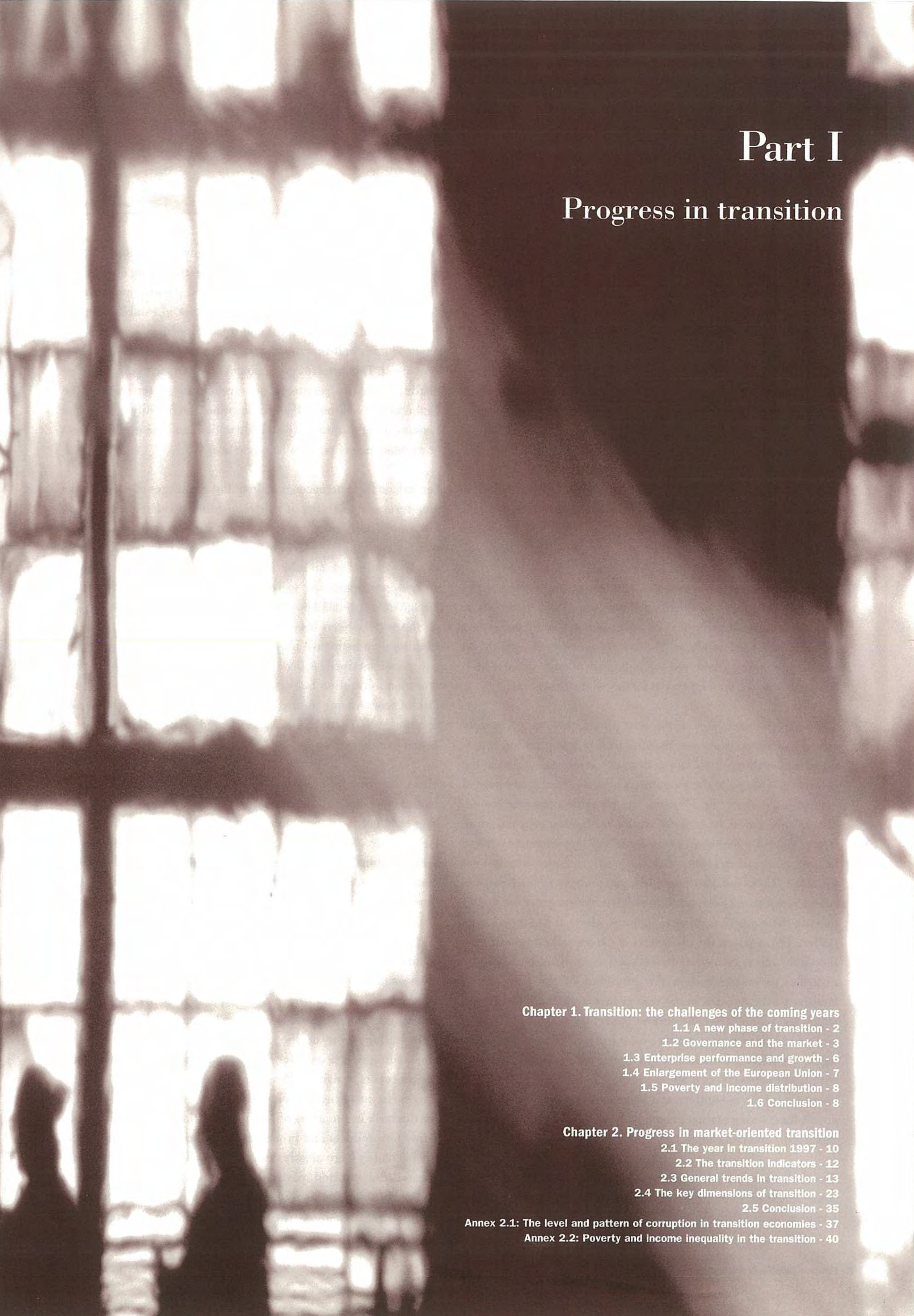

Part I

Progress in transition

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Transition: the challenges of the coming years

