level through LPCs;
- make participant application forms available to potential consultants and enterprises;
- propose candidate enterprises that the RPC believed were suitable for the programs;
- review submitted applications and establish a short-list of candidate enterprises;
- select and approve, with USAID and contractors, enterprises to participate in the projects; and
- monitor contractor progress.

In addition to assisting with program implementation, USAID's strategy to get the RPC and LPC network involved was also directed at developing LPC staff capabilities. USAID expected that the RPC network would continue to provide technical assistance for enterprise restructuring on a cost-recovery, self-sustainable basis.

Both USAID and the contractors found the RPC's efforts to publicize the programs and coordinate the application process very useful. Enterprises also commended the RPC and LPC network on these accomplishments. Reaching enterprises that could become candidates for receiving assistance was an important component of the projects because the implementing contractors were unfamiliar with the potential clients. The LPC staff knew the clients in their locations and made the necessary contacts.

According to one of the contractors, a few of the RPC's selections of candidates to participate in the FMA and PIES programs appeared politically motivated (i.e., there were political or personal ties between senior-level RPC and LPC staff and the heads of selected enterprises), but they could provide no proof of this.

Land Reform Initiatives

The RPC and LPCs played a role in two USAID model land reform initiatives:[3]

- the Real Estate Information Systems project (REIS), which was to design and implement integrated land and real estate information systems for local jurisdictions that would serve as a basis for later land registration and titling and
- the Enterprise Land Sales project (ELS), which was designed to assist enterprises in acquiring municipal land they were presently using and in managing the land as an asset.

REIS Project Did Not Meet Expectations

The real estate information and titling systems, the largest model project, encountered difficulties in meeting its targets. USAID expected the REIS project, funded at about $22 million, would be installed in up to 19 cities. However, the project was implemented in only nine cities, of which six are still not providing land registration. According to the USAID project officer, municipal officials in five cities rejected the systems offered by the contractors and were working on their own versions. The principal reason for this was dissatisfaction with the information system design the contractor chose to implement and a desire to obtain a more advanced system. In one city, the officials implemented their own system after observing the implementation of a real estate information system by contractors in a neighboring city.

The RPC helped select the cities included in the project. The RPC and LPCs negotiated with the municipal authorities, helped prepare drafts of sample documents used in the project, prepared drafts of local legislation (although this legislation's passage was the responsibility of the local authorities), and were involved at the federal level in working on a draft law to codify land registration nationwide. Despite RPC and LPC efforts, a major hurdle that the REIS contractors faced was getting the various municipal agencies to agree on how the information that each agency was collecting, such as data on land, structures on land, and housing, would be made available to all of the other municipal agency users of the new system.

In St. Petersburg, the U.S. contractor had a difficult relationship with some of the directors of city agencies with which it had to interact. The contractor had difficulties with his computer subcontractor, who was not

[3]At the beginning of the land reform projects in 1994, the RPC managed their implementation because USAID/Moscow had only one project officer assigned to this work. Once USAID staffing was increased, the RPC and LPC acted as facilitators and advisors to the participants of the projects, particularly at the local level.

selected in an open and transparent manner but was forced on the contractor by the city. The RPC land reform manager was assigned to help coordinate and mediate the final implementation of the St. Petersburg project, but after 1 year of disagreement some issues were still not resolved.

U.S. contractors cited other reasons for REIS' limited results:

- USAID pushed to get the projects started before the project design was completed;
- the legislative basis for the work was only in place in one of the cities when the projects were started;
- the project was "oversold" by USAID, and some cities did not know what they would get; and
- the cities were not required to pay for the services of the REIS contractors and, consequently, some did not value the contractor's work.

ELS Project Implementation Is Promising

The $8-million ELS project established and implemented a legal and procedural process for the sale of land initially by the municipal administrations to the new owners of the privatized former state enterprises. At first, enterprises in Russia were privatized without the new owners' obtaining title to the land on which the enterprises were located or used in the course of doing business. ELS was designed to help with this problem and is now being rolled out in about 43 cities. In St. Petersburg, where we observed the program, ELS appears to be meeting its goals for enterprises that have obtained titles to land. Although the ELS project also had goals for secondary sales—subsequent sales to new buyers—the contractor said that the project was running into difficulty in meeting these goals. Some people fear that if the political situation changes, sales to secondary buyers could be considered illegal, as land ownership was under the communist system.

The challenge for USAID's contractor was to work within the present legal environment where there is no federal land code that addresses the purchase of urban land. The contractor made recommendations to city administrators and managers of enterprises and provided training on how to organize land privatization. The contractor also prepared legal documents and suggested strategies for enterprises on how to begin to purchase land from the state. Furthermore, sales of commercial property that are being undertaken under the project are already being copied by others without the contractor's help. Thus, there is reason to believe that if the political and legal environment continues to be conducive, private

citizens will be able to buy and sell land without the intervention of further technical assistance.

The U.S. contractor told us that while RPC and LPC staff were helpful in making the initial contacts for the project, the staff were not real estate professionals and were not particularly useful to the subsequent development of the ELS project.

Sustainability of RPC Network Is Uncertain

The RPC has relied almost exclusively on USAID grant funds for its existence. Despite USAID's approximately $45 million investment in the RPC network, the RPC did not comply with the reporting requirements of the grant agreement. Therefore, USAID never had a clear understanding of the RPC's long-term goals and business plan. Moreover, it is uncertain whether the RPC will be capable of providing continued technical assistance on a cost-recovery basis. Although the World Bank is committed to using the RPC for an upcoming large-scale enterprise restructuring project, this project will not support all of the RPC's operational costs.[4]

RPC's Lack of Reporting to USAID

The lack of adequate RPC progress reporting to USAID managers made it very difficult for USAID to effectively manage and evaluate the RPC's performance. As a result, USAID has been unable to identify a well-thought-out post-privatization role for the RPC. USAID also has raised questions about whether the RPC would be able to manage other donor resources—the World Bank included—when USAID assistance ends. The RPC did not comply with the grant agreement, which required the RPC to submit an annual work plan and quarterly progress reports. The RPC has never submitted a work plan or presented an adequate financial plan showing its strategy for spending the grant monies and graduating from dependence on USAID.

Although RPC representatives have sought additional funding from USAID, USAID/Moscow does not support giving the RPC additional resources. USAID/Moscow believes (1) the existing pipeline will provide the RPC operating funds for about 6 months beyond the original grant completion date and (2) the RPC has been unable to clearly identify its objectives for the proposed extension period in a carefully considered business plan and budget.

[4]The RPC did not provide us with complete access to its donor portfolio and, therefore, our conclusions about the RPC's operational cost needs are based on USAID's assessment.

Future RPC Role in Enterprise Restructuring and Land Reform Is Unclear

Contractors working on the FMA and PIES programs have raised questions about the RPC's role in future projects and whether it would be able to sustain its operations in a competitive market. Some contractors stated that what the LPC network did best will increasingly become less valuable for the programs. For example, now that many western consulting companies have been working throughout Russia, they have established contacts and personal relationships with many potential clients. Thus, the need for the LPC network to provide this service may be doubtful.

In addition, contractors said that the RPC and LPC network does not possess the consulting expertise on a scale required to compete in a market economy. According to two contractors, the RPC simply cannot compete with the ever-developing consulting base in Russia and, therefore, should not try to duplicate what others can do more effectively. Commercially, however, these Russian enterprises might use the LPC network on a case-by-case basis depending on whether the services would be needed in more remote locations.

We asked enterprises that participated in the FMA and PIES program whether they would be able to afford similar but unsubsidized technical assistance. Representatives from these enterprises said that they did not have the resources to pay what the FMA and PIES programs cost. One representative stated that even after downsizing his company as recommended by the contractor, the company still has been unable to pay its remaining employees on a regular basis. He said that his employees had not been paid in 3 months.

Other representatives said that they could afford to pay nominal fees for more limited assistance. USAID maintains that the potential exists for the RPC to take consulting materials developed in the FMA and PIES programs and provide them for a fee. USAID informed us in November 1996 that the RPC has successfully implemented on a fee basis a series of consulting seminars using materials developed by the FMA and PIES contractors. However, according to USAID, the development of LPC staff skills has been uneven, and it is not clear whether all LPCs could successfully offer the existing consulting materials.

With regard to the RPC and future land reform activities, the ELS contractor trained some LPC staff, along with others, in commercial real estate transactions as part of the project. These skills could be useful once a commercial real estate market develops. At present, it is unclear to what extent those who received this training will be able to sell their services to

facilitate commercial real estate transactions. It is also unclear if LPCs will be able to collect fees for these services.

A contractor involved in REIS was preparing a manual that could be used to help spread information about the techniques of land information and titling, but no plans exist for disseminating the manual. The RPC said it will not take on the responsibility for doing this because it lacked funds for this activity. An upcoming USAID project will have the task of identifying mechanisms for disseminating the land reform training materials.

World Bank Will Provide Increased Support to the RPC

The RPC recently concluded negotiations with the World Bank in which the Bank agreed to cover some of the administrative overhead costs associated with management and disbursement of its current privatization loan managed by the RPC. This agreement will become effective in January 1997.

In November 1996, USAID informed us that the World Bank will use the RPC network to implement its estimated $100-million Enterprise Restructuring Services Project. This loan is expected to support enterprise restructuring activities for about 200 newly privatized enterprises throughout Russia. However, the loan will not cover all of the RPC network's operational costs. If the RPC is unable to obtain other resources to make up the deficit, it may be forced to downsize and streamline its operations accordingly. USAID also informed us that the Japanese government has committed to support the full operational costs of the LPC network.

HIID and Agency Comments and Our Evaluation

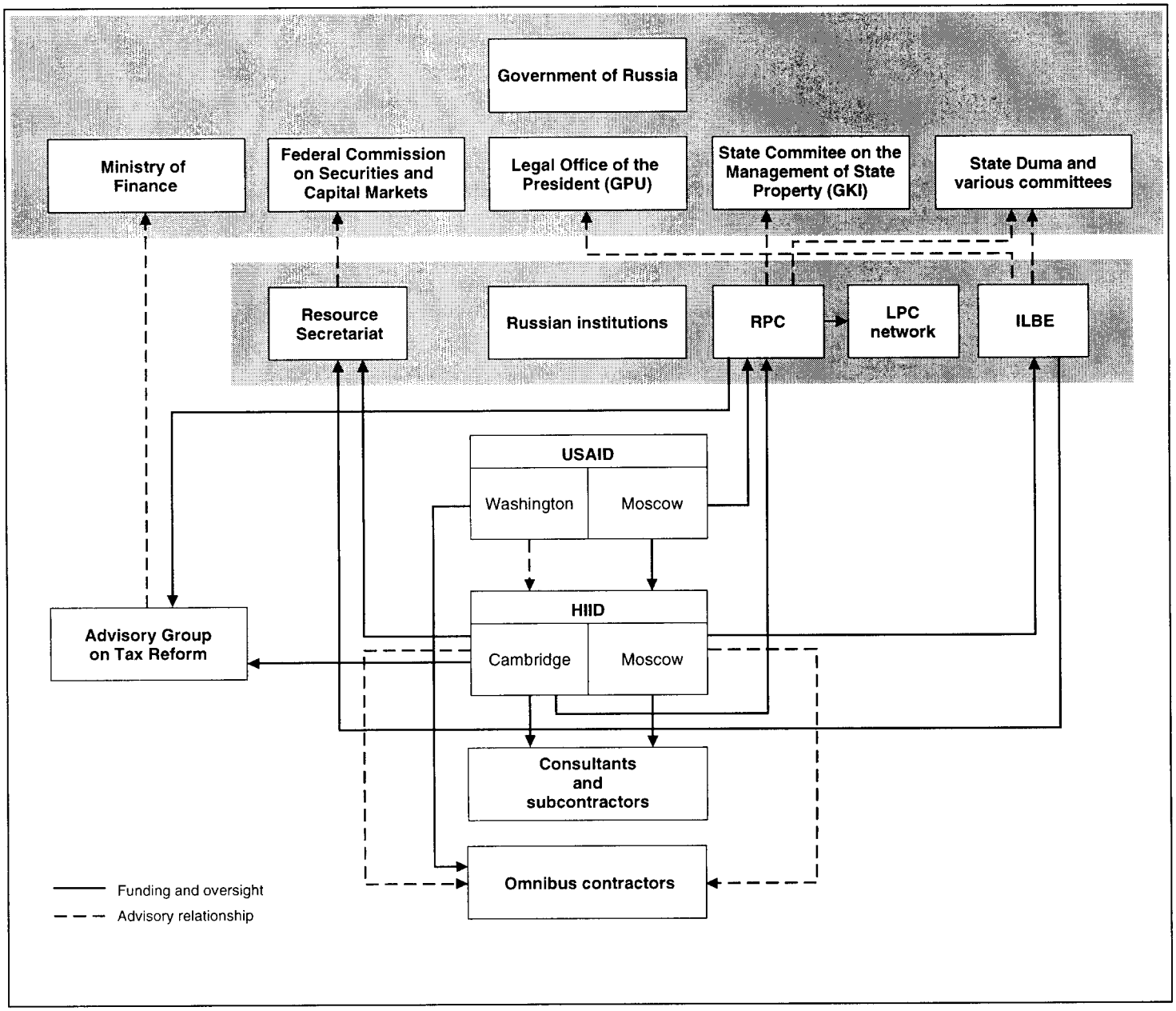
In commenting on this report, USAID stated that while the sustainability of the RPC and the LPC network as a private consulting organization may be questionable, the sustainability of that network as a donor coordination and project implementation organization is not. USAID added that at the time the RPC was established it was not planned that the RPC would be a long-lasting organization but one that "would support the effective implementation of privatization now."