1

1.1 A new phase of transition

A new phase is beginning in the process of transition towards a market economy in central and eastern Europe and the former Soviet Union. The first phase was dominated by the structure of the inheritance from the communist system and the political repercussions following the collapse of this regime. The key achievements of this first phase were the privatisation of assets, the liberalisation of markets and the establishment of a degree of macroeconomic stability. These achievements have led in most countries to the recovery of growth. In 1993, of the EBRD's 25 countries of operations only Albania, Poland, Romania and Slovenia were showing positive growth, and one year earlier this applied only to Poland. In 1997 it is likely that only six or seven economies will be in decline. The next phase of transition requires policies, institutions and behaviour that can foster and accelerate this growth.

The challenges of the second phase of transition, and the forthcoming response, will be determined not only by the conditions in the countries at the start of the transition but also by the events and actions of the first phase. This new phase of transition will be shaped therefore by both the broad history of each country and, more particularly, the very recent history of the first phase.

The policies and events of the first phase have varied greatly across and within countries. Starting with widely differing conditions, the result has been strong diversity across the region in the progress and shape of the transition and in the timing and form of economic recovery. In addition, the transition has not been a "linear" process in the sense of steady, continuing progress on all fronts. There are important examples where transition has faltered or been reversed in some areas and where recovery has not yet occurred. There are also examples, particularly in the last year, where governments or electorates have shown great resolve in moving the transition process forward where it had previously stalled. The nature of the challenges of the second phase will vary, therefore, across countries. Indeed, a few countries must still be regarded as entrenched in the problems of the first phase. However, all countries in the region face a common challenge, which will characterise the second phase: the task of developing and providing effective, market-oriented governance. By governance we mean the manner of governing within enterprises and within the economy as a whole, in particular the building and deepening of the institutions and behaviour that are at the heart of a well-functioning market economy. It will be a central theme of this Report and this chapter.

The challenges and issues of the new phase, which are present in some shape or form in all of the countries in the region, are complex, multi-dimensional and inter-related. They can be grouped into the following broad areas: governance and institutions; macroeconomic and fiscal issues; restructuring enterprises and the financial system; regional issues; poverty and income distribution. First, the magnitude of the task of establishing the governmental, financial, legal and regulatory framework which is required for a well-functioning market economy is becoming ever more clear. This involves governance issues and in many countries dealing with the problems of bureaucratic interference, the haphazard or arbitrary effects of taxation, the fragility of financial systems, fraud, criminality and corruption, and the establishment or maintenance of monopolistic practices.

Second, on the macroeconomic front the challenges of ensuring the long-term sustainability of hard-won gains are starting to appear. For example, after the impressive reductions in inflation achieved across the region from 1993 to 1995, inflation has started to climb in a few countries. In other countries, growing current account deficits are beginning to raise problems of instability on the foreign exchange markets. This is partly because fiscal policy has, on the whole, been less rigorous than monetary policy. In the medium term both must play a strong role if inflationary pressures are to be contained. A fiscal reform will require not only careful attention to taxation but also to public expenditure. Indeed, the task of reorganising public expenditure, reforming pensions and creating an efficient and market-oriented civil service has barely begun in most countries.

Third, the experience of enterprise reform and building financial institutions and capital markets demonstrates the difficult and long-term nature of the challenges involved. The magnitude of the task of restructuring is being revealed in part by the "deflation" of the "cushions" which had earlier eased the pressure for fundamental restructuring. These cushions included small debt burdens, very low real exchange rates and under-employed or "surplus" labour.

Fourth, many countries are likely to see further and fundamental changes in their economic and political relationships on a regional level. A few of them have already joined OECD and NATO. Several are moving towards membership of the European Union. This enlargement of the EU would represent an event of outstanding significance for Europe as a whole and a landmark in the process of transition. However, the scale and scope of the challenges in meeting the conditions for accession to the EU, particularly in the areas of environment, health and safety standards for products and processes as well as the financial sector, are becoming more clearly defined. Major advances in the transition will be required, particularly in institutional development, and very large additional investments are needed. The changes to regional relationships will not be confined to the west of the region. The countries of the former Soviet Union are looking to push forward the process of integration into the world economy, in sharp contrast to the narrow and rigid economic and political relationships which existed under the old regime. For example, the countries of Central Asia are seeking to develop their links (such as transport and petroleum) with their neighbours in other parts of Asia and with Europe.