We recognize that USAID's original expectations were short term and based on the RPC's immediate role to support privatization. However, USAID later expected the RPC to sustain itself either through donor resources or fees generated by consulting services based on the objectives of USAID's assistance to the RPC. Accordingly, when USAID made its final direct contribution in 1995 to support the LPC network, it stressed that the RPC

needed to develop a strategy for sustainability. From fiscal years 1992 through 1996, USAID budgeted nearly $50 million for enterprise restructuring and land reform assistance programs to, among other things, develop the RPC and the LPC network's capabilities to continue such activities after graduating from USAID assistance. Furthermore, USAID made funding available to PIES and FMA contractors to develop consulting materials for the RPC and the LPC network specifically as a fee-generating service. In addition to providing its own funding, USAID informed us in August 1996 that it was working very closely with the World Bank to secure the RPC's best prospects for sustainability—the Enterprise Restructuring Services Project. USAID and HIID have dedicated substantial financial and human resources to the RPC and, therefore, both have a significant investment in the RPC's future.

HIID said that it had not been significantly involved in the development and operations of the RPC. We recognize that the RPC is an independent Russian institution governed by its own management structure and board of directors; however, HIID has had an important relationship with the RPC. For example, HIID, with financial resources from USAID and assistance from private contractors, oversaw the creation of the RPC in 1993 and continues to support the RPC's mission. Since 1993, HIID has received about $13 million from USAID to provide project managers and high-level administrators to the RPC and to provide impartial oversight of the RPC for USAID. In addition, HIID had substantial access to the RPC's leadership through its ongoing dialogue with the RPC Chief Executive Officer and its project managers and high-level administrators. Furthermore, the memorandum of understanding that governs the relationship between HIID and the RPC underscores the significant role that HIID played in the RPC's creation and its current operations. Specifically, the memorandum states that HIID is both a "founder" and "Full Member of the Center," which is the "highest governing body of the RPC."

Organizational Profile of the Harvard Institute for International Development (as of June 30, 1996)



Source: GAO analysis.

Legend:

HIID = Harvard Institute for International Development
ILBE = Institute for Law-Based Economy
LPC = local privatization center
RPC = Russian Privatization Center
USAID = U.S. Agency for International Development

Events Leading to HIID's Cooperative Agreement for Work in Ukraine

This appendix responds to specific questions by the House Committee on International Relations concerning events leading to USAID's May 24, 1996, noncompetitive cooperative agreement with HIID to provide strategic policy advice to Ukraine. It discusses the roles that U.S. government officials, private participants, and government of Ukraine officials played in the development of the agreement. It also provides details on the concerns that were raised by USAID, National Bank of Ukraine (NBU), and International Monetary Fund officials over the HIID proposal. Finally, it provides information on what knowledge Ukrainian ministries and other agencies had about the cooperative agreement when we discussed the proposal with them in late June 1996.

Chronology of Events

USAID issued a request for applications on March 17, 1995, that, among other things, sought proposals for assistance to the western newly independent states (NIS), including Ukraine, Moldova, and Belarus. The request was for impartial oversight and strategic advice for privatization and market reform programs. The main areas identified included mass privatization, capital market development, legal and regulatory reform, land privatization, post-privatization assistance, and public education. With respect to the area of legal reform, the request stated that given the importance of tax law for the viability of commercial businesses, the structure of the tax law and its system of incentives and disincentives must be addressed in developing policy objectives for many of the fields of law covered in the request.

On May 23, 1995, while applicants were preparing proposals but before they were submitted, USAID decided not to award a cooperative agreement for assistance to Ukraine and withdrew that portion of the request.[1] According to USAID, the decision to withdraw the request was made because of limited funds and because Ukrainian officials had indicated they were not interested in oversight assistance.

On June 21 and 22, 1995, USAID sent letters to applicants explaining why it was canceling the request for applications. USAID stated that Ukraine had recently more clearly defined its priorities for technical assistance and that it did not want long-term advisors in these areas. It preferred technical assistance to be focused on program implementation rather than the kind of strategic guidance and oversight suggested in the request for applications. In addition, USAID's tight budget conditions were noted as a contributing factor to the cancellation decision.

[1]HIID was not among those preparing to submit a proposal pursuant to the March 17, 1995, request.

In early July 1995, a representative from the Washington, D.C.-based, Carnegie Endowment for International Peace, who managed a small team of advisors in Ukraine funded by the New York City-based George Soros Open Societies Institute, encouraged the HIID Director to become involved in economic policy work in Ukraine. The HIID Director said that he had a long-standing relationship with the Carnegie Endowment representative who encouraged him to increase his assistance to the Ukrainian government at this critical time when the Ukrainian government was beginning to seriously undertake reform. HIID's Director also said that he had been providing unpaid advice to Ukrainian officials since its independence. For example, in February 1995, he had met with a Ukrainian delegation in Davos, Switzerland, and had discussed substantial economic issues with them, and again during March 19-22, 1995, when he had visited Ukraine and discussed economic issues with high-level Ukrainian officials.

On July 24, 1995, USAID received an unsolicited proposal for a project to be led jointly by the Carnegie Endowment and HIID's Director, with HIID as the project administrator. According to the HIID Director, the proposal was jointly developed by HIID and the Soros Institute staff.

Between July 24 and July 29, 1995, the Deputy Assistant Secretary of the Treasury and a National Security Council (NSC) Director for the NIS visited Ukraine to discuss broad economic issues with key Ukrainian government officials. During these discussions, the NBU Governor expressed concern that there was an internal conflict within the NBU between the foreign exchange, internal debt, and capital market blocs. The Treasury's Deputy Assistant Secretary said that he knew of an advisor who might be able to provide some assistance in unifying the NBU approach to policy issues.

During this visit, the Ukrainian Deputy Prime Minister responsible for economic affairs in Ukraine specifically asked the U.S. visitors for macroeconomic technical assistance to focus on policy and strategy formulation. The Ukrainian Deputy Prime Minister asked that HIID's Director coordinate such policy advice. In addition, he told the Treasury's Deputy Assistant Secretary and the NSC Director that he had previously tried to contact HIID's Director, but a proposed meeting with him in Paris did not take place. The request for policy assistance came at a time when Ukraine was experiencing particular difficulties in both formulating and implementing a coordinated macroeconomic strategy, according to the NSC Director. The NSC Director stated that he was not aware of the HIID proposal until he returned to the United States on August 4, 1995.

On August 10, 1995, at the invitation of the George Soros Institute, the HIID Director, representatives from the World Bank and the International Monetary Fund, the NSC Director, and the Deputy Assistant Secretary of the Treasury met to discuss a wide range of issues. These included the need to help the Ukrainians develop a coordinated, consensus-building apparatus within the government of Ukraine.

Between August 21 and 24, 1995, HIID's Director, along with the expert recommended by the Treasury's Deputy Assistant Secretary, met in Kiev with the Ukrainian Deputy Prime Minister and the NBU Governor. According to the HIID Director, he had a broad discussion with the Deputy Prime Minister that covered substantial economic problems facing Ukraine. He indicated that HIID was prepared to enter a more formal advisory relationship with the government of Ukraine. The HIID Director told us that these discussions covered the key elements in the July 1995 proposal and some of the logistic considerations of the proposal. The Director said that the Deputy Prime Minister was very enthusiastic about the prospects of working with him.

The Governor of the NBU told us in June 1996 that during the late-August 1995 meeting with the HIID Director, he told the Director that the NBU fully supported existing USAID programs and that additional assistance should not be provided at the expense of existing U.S. assistance. The HIID Director told us that he had known the Governor for many years and that as he recalled the discussion, it had focused on macroeconomic issues. He said that he did not recall anything negative being said about HIID assistance at the meeting, or that they should not move ahead with the proposal. The HIID Director noted in passing that he had a long-term professional relationship with the monetary expert who accompanied him and it was appropriate that he participate in these discussions.

On August 30, 1995, HIID submitted a revised proposal to USAID to organize a high-level macroeconomic management mission of resident and nonresident advisors for a period of 2 years. HIID proposed that it focus on (1) monetary reform and monetary management, (2) tax reform, (3) public administration of fiscal systems, (4) fiscal reform of social programs, (5) macroeconomic forecasting, (6) banking sector regulations, (7) enterprise payments reform, and (8) regional fiscal finance at the oblast (regional) level. This proposal did not have an estimated budget.

On October 2, 1995, the State Department Coordinator held a working group meeting to discuss Ukrainian reforms, as well as tax reform in Russia, issues covered in HIID's August Ukraine proposal for future work in Ukraine, and HIID's September 1995 cooperative agreement for work in Russia. According to the Deputy Assistant Secretary of the Treasury, he participated in the working group discussion on the U.S. tax reform technical assistance effort in Russia. The discussion centered on rationalizing coordination of the U.S. effort there, which included U.S. Treasury advisors, a Klynveld, Peat, Marwick, Goerdeler/Barents project, and an ongoing HIID proposal. He said that because of his previous professional relationship with HIID's Director, he chose not to be part of any Ukraine discussion.

On October 30, 1995, HIID submitted revised proposals to USAID that gave a more detailed description for a 2-year program in Ukraine. The preliminary budget for this proposal was $6 million. It covered the first four areas contained in the August 30 proposal and dropped the remaining areas. However, it added a fifth proposal to assist with privatization and private sector development. Subsequently, an NBU official reviewed the October 30, 1995, proposal and told the USAID/Kiev mission that there was no need for a long-term advisor from HIID and that the NBU could use only short-term advice on specific matters and continuing the ongoing technical assistance from USAID.

On December 1, 1995, USAID notified Congress that it intended to obligate up to $6 million for a policy advisory component of its assistance program for Ukraine.

On December 22, 1995, the Chairman of the House Committee on International Relations gave written notification to the USAID Administrator that he was placing a "hold" on the obligation of funds and that he had continuing concerns about the proposed effort. This notification was supplemented by a series of questions directed to the State Department Coordinator for U.S. assistance to the NIS.

On January 25, 1996, the Committee sent a letter to the Coordinator stating that the answers it had received from the Coordinator on January 17, 1996, were nonresponsive to all of the questions.

On February 22, 1996, the Chairman of the House Committee on International Relations sent another letter to the USAID Administrator expressing his continued concerns and asked for certain assurances

before the "hold" would be removed. These included assurances that (1) a thorough review of the economic restructuring project in Ukraine would be performed and a report submitted by May 1, 1996; (2) a process of competition for the HIID work in Ukraine would be conducted in the near future so that work based on a competitive award could start by February 1997; (3) coordination would remain within the U.S. government jurisdiction and not be influenced by HIID for work not related to HIID's program; (4) funding of the HIID noncompetitive proposal would not exceed $2 million and would end by February 1997; and (5) a briefing would be provided to Committee staff on the status and progress of HIID's work.

On February 27, 1996, the International Monetary Fund's Assistant Director for the Monetary and Exchange Department sent a letter to the USAID/Kiev mission stating that

"[t]here is always the danger that with many possible sources of technical advice, the NBU management will search for advice until it finds the one that it is looking for. Indeed, we must also be cognizant of the possibility of contradictory advice when many sources are involved and little coordination takes place. It is with these elements in mind that I would caution providing additional advisors to the NBU at this time and would think that the proposed advisor from Jeffrey Sachs' Think Tank could be repetitive of assistance already provided and could even be counterproductive."

In early March 1996, HIID staff visited Ukraine and discussed the proposed program with the USAID/Kiev mission, representatives of the Ukrainian Deputy Prime Minister, the Ukrainian NBU official, and the U.S. Treasury advisor.[2] According to an NBU official, HIID was told that the NBU would accept only one advisor to work on the project.

On March 19, 1996, the head of USAID's privatization/economic reform office in Washington indicated a reluctance to clear the waiver of competition that would permit the award of a cooperative agreement to HIID because she was concerned that some parts of the proposed agreement may had been included in the withdrawn request for applications. The officer did not clear the waiver because she was not

[2]The U.S. Treasury advisor was part of a working group consisting of the Vekhovna Rada (the Ukrainian parliament) and the State Tax Inspectorate (now the State Tax Administration). He told us that the best chance to succeed in Ukraine was to divide its work into five major areas of tax law. He said that there were five areas that needed attention—administrative provisions, value-added tax, enterprise profit (corporate income) taxes, personal property taxes, and excise taxes. He added that the issue of using a cash versus accrual basis for making a value-added tax payment, which was discussed in detail in the HIID proposal, was already included in the value-added tax legislation awaiting the third reading of the parliament.

involved in discussions of the foreign policy circumstances that formed the basis of the waiver.

On March 26, 1996, USAID's Assistant Administrator determined that an award for work in Ukraine on macroeconomic issues would be made without competition based on foreign policy considerations. Other U.S. officials also approved the waiver.

On April 9, 1996, HIID submitted a scaled-back proposal that had three components: provision of advice on macroeconomic and monetary policies, assistance on tax and budget matters, and advice on reforming Ukraine's pension program.

On April 19, 1996, the USAID/Kiev mission completed its analysis of HIID's April 9, 1996, proposal and concluded that

"there is a clear need for the type of assistance for which the waiver was granted: strategic policy advice by long-term advisors who are highly qualified and recognized experts in their fields, to help shore up the Government of Ukraine's (GOU) political will and leadership in reform efforts. This would be a major contribution and a valuable complement to our ongoing USAID fiscal and financial reform programs, which are well-focused and staffed with highly-qualified experts, but are hampered and often delayed by a lack of high-level commitment and direction.

"However, most of HIID's current proposal does not meet these criteria. It is overly rich in lower-level researchers doing the same policy studies produced by our existing contractors, and scarce in sustained commitments from senior-level policy advisors to spend time in Ukraine persuading top officials to move on needed reforms."

This analysis was faxed to USAID/Washington on April 19, 1996, and was taken into account in negotiating the subsequent cooperative agreement between USAID and HIID.

On April 26, 1996, the Ukrainian Deputy Prime Minister sent a letter to the State Department Coordinator confirming his desire to obtain HIID assistance, and on May 24, 1996, HIID and USAID entered into a cooperative agreement for $1.5 million.

Ukrainian Government Knowledge of HIID's Proposal

Concerning questions about what knowledge Ukrainian officials had about the cooperative agreement, our interviews in June 1996 indicated that while the Ukrainian Prime Minister and a Deputy Prime Minister endorsed

HIID's role in assisting Ukraine, others within the Ukrainian government had little or no knowledge of the proposed project. Most other ministries, including the Ministry of Economy, the Ministry of Finance, the State Property Fund, and the General State Tax Inspection Agency, told us they did not know about HIID's proposal until after it was approved in May 1996. However, these ministry officials told us that they generally believed that HIID's proposal held some promise.

Status of 19 Laws in HIID's First Work Plan

Laws	Status
Tax Code	Not passed
Contract Law	Passed/Civil Code, 1/26/96
Law on Insurance	Passed/Civil Code, 1/26/96
Law on Holding Companies and Financial Industrial Groups	Passed, 11/30/95
Law on Fundamentals of Pricing Policy	Not passed
Law on Noncommercial Organizations	Passed, 1/12/96
Law on Advertisements	Passed, 7/18/95
Law on Delivery of Products for State Needs	Not passed
Law on Nonstate Pension Funds	Not passed
Law on Bankruptcy	Not passed
Law on Pledges	Passed/Civil Code, 1/26/96
Law on Foreign Economic Activity and Investment	Not passed
Law on Management of State Property	Not passed
Law on Joint Stock Companies	Passed, 12/26/95
Law on Movement of Capital	Not passed
Law on Securities	Passed, 4/22/96
Law on Intellectual Property	Not passed
Law on Concession Contracts and Agreements on Division of Production	Not passed
Law on Competition and Restrictions of Monopolistic Activities in Commodities Market	Not passed

Source: HIID/Russia documents.

Comments From USAID

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

NOV 5 1996

Mr. Henry L. Hinton, Jr.
Assistant Comptroller General
National Security and International Affairs Division
U.S. General Accounting Office
441 G Street, N.W. - Room 4039
Washington, D.C. 20548

Dear Mr. Hinton:

I am pleased to provide the U.S. Agency for International Development's (USAID's) formal response to the draft GAO report entitled, "Foreign Assistance: Harvard Institute for International Development's Work in Russia and Ukraine" (October, 1996).

The report reflects considerable time and effort by the GAO in assessing a major assistance effort undertaken by the Harvard Institute for International Development (HIID) and USAID. We agree with the finding that the award to HIID was consistent with applicable laws and USAID guidelines, and generally agree with the positive assessment of HIID's role and accomplishments in implementing programs in the areas of capital markets, legal reform and privatization.

Although no formal recommendations were contained in the draft report, we plan to take the following actions: (1) review existing policy regarding amendments to non-competitive agreements; and (2) improve management and oversight of the grantee with respect to reporting requirements, establishment of measurable goals, performance monitoring, and results evaluation.

Enclosures (1) and (2) provide specific comments on the report. These comments were developed by individuals and operating units most familiar with the subject matter and we respectfully request that they be given consideration in completing your final report.

320 TWENTY-FIRST STREET, N.W., WASHINGTON, D.C. 20523

Thank you for the opportunity to respond to the GAO draft report and for the courtesies extended by your staff in the conduct of this review.

Sincerely,

Richard C Nygard for

Larry E. Byrne
Assistant Administrator
Bureau for Management

Enclosures: as stated

ENCLOSURE (1)

USAID Comments on the Principal Findings

USAID has one general comment and several specific comments on the GAO findings.

Our general comment concerns the respective roles of USAID and HIID. HIID has not had substantial control over the U.S. assistance program. Nor did HIID "manage" other contractors in the sense of exercising any fiscal controls or even day-to-day work supervision. HIID has worked under the direction of, and in close coordination with, both USAID and appropriate counterparts in providing strategic guidance and oversight and in actively coordinating other contractors' efforts in capital markets and privatization. At no time did USAID cede its own project management responsibilities to HIID.

See comment 1.

Our specific comments below are keyed to the findings in the draft GAO report.

Finding: Awarding of Cooperative Agreements Consistent with Applicable Guidelines, But Process Errors Occurred

As noted in the GAO report, USAID's policy is to encourage competition in the award of cooperative agreements. The policy also allows for flexibility when a noncompetitive award is in the best interests of the U.S. Government. Decisions regarding noncompetitive procurements are thoroughly vetted with appropriate parties to ensure that viable alternatives for meeting the Agency's needs are considered. The GAO report accurately acknowledges that USAID made prudent decisions in the award of noncompetitive agreements to HIID given their established relationship with the Russian government and experience working in the country.

See comment 2.

The report indicates that USAID used erroneous scores to select the winning proposal for the Russian SEC activity due to a mistabulation of panelists' scores for the proposals. USAID disagrees with GAO's conclusion that the discrepancy was the result of an error in scoring. The procurement officer interpreted the handwriting of an evaluation committee member differently than the GAO evaluator when aggregating the individual evaluation scores for a total component score percentage. The procurement officer provided this explanation to the evaluator prior to the issuance of the draft report.

Finding: Mixed Progress on Key Features of an Efficient Capital Market

Recent events indicate that progress is no longer "mixed". The situation in Russian capital markets changed significantly in the period immediately following the completion of the GAO fieldwork.

The GAO may therefore wish to update its report and adjust two of its sub-findings to reflect the changes.

Sub-finding: Efforts to Develop CSOs were Disappointing

This finding should be revised based on events subsequent to the field work of the audit. Efforts to develop clearing and settlement organizations (CSOs) were disappointing until the summer of 1996. However, since that time, significant progress has been made by the Depository Clearing Company (DCC), a central Moscow-based depository:

See p. 42.

- In August 1996, the President, a political appointee, resigned and in September 1996, a new President was elected by the board of directors.
- In October 1996, the shareholders' meeting elected a vice-president and approved: (i) a strategic and financial plan; (ii) a company charter and, (iii) a protocol for settlement procedures electronically linked with the Russian Trading System (RTS).
- Two crucial new shareholders -- the National Association of Professional Market Participants (NAUFOR) and Interbank Credit Union (MKS), a cash settlement bank owned by Russian banks -- joined DCC in October.
- The International Finance Corporation intends to provide DCC with technical assistance, including assistance with the development of a business plan and in the examination of financing alternatives.

This progress is being driven by increased trading activity, which jumped from $15 million per day in July 1996 to $49.4 million in October 1996. The number of brokers connected to the RTS has grown from 130 in July to more than 200 in October 1996. Membership of the National Association of the Professional Market Participants (NAUFOR) has grown to more than 328 companies. With the increasing demand by market participants for clearing and settlement services, DCC is rapidly developing into a leading Russian clearing house.

See p. 37.

We propose that discussions in the report concerning unfavorable market conditions for clearing and settlement services, as well as discussions concerning political power struggles, be revised to include this updated information.

See p. 41.

Sub-finding: Future Independence of the Russian SEC may be in Doubt

We recommend that this sub-finding be revised. The report argues that the legal status and mandate of the Russian SEC is unclear,

and questions whether the workforce can be maintained due to the inability to match private sector salaries.

The Russian SEC's status, defined by a federal law as an independent federal agency with ministerial status subordinated directly to the President of the Russian Federation, was restored by a Presidential Decree on September 6, 1996. As of October 1996, the Russian SEC has a staff of more than 100 professionals at its headquarters and is in the process of establishing 12 regional offices. The Russian SEC has issued more than 40 regulations for the securities market and licensed more than 150 professional market participants.

See comment 3.

With regard to salaries, regulatory agencies in general tend to pay lower salaries than would be available to staff in the private sector (the United States is a good example). However, this has not been seen to be detrimental to the sustainability of those agencies. The Russian SEC is one of five federal ministries that compensate employees at the highest federal government rates.

See comment 4.

We propose that sections of the report and executive summary that question the Russian SEC's future be revised to reflect the Russian SEC's current status and prospects.

Sub-finding: HIID's Substantive Role in Establishing a Capital Market

See comment 5.

It is recommended that the report note a very relevant contribution by HIID to the establishment of capital markets in Russia. HIID executives at the Resource Secretariat played a critical role in securing funding for capital markets activities from other donor organizations. The $89-million World Bank capital markets loan, approved by the Bank's Board on May 28, 1996, will build upon the USAID-funded effort and could have long-term ramifications for Russian capital markets. HIID also helped to secure funding from other donors - TACIS (about 7.4 million ECU) and British Know How Fund (about $5 million). The total amount of this funding -- more than $100 million -- is significant, and will exceed USAID's contributions.

See comment 6.

Finding: HIID Played a Key Role in Legal Reform Project

We agree with this finding, but object to two of its contributing sub-findings. We also suggest that the GAO clarify its text regarding the issue of the number of new laws expected as a result of HIID assistance. First, the cooperative agreement with HIID did not require that they achieve the passage of 19 laws in 2 years; rather, it required that HIID work in certain areas and that the areas of law to be addressed could include the 19 laws. Second, in terms of HIID accomplishments, it is misleading to state that HIID played a major role in the passage of only 5 key

See p. 43.

commercial laws passed by the Duma. In Russia, presidential decrees have the same force as laws passed by the Duma, as long as there is not a conflict between the decrees and laws. HIID contributed to completion of 20 major commercial laws or decrees, many provisions of Part II of the Civil Code, and an additional 6 laws and 19 regulations promulgated in the capital markets area. The laws and the decrees were for the most part the result of the same collaborative drafting process involving members of the Duma, academia, government ministries, the practicing bar, the judiciary, the business community, etc.

See comment 7.

Sub-Finding: Lack of USAID Oversight May Have Resulted in Unnecessary Costs

We do not agree with the finding and request that it be eliminated. Our reading of the record indicates that: (a) HIID's work on the Civil Code was a complementary and not a duplicative effort to the work of IRIS; (b) it had been requested by Duma and Presidential administration officials; and (c) it had been officially approved by the USAID Mission and USAID/Washington.

See p. 49.

The report is misleading because it ignores the positive benefits that came from HIID's participation in the process of drafting Part I of the Civil Code. The legal reform project was asked to become involved to create competition and force the Research Center to open up the drafting process to other points of view. The ultimate version of Part I that was passed by the Duma was improved because of this pressure, in addition to the excellent work the IRIS project performed in expanding the horizons of this small group of drafters. It should be noted that the President's office solicited the draft produced by the HIID Russian lawyers. The fact that the legal reform project was brought into the drafting process led to the two entities working more collaboratively on Part II of the Code, which Russian and foreign experts alike agree was a far better piece of legislation.

Sub-Finding: Lack of Oversight Over HIID's Strategy

We disagree with the GAO assertion that "HIID altered the ...legal reform strategy by deciding to emphasize the use of presidential decrees without receiving approval from USAID". The agreement document is broad, and there is no indication that there was a violation of the terms or spirit of the cooperative agreement. Since the inception of this project, HIID and its Russian legal team have worked closely with the coordinating committee to advance economic reform legislation using a variety of strategic approaches. USAID/Moscow and USAID/Washington have been aware of, and in agreement with, this strategy. In fact, the agreement was drafted in such a way as to afford HIID maximum flexibility to identify opportunities for reform legislation, and to move forward in the most appropriate manner. Thus, the use of

See comment 7.

decrees was not a change in strategy, but was part of the strategy itself.

Finding: Sustainability of Privatization Centers Questionable

We recommend that the finding be modified or clarified. While the sustainability of the Russian Privatization Center (RPC) and its Local Privatization Center (LPC) network as private consulting organizations may be questionable, the sustainability of that network as a donor coordination and project implementation organization is not. The latter point is supported by the fact that the World Bank has designated the RPC to be a Project Implementation Unit for a $100 million loan project, the Japanese have committed to support the full operational costs of the LPC network, and EU-TACIS has initiated three new enterprise restructuring projects designed and implemented in conjunction with the RPC.

See pp. 57-59.

It should also be noted that the body of the report contains several conclusions about USAID's expectations for the sustainability of the RPC that are incorrect. At the time the RPC was established, USAID design documents stated that the "purpose of A.I.D. assistance is not to establish a long-lasting Russian institution, but rather to support the effective implementation of privatization now." It was also stated that "RPC financial independence through revenue generating programs is not politically or bureaucratically possible at this time." As privatization progressed rapidly, it became clear that massive post-privatization support for restructuring privatized enterprises would be necessary and the GOR designated the RPC to undertake that responsibility through a presidential decree establishing the LPC network, which USAID subsequently supported. When USAID made its final direct contribution in 1995 to support the LPC network, USAID stressed that RPC needed to develop a strategy for sustainability. Since then, USAID has assisted the RPC to do so, to ensure a rational and responsible phase out of the USAID investment to the RPC and LPCs.

See comment 8.

The following are GAO's comments on USAID's letter dated November 5, 1996.

GAO's Comments

1. To assess the respective roles of HIID and USAID, it is important to understand the position that HIID had in providing technical assistance. As indicated in appendix I, HIID had direct access to the Russian reformers through the Russian Securities and Exchange Commission's (SEC) Resource Secretariat, ILBE, and the RPC. The HIID/Moscow General Manager told us that he considered his clients to be the Russian reformers, not USAID, and that he responded to his client's requests for assistance. HIID's responsibilities included gathering information necessary to develop task orders, determining key concepts for the project, and defining and implementing the project. HIID was in daily contact with Russian reformers and U.S. contractors that were co-located with HIID. Contractor personnel told us that although USAID signed the task orders, it was the Russian reformers and HIID that directed their activities. Moreover, HIID officials told us that they gave advice to Russian reformers on a confidential basis and did not always inform USAID or the Department of State that sensitive areas were being discussed. USAID and State officials confirmed to us that they did not always know about these discussions. Similarly, USAID relied on HIID to work with the Russian President's Legal Advisor and the legislative coordinating committee to develop the legislative agenda, and at times HIID initiated activities before funding approval was received from USAID.

2. We confirmed the individual scores of the panel members and, at the time of our review, the procurement specialist agreed with our finding.

3. The report has been modified to reflect this new information. However, the information illustrates the political struggle that the Russian SEC has encountered from its inception.

4. We revised the report to expand the discussion of SEC resources issues beyond that of federal versus private sector salaries. Market participants told us that fulfilling the Russian SEC's considerable responsibilities will require a significant enlargement of its staff and budget.

5. The report was modified to include this information.

6. Our objective was to provide an assessment of HIID's role in the legal reform effort and the progress made in the 19 areas, since success in this

regard was viewed by State as critical to the overall political and economic transition. We did not intend to imply that HIID only provided assistance on 19 pieces of legislation and we acknowledge HIID's involvement in many legislative areas. We have attempted to clarify this point.

7. USAID's comment about the use of decrees to achieve reform is correct, as far as it goes. We recognize in the report that the situation that developed after the 1995 parliamentary elections, may have prompted a greater use of decrees to accomplish reforms. However, none of the USAID or Department of State documents authorizing the program discuss getting decrees issued; they only discuss the passage of legislation. Furthermore, the U.S. Ambassador told us that decrees were not an integral part of the initial legal reform strategy. As we point out in the report, it was this very use of decrees during the initial privatization effort that led the U.S. Ambassador to push for the coordinating committee to gain legislative involvement. Further, USAID's action memorandum justified the program based on the need to pass legislation to "foster a new pattern of executive-legislative cooperation . . . necessary to adopt and implement the new laws . . . ."

8. USAID's comments do not reflect the change in strategy regarding the RPC that took place in light of emerging economic and business issues. We recognize that USAID's original expectations were short term and based on the RPC's immediate role to support privatization. However, USAID later expected the RPC to sustain itself either through donor resources or fees generated by consulting services based on the objectives of USAID's assistance to the RPC. Accordingly, USAID documents show that when it made its final direct contribution in 1995 to support the LPC network, it stressed that the RPC needed to develop a strategy for sustainability. From fiscal years 1992 through 1996, USAID budgeted nearly $50 million for enterprise restructuring and land reform assistance programs to, among other things, develop the RPC and the LPC network's capabilities to continue such activities after graduating from USAID assistance. Furthermore, USAID made funding available to Program for Intensive Enterprise Support and Financial Management Assistance program contractors to develop consulting materials for the RPC and the LPC network specifically as a fee-generating service. In addition to providing its own funding, USAID informed us in August 1996 that it was working very closely with the World Bank to secure the RPC's best prospects for sustainability—the Enterprise Restructuring Services Project. USAID and HIID have dedicated substantial financial and human resources to the RPC and, therefore, both have a significant investment in the RPC's future.

Comments From HIID

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

HARVARD UNIVERSITY

HARVARD INSTITUTE FOR INTERNATIONAL DEVELOPMENT
One Eliot Street, Cambridge, Massachusetts 02138
Jeffrey D. Sachs, Director
Galen L. Stone Professor of International Trade
Department of Economics

Tel: (617) 495-4112, 495-9871
Fax: (617) 495-8685, 496-3967
email: jsachs@hiid.harvard.edu
Cable Address: HIID
Telex: 275276

October 29, 1996

Mr. Benjamin F. Nelson
Director, International Relations and Trade Issues
International Affairs Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Nelson:

The following are the comments of the Harvard Institute for International Development (HIID) on the draft GAO Report you kindly sent us for review. We very much appreciate the opportunity to comment.

In general, we think that the conclusions of the report are reasonably balanced. We are pleased to note, in particular, the finding that USAID's awards to HIID "were consistent with applicable laws and USAID guidelines" and reflected HIID's "early and extensive work in advising the Russian reformers" and "its experience, expertise and a system of contacts within the Russian Government."

We are pleased that the report concludes that "Russia, with HIID's support and assistance, has made substantial progress on some of the key features of a functioning, efficient capital market." We are also pleased that the report concludes that the laws and decrees which the Legal Reform Project helped to draft represent "significant accomplishments" and covered "37 general areas [of law] related to economic activity." We would go further and say they represent a fundamental transformation of the legal environment and are a critical foundation of the development of a market economy in Russia. When the legal reform process started in Russia, Western legal systems and concepts in commercial law were totally unknown, unlike Eastern Europe where such systems and concepts existed until the end of World War II and thus could provide a solid model or framework for new action. As a result, legal reform has been a much more difficult task in Russia than in Eastern Europe.

With respect to Ukraine, we are pleased that the Report makes clear that the current HIID project

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See comment 1.

originated with a request from the Government of Ukraine (GOU) to HIID. The project was entirely unrelated to the previous USAID consideration of a cooperative agreement for assistance to Ukraine in Spring 1995 (subsequently withdrawn by USAID) and covered much different work than was contemplated in the 1995 proposal. The project involves provision of advice to the GOU at the highest levels on strategic macroeconomic policy. The project has been highly successful and has made unique contributions that are highly regarded by senior GOU officials.

We understand the terms of reference of the Report (as set forth on pp. 3 and 37) are limited, and do not include an evaluation of HIID's work in Russia in providing advice in the areas of price liberalization, stabilization and privatization. Nevertheless, it is worth stating that these three issues (which are at the heart of the transition to a market economy) represented a substantial element of HIID's work in Russia. We would be happy to provide any further information the GAO wishes on these matters.

Finally, we wish to note that in a number of matters the Report is in error, misleading or incomplete. HIID activities in Russia are complex and our comments are not intended to reflect adversely on the work of the GAO staff. In some cases, events since the GAO staff completed their investigation have superseded the conclusions of the draft Report. We think it important to set forth these matters in some depth and have attached a memorandum listing them. We have also attached for your convenience the specific changes in the language of the Report to correct these matters. To the extent that our comments are not reflected in the final Report, we request that this letter, the enclosed memorandum and the charts attached be printed in the Report. The memorandum containing our suggested draft language does not need to be included in printing our response.

Very truly yours,

Jeffrey Sachs
Director

Attachments: 2

Now on p. 17.

See comment 2.

Now on pp. 2, 4, 18, and 47.

Now on p. 17.

See comment 3.

See comment 4.

MEMORANDUM: DETAILED COMMENTS ON GAO REPORT

I. General Comments and Award of Contracts

1. The Report misstates HIID's role in legal reform, capital markets and the Russian Privatization Center (RPC). HIID did not have "substantial control" (p. 32) over the US Assistance Program. This control was actually given to Russian reformers through the vehicle of the Coordinating Committee for legal reform matters, to the Russian SEC for capital markets, and to the RPC for enterprise restructuring. All the work of HIID and its principal subcontractor, the non-profit Russian entity the Institute for Law-Based Economy (ILBE), was directed and controlled by the Coordinating Committee and the Russian SEC; there was an agreement with USAID and the Legal Office of the President of Russia and the State Duma expressly providing for this control, which stated that "coordination of technical and legal assistance funded by USAID and aimed at the support of legal reform" and the "determining [of] top priority areas to support the legal reform funded by the USAID" shall be exercised "exclusively" and "independently" by the Coordinating Committee.

ILBE had been formed and was staffed by an elite group of Russian professionals - lawyers and economists - who had been working in the area of commercial legal reform and privatization for some time and who actually performed the substantive legal work standing behind the reform process. All the legal work discussed in the Report was done in what properly should be called the Legal Reform Project (LRP) whose participants were the leadership of the Duma, the Legal Office of the President, ILBE and HIID. Many of the references in the Report to HIID should actually be changed to LRP.

2. The Report appears to suggest (pp. 2, 7, 33, 92) that HIID had a significant role in establishing Russian institutions like the RPC, ILBE or others. These were conceived of and formed by Russians on their own initiative with only modest help from HIID.

3. It is incorrect to state (p. 33) that assistance in drafting commercial laws was "channeled" through the Russian President's Legal Advisor. Such assistance actually was channeled through the Coordinating Committee of which the Legal Advisor was a member.

4. The Report suggests that the Ukraine contract duplicates work already being done in the Ukraine. We think the Report fails to distinguish between the concerns of some individuals at the USAID Mission in Kiev at the very start of the project and the position of the mission itself as determined by the senior officials responsible. We doubt that the mission would have awarded the agreement if it thought major portions of the work would duplicate, possibly delay or be counterproductive to other projects. Prior to entering into the cooperative agreement, HIID was made aware of the concerns that individual staffers had raised, and was explicitly committed to avoiding duplication in effort. The essence of the HIID project (strategic advising to the most senior GOU officials on macroeconomic and tax policy) is fundamentally different from other

See comment 5.

ongoing projects. We do not at all understand the comment in the Report concerning the work on pension reform and the suggestion that it would have been counterproductive to a German sponsored program. This statement is completely contrary to many representations made by senior US government officials, including senior USAID officials during the entire process. We are confident that examination of the project today would make it clear that there is no duplication of the work being done by the US Treasury advisor or by the International Monetary Fund.

II. Comments on Chapter 3: Capital Markets

Now on pp. 4 and 9.

Now on pp. 31 and 41-42.
See comment 6.

1. **Future of the Russian SEC:** The Executive Summary (pp. 7, 18-19) and the draft Report (pp. 60, 81-82) state that in August 1996 a Presidential Decree was signed which downgraded the status of the Russian Federal Commission and thereby rendered uncertain the future of the Commission. The information in the Summary and Report is dated. Less than one month later, the action taken in the August 14 Decree was corrected in a Decree of the President #1326 "On the System of Federal Executive Agencies" dated 6 September 1996. In the September Decree, the status of the Federal Securities Commission was reconfirmed as a ministry in full accordance with the Russian federal "Law on Securities." It is widely acknowledged that the inclusion of the Commission in certain provisions of the August Decree, which reorganized the entire federal government in detail, was a mistake by the drafters of the August Decree.

Now on pp. 9 and 41.

See comment 7.

The Summary (p. 19) and the Report (p. 82) also state incorrectly that "[I]t is unclear whether the Russian SEC will be able to maintain its work force due to its inability to match private sector salaries," because the salaries of federal employees are capped at a level below that of the private sector. This is true of all federal governments around the world, and the conclusion is an overstatement. The federal employees that make up the Commission staff are professional bureaucrats who were hired by the Commission from other government agencies, such as the Russian Committee for State Property Management (privatization agency), the Russian Ministry of Finance, and the Russian Central Bank. This staff is accustomed to the normal range of federal government salaries. In March 1995, the Commission was not only granted ministry status, but also "privileged" ministry status so that it is one of five federal ministries that pay the highest federal government salaries. The rate of attrition of Commission staff to the private sector is expected to be lower than normal.

The Report and Summary should point out that an independent federal regulatory agency for the securities market has been established with a privileged ministry status which gained the respect of the market almost immediately as a competent regulator. The ministry has grown from 3 officials in November 1994 to a staff of more than 100 professionals by October 1996. The Commission has adopted more than 40 regulations for the securities market, and has issued more than 150 licenses to fund managers, specialized depositories and registrars. The Commission is

currently in the process of establishing 12 territorial branch offices. The status of the Commission as a federal ministry, and its authority to regulate the securities market, is established by a federal law passed almost unanimously by the Russian legislature and signed by the President in 1996.

2. **Future and Status of Depository Clearing Company (DCC) and Other Clearing and Settlement Organizations (CSOs):** The Report and Summary contain various inaccuracies and dated information about the CSO project, and in particular about DCC.

Now on pp. 38-41.

The Report (pp. 75-76) and the Summary (p. 18) state that "[E]ach CSO evolved from an existing stock exchange and was owned and controlled by the exchange and the market participant [sic]." The Report and Summary then imply the incorrect conclusion that the CSOs are no longer viable because trading on these exchanges is no longer significant.[1] This conclusion confuses the difference between floor-based exchanges and the over-the-counter market. CSOs are an integral portion of any securities trading infrastructure, whether the trades are made on a floor-based trading system or an over-the-counter system or a hybrid. So long as trades are executed on any trading system, the need exists for an organization to clear and settle such trades.

See comment 8.

In 1994, when the Russian CSO project was initially designed, each of the CSOs was paired with a developing floor-based exchange in the respective city. Because the floor-based exchange was never a viable equities trading platform in Russia, the initial floor-based exchanges have not survived. Instead, the over-the-counter market for equities which began to develop naturally has been successfully institutionalized as the Russian Trading System (RTS). As this natural trading structure emerged during 1994, a parallel structure was devised for the CSOs--i.e., a central depository in Moscow with branch depositories in the other cities where the Russian Trading System operates. Today, the DCC (the Moscow CSO) is electronically linked to RTS in order to clear and settle trades on the system.

Now on p. 39.

The Report (p. 77) also states that "DCC is not yet fully operational in part because the market was not ready for such an organization." DCC has been "fully operational" as a professional re-registration business for about two years. It has, however, taken longer than hoped for DCC to fully develop simultaneous book-entry settlement of share ownership and payment-vs-delivery clearing of trades that is a natural function of the depository business. As the Report (pp. 77-81) points out, this has been due to the slower-than-expected development of demand for such services by the market participants. A clearing and settlement organization is a derivative service provider, and can only develop as the market matures and its services are demanded by market

Now on pp. 39-40.

See comment 9.

[1] "According to the contractor, as of mid-1996, only the Vladivostok stock exchange was active, executing about 30 transactions a day, and as of mid-1996 DCC was disintegrating." Report (pg. 77) and Executive Summary (pg. 18).

participants.

Only recently has this demand by market participants for the clearing and settlement services provided by DCC reached a critical level. Trading activity in Russia as reported by NAUFOR has increased since June 1996 from $10 million to $15 million per day, with a daily high that has jumped from $15 million to $47 million in October 1996. This increased activity has significantly influenced the attitudes and commitment of those market participants that drive DCC's development. Further evidence of the increasing growth and maturity of the market participants and market infrastructure is the growth of NAUFOR. In the last six months, NAUFOR has grown from 200 to 300 members.

See comment 9.

Now on pp. 40-41.

In addition, the political struggles mentioned in the Report (pp. 80-81) which inhibited the market demand for CSO services have been ameliorated. In August 1996, the DCC management resigned. At a mid-October 1996 shareholders' meeting, the shareholders elected a new management team which is rapidly building credibility in the marketplace. The Board of Directors of DCC was adjusted to include Chase and Credit Suisse (two of the largest global custodians), NAUFOR and MKS, a limited-purpose cash settlement bank collectively owned by many of Russia's largest banks. A representative of each of the Federal Securities Commission and the Russian Central Bank also were elected to DCC's Board of Directors.

At the same October 1996 meeting, a representative of the International Financial Corporation repeated IFC's prior written intention to provide specialists and participate in the long process of raising capital to support DCC's gradual assumption of guarantees for re-registration, settlement and depository activities. The IFC also agreed that the Corporation's name could be used to help boost market confidence in the DCC.

New members are joining DCC, including NAUFOR and the Interbank Credit Union (MKS), each of which has committed $200,000 in new capital. New services are being developed, including a program to offer a form of delivery vs. payment when funds settlement is handled offshore. DCC is now rapidly realizing its potential as the leading member-owned depository institution in Russia.

Now on p. 37.

3. **Status of the National Registry Company (NRC):** The Report (p. 75) and the Executive Summary (p. 17) incorrectly state that Lukoil has "backed out" of its agreement to transfer its company register to the NRC, and that this factor has led to skepticism on the part of market participants about whether NRC has the momentum to succeed.

In fact, Lukoil has consistently reconfirmed publicly its intention to transfer its company register to NRC as soon as its internal corporate reorganization is complete, which should be by April 1, 1997. Lukoil and NRC are currently finalizing the contract for such transfer. To date, NRC has taken over the registers of 17 Russian companies, all of whom have more than 1,000 shareholders. Five of these companies have more than 10,000 shareholders. In September 1996, NRC became the registrar for Norilsk Nickel, the world's largest nickel producer. NRC is

See comment 10.
See pp. 37-38.

currently in the final stages of negotiation for client agreements with an additional four Russian companies.

See comment 3.

Now on pp. 8 and 36.

4. **Status of the Russian Trading System**: Although described in the Report as an unqualified success, the statistics in the Report (p. 14) and the Summary (p. 70) about the RTS are dated already. The Report and Summary state that "[C]urrently, over 130 brokers use the system" and "[T]he trading system connects several cities throughout the Russian Federation." In fact, as of October 1996, there are 328 NAUFOR members, of whom 215 have RTS terminals in their offices. NAUFOR now has members in 39 cities, and in 24 of these cities members have access to the RTS. Most of the 15 cities where RTS does not now have access will be connected over the next two months by KPMG/Barents under its task order.

Now on p. 36.

The Report (p. 71) and Summary (p. 15) state that there are two organizations bearing the name PAUFOR--a Moscow-based organization and a national organization. The Moscow-based organization of brokers is named PAUFOR, but the self-regulating national association of brokers which owns the RTS is named NAUFOR.

See comment 3.

5. **Additional Financing for Capital Markets Assistance**: The Report and Summary neglect to mention one important contribution of HIID and the Resource Secretariat to the capital market development in Russia. HIID has been instrumental in attracting significant bi-lateral technical assistance funds for capital market projects from the British Know-How Fund and from the European Union's TACIS, and in integrating those projects into the work of the Resource Secretariat. HIID has also been instrumental in preparing an $89 million World Bank loan for Russian capital market development which was signed by the Russian Government on September 29, 1996 and which will provide funds over the coming three year period for further development of the Russian capital market through the Resource Secretariat.

III. Comments on Chapter 4: Legal Reform

See comment 11.

1. **Attempts to Develop Benchmarks**: The Report at various places states that HIID (it should have stated LRP) originally was to work on 19 specific pieces of legislation, and that the Coordinating Committee had identified these 19 subjects as priority items. The Report then attempts to add up how many "laws" were passed and to determine how many were on the original "list" of 19 and how many were not. This approach mischaracterizes HIID's contractual undertakings and the LRP.

A. As stated in HIID's June 21, 1996 letter to the GAO, the Cooperative Agreement, HIID's Agreement with the Coordinating Committee and HIID's Work Plan all provided for HIID to do legal drafting service for commercial law development in general. These three documents did not provide (and HIID, USAID and the Coordinating Committee did not intend) that the LRP would work on 19 laws, 21 laws, 150 laws or any other number.

The Cooperative Agreement states that HIID will provide legal assistance "as requested by the Coordinating Committee ..." and that "the specific laws and areas of law to be addressed ... could include [the 19 areas referred to in the Report]." The July 25, 1994 Agreement between HIID and the Coordinating Committee (which was done only in Russian) provides that:

> "The body of law affecting business incorporates a wide range of different fields of law, including laws concerning property and corporate relationships, commercial and financial activities. The Project would support drafting efforts in these areas. The specific laws and areas of law to be addressed by the Project include, but are not limited to, the following:" [listing 14, not 19, very broad areas of Law, e.g. "Civil-Code," "Commercial Law," "Securities Law," "Land Law," etc., each of which could include many separate laws.]

Finally, as set forth in HIID's Six Month Work Plan, the Coordinating Committee formed working groups on 19 specified topics and stated that the LRP would ".... provide assistance to the working groups as requested by the Committee." It also stated that the "nature and duration" of the work will be determined by the Committee. In no sense was this a list of 19 specific laws to be adopted on a priority basis - this was simply an indication of laws or areas of law to be studied. It was not intended (and the Work Plan did not state) that the LRP would not work on matters beyond the 19 subjects listed or that each of the 19 subjects was of equal priority or deserved major attention. Indeed, some of the 19 subjects listed were seriously adverse to the development of a free market economy where any legislation would be opposed, and this was recognized by all concerned. And as set forth in the June 21, 1996 letter, the direction from the Coordinating Committee shifted with events, and the subjects worked on by the LRP were a changing mix of emphasis and priority of various aspects of commercial law.

See p. 45.

If the report wants to record totals it should simply note, as set forth in the detailed charts that HIID submitted to GAO on June 21, 1996 (attached), that as a result of the LRP, in the commercial law area 13 laws were passed, plus Title II of the Civil Code which contained 7 major chapters which are each very separate areas of law, 13 decrees were promulgated having the force of law and 19 major regulations were promulgated in the capital markets area. The LRP was the principal drafter of 4 of the laws, 5 of the decrees , and all 19 of the regulations, and was either the co-drafter or contributed in a significant way in the drafting of the others.

See comment 12.

B. The Report is in error in describing the LRP's work on some of the laws (which should also include the decrees) actually passed as merely "providing some comments." The detailed charts that HIID submitted to GAO listing the laws and decrees that LRP worked on were broken into three categories: (a) "principally drafted" (b) "co-drafted" or (c) "contributed to in a significant way." HIID did not attempt to list matters where the LRP merely provided some comments.

See comment 13.

C. The Report's suggestion that it was desired to enact laws in all 19 categories is wrong. As discussed on the chart submitted to the GAO on June 23, 1996, four of the 19 "laws" or areas of law listed would be seriously detrimental to development of a free market economy and we discouraged

See comment 13.

any efforts to propose or pass any law in these areas: (1) Fundamentals of Pricing Policy, which involved the government setting rules for pricing and thus inviting bureaucratic control instead of market forces (2) Delivery of Products for State Needs, which raised problems of expanding the Government's role in setting standards for goods and services (3) Management of State Property, which raised the same problem (4) Movement of Capital, which raised the problem of the Government, instead of market forces, allocating capital.

See comment 12.

D. Even using the list of 19 subjects of law, the Report is in error in the totals. As discussed at length on the chart submitted on June 23 1996, laws were actually passed in nine categories, not four. Thus, if the Report continues to focus on the 19 subjects of law originally listed, it would be a fair statement that the LRP's work resulted in the passage of laws in 9 out of 15 categories where laws were desired. Appendix I of the Report should be revised to reflect this.

2. HIID's Reports: The Report at various places deals with the regularity and adequacy of HIID's written reports to USAID, and suggests that there was a lack of performance by HIID. HIID acknowledges that for the first few months of the Project it submitted only quarterly reports, not monthly reports, but this deficiency was soon cleared up, starting about January, 1995. The substance of the reports (which ranged from 10 to 50 pages), however, was fully in accord with the requirements of Moscow USAID and was satisfactory to them. As stated in the June 21, 1996 letter to GAO:

> "Because of the sensitivity of working within the political process of Russia, it was specifically understood by USAID and HIID that there would not be a comprehensive paper trail of formal reports listing specific accomplishments, although there was regular written reporting. Nonetheless, the Legal Reform Project had an open door and open file policy with USAID, and USAID officials were regularly in the offices of the Legal Reform Project almost on a daily basis and certainly on a weekly basis. As you can readily confirm with Matthew Mosner or James Norris, USAID knew and approved of all significant activities of the Project and of anything the Project was not doing that might have been listed in the agreements."

Finally, it is incorrect to state that USAID Washington did not receive HIID's reports until late 1995. The two staff persons in Washington at the Office of Private Enterprise Restructuring responsible for the HIID agreement received all of HIID's reports, were satisfied with them, and in addition, were in regular telephone contact with HIID and were fully informed about HIID's activities.

See comment 14.

3. Use of Decrees:

A. The Report deals at various places with the use of decrees but does not mention the number of decrees issued covering commercial law areas, which total 13, nor does it describe the process by which decrees were adopted. It would be more informative if the Report indicated that a decree in a given area of commercial law is typically the culmination of the same process that leads to enactment of a law - e.g. development of concept papers; consultation with various ministries, the office of the President, various Duma Committees, outside experts, academics and the Russian private sector;

See comment 15.

preparation and review of amendments; and development of a consensus or political will to issue a decree in the absence of adequate legislation. Thus the decree making process in Russia has been broadly consistent with the development of democratic processes, and indeed has provided the Duma with an incentive to take positive action.

See p. 50.

B. The report is wrong in stating that HIID (more correctly, the LRP) altered the USAID and Department of State legal reform strategy by deciding to emphasize the use of decrees without receiving approval from USAID. Prior to entering into the Cooperative Agreement both HIID and USAID had been actively involved in the Russian privatization effort and the beginnings of legal reform, both of which had involved extensive use of decrees where legislation was blocked or delayed. Use of decrees was a fact of life known and recognized by everyone as necessary to hasten the transition of Russia to a free market society; contrary to the suggestion of the Report such use was an integral part of the legal reform strategy. The LRP's increasing use of decrees, after the major communist gains in the 1995 election made it more difficult to get laws enacted by the Duma, was known to and approved by Moscow USAID and by more senior US Government officials, and was not a change in strategy requiring formal USAID approval.

See comment 16.

4. Work on Part I of the Civic Code: The discussion (p. 96) of the work on Part I of the Civil Code is almost entirely wrong. HIID began work on Part I of the Civil Code at the request of the legal office of the President of the Russian Federation and the chairmen of the relevant committees of the Duma. (The work was done before ILBE was formed.) The work was known to and authorized by Moscow USAID, and we have in our files a memorandum dated March 11, 1994 from the Director of USAID Moscow seeking approval from USAID Washington (which was subsequently granted) for HIID to hire the French and Dutch experts. The project was considered a sufficiently high priority by the Duma chairmen and the Legal Office of the President that a special dacha was provided by the President's office at its expense where the Russian specialists could work without distraction. We do not understand how GAO estimated that HIID spent $500,000 on the work on Part 1. In the short time available to prepare this response we have determined that approximately $85,000 to $90,000 was spent for the non-Russian experts hired and estimated that the cost of the work of the Russian specialists on HIID's staff did not exceed $50,000, thus the total cost was approximately $135,000 to $140,000. The work of HIID's Russian specialists and the foreign consultants was not rejected by the President's office; to the contrary it was used by the President's office as a threat to the Russian Center for Private Law to move more quickly to publish its draft of Part I and to incorporate the work of HIID's specialists. This work (and the work of IRIS) contributed to the result of Part I and was not duplicative of IRIS's work.

See comment 17.

Now on pp. 10 and 35.

5. Two-Year Time Table: On pages 20 and 68, the Report states that USAID hoped that the necessary laws and institutions for legal reform would be passed and in place in two years. We question such a statement - we are not aware of anyone in USAID Moscow or Washington knowledgeable about the Russian situation who could have had that view. When one considers how long it may take to enact legislation in the U.S. on controversial subjects - e.g. medical care, entitlement reform, etc. - it is not realistic to expect such rapid development in Russia, particularly when the subject (commercial law) is one where most Russians have little experience and where there

See comment 18.

is still strong opposition to the whole idea.

6. Work of the Rural Development Institute (RDI):

See comment 3.

A. The Report on page 40 is not accurate in stating that RDI did not want its Russian contacts "known" by GAO. RDI provided the names of its Russian contacts to GAO at a meeting in Washington on July 17 with the understanding that they would not be interviewed by GAO.

Now on p. 21.

See comment 3.

B. On page 91 the Report misdescribes a Presidential Decree as allowing "individuals who rented small plots to obtain full ownership rights." The Decree was much broader, and a more accurate description would be that it "strengthened private ownership rights of individuals to agricultural land."

Now on p. 47.
See comment 3.

C. Page 91 does not give a complete description of RDI's efforts on land reform in Russia. In addition to what is mentioned, RDI has provided advice on issues such as real estate registration, mortgages and land use planning, and has also provided advice to World Bank personnel regarding land policy initiatives to be included in World Bank loans.

Now on p. 47.

See comment 19.

IV. Comments on Chapter 5: Russian Privatization Center (RPC).

With respect to the RPC, we should clarify the extent of HIID's involvement and responsibility. The RPC is a Russian organization, with its own board of directors and management structure. Several agencies of the Russian government are represented on its board of directors. The RPC gets funding from a variety of sources, and performs a number of services for the Russian government, including most importantly the administration of World Bank loans and other technical assistance.

See pp. 57-60.

HIID cooperates with the RPC in a number of ways, but does not have control over its activities. HIID (through a grant from USAID) is responsible for the employment of a small number of relatively senior RPC officials. These officials fall into two broad categories: project managers and administrators. While the RPC and the HIID have joint responsibility for hiring and firing them, the scope of these officials' work is determined by the RPC management, and they report to the RPC management. In addition, as the Report recognizes, HIID has cooperated with the RPC in the provision of policy advice to senior Russian reformers, and has in this capacity retained consultants to provide some of the advice.

Given the nature of this relationship, we do not feel that it is appropriate for us to comment on the adequacy of the part of the GAO Report that assesses the activities of the RPC. However, we do have two general observations. First, we are pleased that the Report recognizes the valuable contributions that the RPC has made in the transformation of the Russian economy, although in several areas the Report neglects some of the achievments of the RPC while

overempasizing the problems. Second, the Report is too pessimistic about the sustainability of the RPC because it is close to receiving extensive funding from the Russian government through the World Bank to continue its work on promoting enterprise restructuring. It may be more appropriate to ask the RPC directly to respond to GAO's assessment of their work.

LISTING OF LAWS, DECREES AND REGULATIONS, DEVELOPED BY THE HIID LEGAL REFORM PROJECT (LRP) IN THE AREA OF CAPITAL MARKETS

(1995-1996)

I. LAWS, DECREES AND REGULATIONS IN EFFECT

I.A. LAWS, DECREES AND REGULATIONS PROMULGATED ON WHICH LRP SERVED AS THE PRINCIPAL DRAFTER

Law, Decree or Regulation	Date Effective/Signed
Federal Law on Securities Market	Signed by President April 22, 1996
Decree of the President of the Russian Federation No. 765 "On Measures to Raise the Effectiveness of Investment Policy in the Russian Federation"	July 26, 1995
Standard Rules of Open Unit Investment Funds	Approved by the resolution of RFSEC dated October 12, 1995, #13.
Standard Rules of Interval Unit Investment Funds	Approved by the resolution of RFSEC dated October 16, 1995, #14.
Standard Prospectus of Issue of Investment Units	Approved by the resolution of RFSEC dated October 18, 1995 #15.
Standard Agreement of Evaluation or Assets Comprising Unit Investment Fund	Approved by the resolution of RFSEC dated October 20, 1995 #16.
Standard Contract for Auditing Review of Accounting and Reports Related to Trust Management of Assets of Unit Investment Fund	Approved by the resolution of RFSEC dated October 23, 1995 #17.
Provision on Licensing Activity in the Capacity of Specialized Depository of Unit Investment Funds	Approved by the resolution of RFSEC dated October 25, 1995 #18.
Provision on Procedure of Evaluation and Drawing Reports on Value of Net Assets of Open Unit Investment Funds	Approved by the resolution of RFSEC dated October 27, 1995, #19.

Standard Agreement on Provision of Depository Services by Managing Company of Unit Investment Funds	Approved by the resolution of RFSEC dated October 30, 1995, #20.
Provision on Procedure of Evaluation and Drawing Reports on Value of Net Assets of Open Interval Unit Funds	Adopted by the resolution of RFSEC dated November 2, 1995, #21.
Provision of Procedure of Maintaining Register of Unit Investment Funds	Approved by the resolution of RFSEC dated January 9, 1996, #1.
Provision on Procedure of Registration of Rules of Unit Investment Funds and Prospectus of Issue of Unit Investment Funds	Approved by the resolution of RFSEC dated January 11, 1996, #2.
Temporary Provision on Maintaining Register of Owners of Units of Unit Investment Funds	Approved by the resolution of RFSEC dated January 12, 1996, #3.
Methods of Accounting and Reporting in Unit Investment Fund	Approved by the resolution of RFSEC dated February 19, 1996, #4.
Interim Order of Licensing of Activities on Maintaining of Register of Owners of Registered Securities	Approved by the resolution of RFSEC dated August 30, #6
Interim Provision On Maintaining of Register of Owners of Investment Shares of Unit Investment Funds	Approved by the resolution of RFSEC dated January 12, 1996 #3
Temporary Provision on Trust Management of Property of Unit Investment Funds and its Licensing	Approved by the resolution of RFSEC dated October 10, 1995 #12.
Temporary Provision on Managing Companies of Unit Investment Funds	Approved by the resolution of RFSEC dated October 10, 1995 #12.
Clarification of RFSEC "On the Order of Additional Issue of Shares by a Joint Stock Company, In Regard to Reevaluation of Fixed Assets"	Approved by the resolution of RFSEC dated August 17, 1995 #A4-731
Clarification of RFSEC "On Use of Terms in Titles of Investment Funds"	Approved April 1996.

I.B. LAWS, DECREES AND REGULATIONS PROMULGATED ON WHICH LRP SERVED AS THE CO-DRAFTER

Law, Decree or Regulation	Date Effective/Signed
Decree of the President No. 1157 "On Some Measures for Investors and Shareholders Protection"	November 18, 1995
Decree of the President No. 408 "On Approving Complex Program for Securing Investors and Shareholders Rights"	March 21, 1996
Decree of the President No. 416 "On Measures to Protect Investors and Shareholders Interest and Bringing Commercial Activity, Carried Out on Financial and Capital Markets without Corresponding Licenses into Compliance with the Russian Federation Legislation"	April 26, 1996
Letter of the State Tax Service # NP-2-01-80n "On Some Issues of Taxation Arising from Emergence and Operation of Unit Investment Funds"	December 15, 1995.

II. DRAFT LAWS, DECREES AND REGULATIONS UNDER ACTIVE CONSIDERATION BY DUMA, STATE LEGAL OFFICE (GPU), RFSEC AND/OR MINISTRIES

II.A. DRAFT LAWS, DECREES AND REGULATIONS ON WHICH LRP SERVED AS THE PRINCIPAL DRAFTER

Draft Law, Decree or Regulation	Status
Federal Law on Investment Funds	Draft was approved by the RFSEC and submitted to the Government for further consideration June 1996. Adoption expected in Fall 1996.
Federal Law On Cessation of Shares, Reserved in the Federal Property and On Contributing Objects in Federal Property to Charter Capitals of Partnerships and Societies	Adopted by the State Duma after extensive amendment October 1995 Vetoed by the President. Project has redrafted the Law, combining it with the draft Law on the Order of Disposition of Shares Fixed in the Federal property (see below), and is being prepared for introduction to the Duma.
Federal Law On the Order of Disposition of Shares Fixed in the Federal Property	Adopted by the State Duma October 1995 after extensive amendment. Vetoed by the President. Redrafted.
Federal Law on Amending the Criminal Code and the Code of Administrative Violations (Amendments related to violations on securities market)	Submitted to the Government in May 1996; introduced to the Duma in June 1996.
Federal Law on Taxation of Unit Investment Funds	Draft submitted to the RFSEC for consideration April 1996.
Decree "On Granting Additional Authorities to the Federal Commission On Securities Market under the Government of the Russian Federation"	Submitted to the RFSEC May 1996

Decree "On Amending and Amplifying Decree of the RF President N 1186 "On Measures for Regulations of Securities Market During the Privatization of State and Municipal Enterprises, dated October, 7 1992"	Submitted to the Government April 1996.
Decree of the President of the RF "On Investment (Financial) Broker"	Submitted to the Government July 1995.
Decree of the President of the RF "On Self-Regulatory Organizations in Securities Market Area"	Submitted to the Government July 1995
Decree "On Organization of Payments for Securities Market Operations and Certification of Organizations, Including Banks Carrying Out Payments in the Securities Market"	
Decree "On Securities Issued by the State Authorities of the Subjects of the Russian Federation and Local Self-government Bodies"	Submitted to the RFSEC Fall 1995 - 1996
Decree "On Introduction of Amendments and Amplifications to the Draft Decree of the President Russian Federation President "On Securities Issued by the State Authorities of the Subjects of the Russian Federation and Local self-government Bodies"	Submitted to the RFSEC Fall 1995 - 1996
Resolutions of the Government of the Russian Federation on Changing and Amending Resolutions of the Government Nos. 78 and 601	Submitted to the Government in July 1995.
Provision on Program of Guaranty of the Authenticity of Signatures and Insurance of Registrar Activities	Submitted to the RFSEC 1995
Temporary Provision on Specialized Commercial Depository and Procedure of Licensing its Operation	Submitted to the RFSEC October 1995
Resolution of RFSEC on Requirements Applied to Recognized Trade Organizers at Securities Market	Submitted to the RFSEC April 1996.
Resolution of RFSEC On the Order of Transformation of Voucher Investment Funds into Unit Investment Funds	Submitted to the RFSEC in December 1995.
Resolution of RFSEC On Securities Market	Submitted to the RFSEC in April 1996.
Regulation of RFSEC on Procedure of Operation in the Capacity of Sales and Redemption Agent of Investment Units of Unit Investment Funds	Submitted to the RFSEC in March 1996.

Resolution of RFSEC on Presentation and Publication by Managing Company of Unit Investment Fund of Information on Activities Related to Management of Assets of Unit Investment Fund	Submitted in May 1996
Resolution of RFSEC on Changes and Additions Introduced to the Temporary Provision on Managing Companies of Unit Investment Funds, on Activities on Trust Management of Assets of Unit Investment Funds and its Licensing	Submitted in May 1996.
Temporary Provision on Depository Activities at Securities Market	Submitted in October 1995
Temporary Provision on Settlement Depository and Procedure of Licensing of its Operation	Submitted in October 1995

II.B. Draft Laws, Decrees and Regulations on which LRP served as the Co-drafter

Draft Law, Decree or Regulation	Date Submitted
Federal Law on Development of Competition in the Financial Services Market	Introduced to the Duma May 1996.
Order for Opening and Maintaining of Special Broker-Dealer Current and Currency Accounts, which are Opened in Banks for Storing Customer Money	In coordination with the Central Bank of the RF. Submitted to the RFSEC and the Central Bank in Summer 1995.
Provision on Mandatory Norms and Indicators for Regulation of Broker-Dealer Activities	Submitted to the RFSEC Summer 1995
Provision on Accounting and Financial Reports of Broker-Dealers	Submitted to RFSEC in August 1995
Provision on Accounting for Broker-Dealer Securities, Recommendation to Organize Off-balance Accounting of Securities Maintained by Broker-Dealers	Submitted to RFSEC in August 1995
Resolution by RFSEC Russia "On Procedure and Scope of Information, which is to be Published by Joint Stock Company in Public Placement of Securities".	Submitted to RFSEC in August 1995
Provision on the General Provisions of Broker Service Agreement, Formats of Reporting of Broker to Customer	Submitted to RFSEC in August 1995

LAWS AND DECREES PROMULGATED OR IN PROCESS
PREPARED BY THE HIID LEGAL REFORM PROJECT (LRP)
(OUTSIDE THE AREA OF CAPITAL MARKETS)

I. LAWS AND DECREES ADOPTED

A. ADOPTED LAWS AND DECREES ON WHICH LRP SERVED AS THE PRINCIPAL DRAFTER

Law or Decree	Process of Adoption
Federal Law on Joint Stock Societies	Signed by President December 26, 1995
Federal Law on Taxation of Small Business	Signed by President December 29, 1995
Decree No. 746 On Priority Measures for Improving the Tax System of the Russian Federation	Signed by President July 21, 1995
Presidential Decree No. 685 On Main Directions of Tax Reform in the Russian Federation and Measures to Strengthen Tax and Solvency Discipline	Signed by President May 8, 1996
Government Resolution No. 105 On Approval of Provisions on Procedure for Establishment of Boundaries of Land Plots During Buildup of Cities and Other Settlements	Adopted February 2, 1996
Government Resolution No. 475 On Approving Regulations on the Structure and Registration Procedure of cadastre Numbers of Real estate Objects and the Procedure for Completing Forms of State registration of Rights to Immovable Property and Real Estate Transactions	Adopted April 15, 1996
Voronezh *Oblast* Law on Regulation of Land Relations in Vorenzh *Oblast*	Adopted May 25, 1995

B. LAWS AND DECREES ON WHICH LRP SERVED AS A CODRAFTER

Law	Process of Adoption
Federal Law on Non-Commercial Organizations	Signed by President January 12, 1996
Presidential Decree No. 293 "On Additional Measures to Promote Mortgage Lending"	Signed by President February 28, 1996

C. LAWS AND DECREES ON WHICH LRP PARTICIPATED IN THE DRAFTING PROCESS

Law	Process of Adoption
Federal Law on Financial Industrial Groups	Signed by President November 30, 1995
Federal Law on Introducing Amendments and Changes to the Law on Education	Signed by the President on January 13, 1996.
Federal Law on Condominiums	Signed by the President June 15, 1996.
Federal Law on Advertising	Signed by the President July 18, 1995.
Federal Law on Banks and Banking Activity	Signed by the President February 3, 1996.
Federal Law on the Central Bank (Bank of Russia)	Signed by the President April 26, 1995.
Federal Law on Agricultural Cooperatives	Signed by the President November 15, 1995
Federal Law on Introducing Amendments and Changes to the Law of the Russian Federation "On Protection of Consumer Rights" and the RSFSR Code of Administrative Violations"	Signed by the President January 9, 1996.

Civil Code Part II Covering provisions dealing with: a) Contracts for the Purchase and Sale of Goods; b) Provisions on Loans and Lending; c) Chapter on Settlements; d) Chapter on Factoring; e) Chapter on Insurance; f) Chapter on Agency; g) Chapter on Bailments.	Signed by the President January 26, 1996.
Presidential Decree No. 2130 "On State Land Cadastre and Realty Right Documents Registration"	Signed by President December 11, 1993
Presidential Decree No. 337 "On Realization of Citizens' Constitutional Rights to Land"	Signed by President March 7, 1996
Government Resolution No. 96, approving On Procedure for Exercising Rights of Owners of Land and Property Shares	Adopted February 1, 1995
Draft Presidential Decree on Some Issues of Implementation of Decree No. 1767 dated October 27, 1993, "On Regulation of Land Relations and Development of Agrarian Reform in Russia"	Fundamental provisions of draft Decree incorporated in Presidential Decree 337 of March 1996

II. DRAFT LEGISLATION OR DECREE UNDER CONSIDERATION BY DUMA AND/OR MINISTRIES, AND WHERE THE LRP HAS A CONTINUED ACTIVE ROLE

A. DRAFT LEGISLATION OR DECREES UNDER CONSIDERATION ON WHICH LRP SERVED AS THE PRINCIPAL DRAFTER

Draft Law or Decree	Status	Expected Date of Adoption
Federal Law on Non-State Pension Supplement	Submitted to Duma May 1996.	July 1996
Federal Law on Property Relations Reform and on Organizational Forms in Health Care System	First draft submitted to the State Duma Spring 1995.	Fall 1996
Federal Law on Functional Zoning	Further elaboration required for adoption on regional levels. Submitted to the Duma Spring 1996.	Summer 1996
Federal Law on Real Estate Valuation	The draft was adopted in the first reading April 15, 1996. The draft is being prepared for the second reading in June 1996.	June 1996
Federal Law On the Basis of Federal Policy in the Area of Land Use and Protection	Submitted to the Duma Committee on Legislation Spring 1996.	Fall 1996
Federal Law on Funds Transfer	First Draft completed May 1995. Amended draft was reintroduced to the Duma Subcommittee in March 1996.	Fall 1996
Federal Law on Introducing Amendments and Changes to the Code of Civil Procedure of the Russian Federation (Class Actions)	Draft submitted to the Government Spring 1996.	Fall 1996
Federal Law on Private Arbitration Courts	First Draft completed, reviewed by foreign experts in December 1995 and is being finalized for introduction to the Duma.	Fall 1996
Federal Law on Tax Amnesty	Draft Law was prepared pursuant to the Presidential Decree No. 685. Submitted to the State Legal Department June 1996.	Fall 1996

Federal Law on Appraisal Activity	First reading began 15 May 1996; various amendments made.	Fall 1996
Federal Law on the Basis of Federal Policy in Regulation of Relations Regarding Use and Conservation of Lands in the Russian Federation	Draft submitted to the State Legal Office and the State Property Committee.	This draft will be enacted if Yeltsin is reelected and vetoes the Federal Land Code. (see II.C., below)
Federal Law On the State Registration of Rights to Real Estate and Real Estate Transactions	Passed first reading in Duma	Fall 1996
Law on the Specifications of Realizing Citizens' Constitutional Right to Land	Draft of April 1996 submitted to GKI for review	
Law on Conducting Real Estate Tax Reform in Novgorod and Tver	Draft submitted to the Ministry of Finance April 1996.	Summer 1996
Presidential Decree of the RF President "On the State Support of Real Estate Market Development in the Russian Federation"	Submitted to the Government for Consideration	Fall 1996
Presidential Decree "On Basic Principles of the Federal Policy Concerning Regulation of Land Use and Land Conservation Relations in the Russian Federation	Draft of May 1996 submitted to the Government	Fall 1996

B. DRAFT LEGISLATION UNDER CONSIDERATION ON WHICH LRP SERVED AS A CODRAFTER

Draft Law	Status	Expected Date of Adoption
Federal Law on State Registration of Legal Entities	This Draft, adopted with significant amendments by the Duma, was vetoed by the President. Second draft was finalized in June 1996.	Fall 1996
Federal Law on State Registration of Real Estate	Draft completed in 1995. Draft adopted on first reading in July 1995. Second reading was scheduled for December 1995; preliminary rejected. Second reading rescheduled for June 1996	June 1996
Federal Law on Trust Management	November 1995 Draft passed first reading in Duma; changes required before second reading to conform with Civil Code	Fall 1996
Federal Law on State and Municipal Enterprises	Draft submitted; second reading scheduled for July 1996	July 1996

C. DRAFT LEGISLATION OR DECREES UNDER CONSIDERATION ON WHICH LRP PARTICIPATED IN THE DRAFTING PROCESS

Draft Law or Decree	Status	Expected Date of Adoption
Tax Code	General Part adopted by Duma in first reading. Working with the principal drafters in joint workgroups.	Fall 1996
Federal Land Code	Draft adopted by the Duma in third reading, May 1996, and is currently being considered by the Council of the Federation. LRP contributed significantly to the original draft, but subsequent amendments introduced by the Communist Party legislators altered the draft's underlying concepts.	Presidential veto is expected and desired.
Federal Law on Bankruptcy (Insolvency)	Work with State Duma has continued in 1996. Working on extensive comments and rewrites with Federal Bankruptcy Agency June 1996.	End 1996 - January 1997
Federal Law on Amending the Law "On Competition and Limitation of Monopolistic Activity in the Commodities Market"	Submitted to the Government in June 1996.	Summer 1996
Federal Law on Educational Finance	Concept paper drafted Spring 1996. This law is not a high priority at the moment.	
Federal Law on Bills of Exchange and Promissory Notes	Submitted for first reading in Duma April 1996.	Fall 1996
Federal Law on Mortgage	Second reading was scheduled for December 1995; preliminary rejected. Second reading rescheduled for July 1996.	Fall 1996
Tula Oblast Law on Land		Fall 1996

Decree "On the Development of Real Estate Market"	December 1995	

III. DRAFTS AND CONCEPT PAPERS COMPLETED/IN PROGRESS ON RECENT PROJECT INITIATIVES

A. DRAFTS AND CONCEPT PAPERS ON WHICH LRP SERVED AS THE PRINCIPAL DRAFTER

Draft Law or Decree	Status	Expected Date of Adoption
Law on Real Estate Taxation	The Draft Law is in the initial stage of preparation.	Winter 1996
Concept Paper on Legal Reform of Russian Payment System	Concept Paper drafted. It was distributed between the deputies and prepared for the hearing June 1996.	

B. DRAFTS AND CONCEPT PAPERS ON WHICH LRP SERVED AS A CODRAFTER

Draft Law or Decree	Status	Expected Date of Adoption
Law on Limited Responsibility Societies (a form of limited partnership with a relatively small number of owners - used extensively in Europe)	This work is in initial stage.	1997
Town Planning Code	Duma Working Group is currently considering a draft code of the Ministry of Construction in addition to this draft. Passage of a Town Planning Code would preclude the need for a separate Law on Functional Zoning (see II.B. above).	End of 1996
Law on Real Estate Transactions	Concept Paper completed. First Draft completed September 1995.	Fall 1996.
Law on Real Estate Leasing	Concept Paper Completed. First Draft completed September 1995.	Fall 1996

C. DRAFTS AND CONCEPT PAPERS ON WHICH LRP PARTICIPATED IN THE DRAFTING PROCESS

Draft Law or Decree	Status	Expected Date of Adoption
Part III of the Civil Code	Extensive comments prepared during conceptual stage.	
Regional Laws on Non-State Pension Funds	Assessed Volgograd region draft law, provided commentary on Irkutsk regional draft law; will work with representative of Irkutsk SEC on Irkutsk drafts; will develop plan with Tula regional legislators for additional work.	Fall 1996

MODEL CONTRACTS AND FORMS RELATING TO LAND REFORM AND LAND MARKET CREATION WHICH THE HIID LEGAL REFORM PROJECT HAS DRAFTED SINCE JULY 1994

I. Model Contracts Adopted and Publicly Disseminated by the Russian Government

1) "Model Land Share Lease Agreement", approved by the State Committee on Land Resource and Land Use on May 16, 1996.

2) "Model Agreement of Lease of Land Share by Multiple Lessors", approved by the State Committee on Land Resource and Land Use on May 16, 1996.

II. Model Contracts and Forms Drafted and Presented to the Russian Government

1) Contract for Purchase-Sale of Agricultural Land Plot (1995).

2) Contract for Purchase-Sale of Agricultural Land Share (1995).

3) Decree "On the Development of Real Estate Market" (December 1995).

4) Land Share Lease Agreement (March/April 1996).

5) Multilateral Land Share Lease Agreement (March/April 1996).

6) Agreement on Transfer of Land Share as Permanent Contribution to Charter Fund of an Agricultural Organization (With the Right to Allocate the Land Share in Kind if the Owner Thereof Withdraws From That Organization) (1996).

7) Agreement on Transfer of the Right to Use Land Share as Permanent Contribution to the Charter Capital or Share Fund of an Agricultural Organization (With the Right to Allocate the Land Share in Kind if the Owner Thereof Withdraws From That Organization) (March/April 1996).

8) Agreement on Transfer of Land Share as Permanent Contribution to Charter Capital or Share Fund of an Agricultural Organization (Without the Right to Allocate the Land Share in Kind if the Owner Thereof Withdraws From That Organization) (March/April 1996).

9) Contract for Lease of Right to Use an Agricultural Land Share to Peasant (Farm) Enterprise (March 1996)

10) Contract for Lease of the Right to Use an Agricultural Land Share to Agricultural Organization (April 1996).

11) Contract for Transfer of Agricultural Land Share on the Basis of Annuity and Maintenance for Life (March/April 1996).

The following are GAO's comments on HIID's letter dated October 29, 1996.

GAO's Comments

1. We agree with HIID that parts of its proposal to provide strategic policy advice through long-term advisors who are highly qualified and recognized experts in their field was not duplicative of ongoing assistance in Ukraine; however, other parts of its proposal did duplicate such assistance. For example, the HIID proposal stated that at the end of the first 8 months, HIID would have fully developed tax reform proposals and would have identified the measures that had the greatest potential to be implemented during the early stages of reform. The proposal identified the value-added tax, payroll and personnel income tax, corporate and business profits tax, and excise tax as areas of interest. However, the U.S. Treasury advisor working with representatives from the Ukrainian parliament and the state tax inspectorate stated that he had informed HIID representatives in early March 1996 that the Ukrainians had settled on how they wanted to address tax issues in five phases, including the four areas identified in the HIID proposal. He told us that the issue of using a cash versus an accrual basis for making value-added tax payments, which was discussed in detail in the HIID proposal, was already awaiting the third reading of the parliament. He said that if HIID could convince key Ukrainian players to move on taxes, it would be very useful. However, if HIID chose to develop an independent tax initiative, it could be counterproductive and might delay enactment of tax reform. Although there was duplication in the proposal, we noted that an August 27, 1996, USAID/Kiev mission's HIID status report indicated that HIID was attempting to coordinate its work with others. The report stated that, according to HIID's draft work plan, HIID will provide comment and analysis in support of changes in the value-added and corporate income taxes already underway with the aid of the U.S. Treasury advisor.

2. We have modified our discussion of the legal reform project; however, our review indicates HIID has understated its role. HIID was the U.S. recipient of U.S. funding and was responsible for directing the program for USAID.

3. We have modified our report to reflect this information.

4. USAID's withdrawn request for applications was not solely for work that differed greatly from HIID's project proposal for Ukraine. The main areas of assistance identified in the withdrawn request for application included mass privatization, capital market development, legal and regulatory reform, land privatization, post-privatization assistance, and public

education, some of which overlapped with HIID's proposal. For example, the structure of the tax law and its system of incentives and disincentives were to be addressed in developing policy objectives for many of the fields of law covered in the request. Moreover, the request required applicants to include the disposal of social assets. HIID's scaled-back April 9, 1996, proposal had four components, including one for taxes and one on pension reform, which would likely be part of any comprehensive enterprise restructuring initiative. Also, HIID's earlier proposal included assistance related to privatization and private sector development.

5. Our finding concerning the work on pension reform and how HIID's proposal may relate to the German program is based on discussions with and documents obtained from USAID officials. Furthermore, the USAID/Kiev mission's August 27, 1996, status report noted a continuing concern over HIID's proposed work on pension reform. It said that

"HIID has generally worked with USAID staff to make sure that its activities are coordinated with those of other USAID-funded advisors and other donor organizations. However, the area of fiscal aspects of social policy requires further discussion and effective coordination in order to make the best use of the resources available. For example, there are other donor organizations with better capability to provide continued support which have done or plan to do pension system work, including the World Bank, the German technical assistance group and the International Labor Organization, and it is important that HIID take these efforts into account in developing its workplan."

6. The report has been changed to reflect this new information. The information illustrates the political struggles that the Russian SEC has encountered from its inception. We recognize that a governmentwide reorganization was taking place about the time the decree was issued; however, according to an expert close to the Russian SEC, there were other motivations behind the provisions of the decree affecting the Russian SEC. For example, we noted that the decree was issued while the Russian President's Chief of Staff was away and that the designated Director of the Russian SEC remains unconfirmed as of October 1996. Furthermore, the Department of State, in commenting on this report, noted that although "recent political maneuvering to downgrade the SEC's status from Ministry to State Committee ultimately proved unsuccessful, the SEC's status and autonomy may continue to come under fire."

7. We revised the report to expand the discussion of resources beyond that of federal versus private sector salaries. Market participants told us that

fulfillment of the Russian SEC's considerable responsibilities will require a significant enlargement of its staff and budget.

8. HIID misunderstood our draft report and inferred a conclusion that we did not make. The draft does not link the failure or success of clearing and settlement organizations (CSO) to any particular type of trading platform, either floor based or over the counter (OTC).

9. Although HIID said that the Depository Clearance Company (DCC) has been fully operational as a professional reregistration business for about 2 years, we found that DCC was not executing the full range of services typically associated with clearance, settlement, and depository organizations. Moreover, as HIID itself noted, "It has, however, taken longer than hoped for DCC to fully develop simultaneous book-entry settlement of share ownership and payment-vs.-delivery clearing of trades that is the natural function of the depository business." Our report acknowledged the performance of registration services.

10. The report has been changed to incorporate the updated information. Nonetheless, it is important to note that (1) the transfer of the registrar has not yet taken place and (2) the "delay" was cited by market participants in Moscow as a reason for skepticism and pessimism about the project.

11. We did not mean to imply that HIID only provided assistance on 19 pieces of legislation. We have attempted to provide clearer and more comprehensive discussions of HIID's role. However, our objective was to show the status of the 19 laws to determine whether USAID's initial program goals were met.

12. We have modified the discussion of the nine laws that HIID said were passed through the legal reform project. According to Institutional Reform and the Informal Sector (University of Maryland Center [IRIS]) officials, IRIS, not HIID, working with the Research Center for Private Law, developed the Civil Code. IRIS officials told us that HIID had no role in the passage of these provisions of the Civil Code.

13. The detailed charts that HIID provided stated that for category (c), HIID "participated in the drafting process," but did not characterize HIID's level of involvement.

14. We have deleted this point from the report.

15. We recognize that the process by which decrees are developed may in some ways parallel the process used to develop draft laws; however, the actual processes for getting legislation passed are quite different.

16. We agree that decrees were used extensively during the privatization program and that HIID contributed to their drafting. However, we disagree with HIID's assertion that the use of decrees was an integral part of the legal reform projects's strategy. None of the USAID or Department of State documents authorizing the program discuss accomplishing legal reform through the issuance of decrees, only the passage of legislation. This was further supported by HIID/Cambridge's Director and General Manager, who told us that the legal reform project was intended to get laws passed and move beyond the issuance of decrees.

The U.S. Ambassador to Russia told us that the issuance of decrees was not part of the legal reform strategy and that it was this very use of decrees during privatization that led him to push for the coordinating committee to gain legislative involvement. Furthermore, USAID justified the project based on the need to pass legislation and the need to "foster a new pattern of executive-legislative cooperation . . . necessary to adopt and implement the new laws."

17. The estimate of HIID's costs for development of part I of the Civil Code were provided by HIID's project manager in a document prepared for the World Bank. The document, entitled Legal Reform Project: Program Expenditure Report for the World Bank, November 1995, described the amount of funding that was necessary to carry out law-drafting activities under the legal reform project. The report stated that HIID spent $500,777 to develop part I of the Civil Code. This covered numerous costs, including the cost for 15 foreign short-term consultants, 37 Russian short-term consultants, project management, administrative support, research support, translations, operational expenses, and a conference.

18. We have modified the report to show that the Department of State's 1995 strategic plan for Russia stated that the passage of specific laws by late 1996 would be the benchmark of success.

19. We have modified the report to clarify this point. Although the RPC was in some ways conceived and formed by Russians, HIID had a significant role in its formation and initial management, and continued to play a role in providing senior-level management even after USAID/Moscow assumed oversight responsibility for the RPC.

Comments From the Department of State

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

United States Department of State

Chief Financial Officer

Washington, D.C. 20520-7427

NOV - 8 1996

Dear Mr. Hinton:

We appreciate the opportunity to provide enclosed Department of State comments on your draft report, "FOREIGN ASSISTANCE: Harvard Institute for International Development's Work in Russia and Ukraine," GAO/NSAID-97-25, GAO Job Code 711186.

If you have any questions concerning this response, please call Ms. Sandra Gust, S/NIS/C, at (202) 647-4635.

Sincerely,

Richard L. Greene

Enclosures:
As Stated.

CC:
GAO - Mr. George, Jr.
STATE/S/NIS/C - Ms. Gust

Mr. Henry Hinton, Jr.,
Assistant Comptroller General,
National Security and International Affairs,
U.S. General Accounting Office.

Department of State comments on GAO Draft Report: "FOREIGN ASSISTANCE: Harvard Institute for International Development; Work in Russia and Ukraine," GAO/NSIAD-97-25, GAO Job Code 711186

S/NIS/C understands that AID will provide separate comments on this draft report with contributions from the AID mission in Moscow, and that AID will address USAID's procurement procedures regarding the award of cooperative agreements to HIID.

Now on pp. 50-51.

The fact that some pieces of Russian legislation were enacted via Presidential decrees as opposed to Duma action is perhaps over-emphasized on pages 90-97. The decree mechanism is provided for in the 1993 Russian constitution. Laws passed through Duma action may be preferable from a strictly jurisprudential point of view, but decrees are not illegal. Reform decrees also may pave the way for later Duma legislation, as was the case with privatization. To suggest as the draft report does, that HIID's involvement with decrees was an unauthorized revision of approved State/AID strategy, especially with the assertion that it undermined democracy, is unfounded. The report further failed to recognize that, in the end, it is the Russian Duma's responsibility to pass or reject legislation, and HIID cannot be held singly responsible for the number of reform laws passed.

See comment 1.

Now on pp. 49-50.

On pages 95 and 96, we note that the HIID-backed version of the Civil Code was not wholly rejected by the Duma. The Civil Code was ultimately divided into three parts. The first part had involvement from IRIS/RCPL. The second part, passed later, had some critical contributions from the HIID team. We understand that the third part is still under consideration, with HIID and ILBE involvement. IRIS and HIID have made different kinds of contributions to the legislative process, both important and each complementary. By working with different Russian teams, all key players, HIID and IRIS in effect widened the consensus around the new Code. Working with senior Russian jurists, IRIS restricted itself to commentary, while HIID actually worked with the drafters and was able to introduce key language up to international business standards. In short, the efforts were not duplicative in any counterproductive sense; they each supported passage of fundamental commercial legislation, and the related costs of these efforts were not unnecessary.

See comment 2.

S/NIS/C also solicited comments on the draft report from officers on the Russia desk at State, EUR/RUS. The following are those comments:

After review of the above report, EUR/RUS has a number of general and specific comments regarding both the HIID effort and the GAO draft. Among general observations, much credit appears given to the Harvard project for endeavors that had a number of contributors. For example, the reform of capital markets has involved not only HIID, but also substantial input by the New York Stock Exchange, the U.S. Securities and Exchange Commission and the Federal Reserve. Not only should appropriate acknowledgment of these efforts be made (e.g., at the end of the first para. on p. 43, middle of second para. on p. 18), it is noteworthy that no interviews were conducted with individuals from these organizations (see p. 38). Additionally, interviews with Embassy economic section staff who served at post during the period could have given a useful perspective on HIID's role during this period. NGO experts headquartered in Washington similarly could have been consulted.

Now on p. 35.

See p. 20.

The justification for the initial selection of the Harvard Institute and its repeated award of increasing contract funds is the position that HIID had "preexisting relationships with Russian officials and had already established several Russian institutions to sustain reforms ..." While this may have been adequate for selection of HIID in the past, an explosion in the numbers of Russian economic specialists and of Americans, with business and academic backgrounds with substantial experience in the Russian market, would make this a less likely rationale for "sole source" selection in the future.

The text should be updated to reflect more recent developments in the matter of the status and role of the Russian SEC -- Federal Commission for the Securities Market.

Now on p. 4.

-- p. 7 (Results in Brief) - Replace "Due to recent..." sentence (para one) with "Although recent political maneuvering to downgrade the SEC's status from Ministry to State Committee ultimately proved unsuccessful, the SEC's status and autonomy may continue to come under fire."

Now on p. 9.

-- p. 19 (Future Independence of the Russian SEC May Be in Doubt) - at end of line two at top of page: "The decree contradicted...", and add, at the end of the paragraph "The SEC has since been upgraded, but moved from subordination to the Ministry of Finance to the Presidential apparatus."

Now on p. 31.

-- p. 60 (Chap 3 - Russian Progress Toward Developing an Efficient Capital Market) - para one in the sentence beginning "However, the goal...," after the words, " a number of problems" replace the end of the sentence with "including recent maneuverings to downgrade its status and autonomy, which although ultimately unsuccessful create uncertainty about its future role.

Other suggested changes include the following:

Now on p. 17.

-- p. 31 (Chapter one - Introduction), the first sentence in para two should be changed to read: "... it admittedly did not have the expertise to accomplish the task at hand owing to the political-strategic confrontation of the past decades and the uniqueness of transitioning command economies to market bases."

See comment 3.

Now on p. 53.

-- p. 103 (Support for Privatization and Enterprise Restructuring), the second sentence clearly links the privatization of 15,000 state-owned enterprises to "these efforts" originating with the HIID. That appears exaggerated. Sentence two should read: "During the process, nearly 15,000 medium and large-scale state-owned enterprises were transferred to private ownership."

The following are GAO's comments on the Department of State's letter dated November 8, 1996.

GAO's Comments

1. We agree with the Department of State that the decree mechanism is provided for in the 1993 Constitution and, as we note in the report, it can pave the way for later legislation. However, none of the key program documents suggest that HIID should be working to get decrees issued rather than legislation enacted. Moreover, USAID's Office of Democracy for Russia indicated that the use of decrees may undermine the democratic process envisioned by the project. USAID's action memorandum justifies the program based on the need to "foster a new pattern of executive-legislative cooperation . . . necessary to adopt and implement the new laws . . . ."

We recognize that HIID cannot be held responsible, nor can it be given credit, for passage of any law. HIID's responsibilities and accomplishments in this area were primarily to provide commentary and drafting assurance on legislation.

2. We agree with the Department of State that Institutional Reform and the Informal Sector (University of Maryland Center), and not HIID, was responsible for part I of the Civil Code. The former Director of the Research Center for Private Law told us that HIID drafted a competing version of part I of the Civil Code and that HIID did not provide its drafts to the Research Center for review. IRIS and the Director of the Research Center noted that part I of the Civil Code presented to the Duma by President Yeltsin had no input from HIID; HIID's effort on part I of the Civil Code did not support the Research Center, the group designated by President Yeltsin to develop the Civil Code; and HIID and GPU delayed passage of part I for several months.

3. The report has been modified to include this information.

Major Contributors to This Report

National Security and International Affairs Division, Washington, D.C.	Harold J. Johnson Louis H. Zanardi Ned J. George Maria Z.Oliver Michael C. Zola Claude T. Adrien Rona Mendelsohn
Accounting and Information Management Division, Washington, D.C.	Roger Stoltz
Office of General Counsel, Washington, D.C.	Lynn Gibson John G. Brosnan Mark C. Speight

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