Fifth, the early phase of transition brought an increase in poverty and widening disparities in income throughout much of the region. This involved great hardships and will have important policy and institutional consequences for the next phase.

This Report focuses on issues arising from growth and restructuring (see Part II), macroeconomic developments (see Part III) and governance issues, which are woven throughout the whole Report. As in earlier Reports, Chapter 2 of Part I charts the overall progress of transition in the past year and assesses the current position. The picture is broadly positive, but progress is mixed. While the past year has generally seen continuing, and often strong, progress, events have also shown that the emergence of a healthy and well-functioning market economy cannot be taken for granted. It requires continued commitment and effective leadership.

The remainder of this introduction looks more closely at governance and institutional issues, highlighting key lessons. It also comments briefly on regional and poverty issues which, notwithstanding their great importance, receive less attention in the chapters that follow. The discussion of the role and nature of governance is developed in section 1.2 below. The main conclusions from Part II of the Report on growth and restructuring are described in section 1.3. Recent developments in the process of the enlargement of the EU, in particular Agenda 2000, are examined in section 1.4. A brief discussion of poverty and income distribution, drawing on Annex 2.2 to Chapter 2, is provided in section 1.5. Concluding comments are offered in section 1.6. The main themes from the chapters which follow are highlighted in the Executive Summary at the beginning of this Report.

1.2 Governance and the market

The *Transition Reports* have attempted to apply systematic criteria to measure progress in the transition. They also present data from national accounts and other sources and, when appropriate, use formal economic models. However, sometimes conditions or issues that are measured explicitly or modelled formally (regardless of how accurately the underlying concepts are captured by the variables or numbers) can monopolise attention to the detriment of the regard which should be paid to more qualitative issues.

Governance is defined as the manner of governing. It is not something that can be measured easily. Yet it is fundamental to the market economy, to the transition and to the process of growth. That is why we have emphasised governance issues and the role of the state in earlier *Transition Reports* and why we give it prominence both in this introduction and in subsequent chapters of this Report.

It is striking that many of those who have looked at economic performance and growth from the perspective of economic history have emphasised governance as the key determining factor. A particularly graphic presentation of this view is in the famous fourteenth century Siena series of frescoes by Ambrogio Lorenzetti on the "Effects of Good and Bad Government".[1] It is also noteworthy that the more naive forms of state minimalism and the more dogmatic assertions of the efficiency of markets which were prominent in the 1980s (around the time of the collapse of communism) have brought a reaction not in terms of calling for a reversion to the command economy but for a closer analysis of the role and responsibilities of the state in the market economy.[2]

The understanding of the meaning and role of good governance in an advanced market economy has taken time to develop and is still developing. And the implementation of good governance is not easy or straightforward. Its establishment for a transition economy is a formidable task, since the state has to lead its own transformation and the basic understanding and experience of market-oriented institutions are limited. It is, in many respects, the central task of the new phase of transition. Detailed below are some of the governance issues that will be vital to the processes of restructuring and growth. Good governance for the market economy involves establishing government institutions that allow markets to work well and to deliver and protect living standards and the rights of its people. In discussing governance in this context, emphasis is placed on public-private partnerships and the inter-relationships between government and non-government activities.

The first two tasks of government in a market economy are the maintenance of macroeconomic stability and of law and order, including defence and basic property rights. These are the basic elements of the "night-watchman state", and most would agree that they are essential responsibilities of a state in a market economy. The next question is how far, and in what way, should the role of the state extend beyond those basic functions. For those creating and shaping the transition economies, the issue is what kind of state they have in mind and, more particularly, what is the goal for their transition. That question must be posed clearly now, and still more strongly as the economies pass from the first to the second phase. Entrenched positions can become established quickly, and sometimes opportunistically or haphazardly, and they can be very difficult to dislodge.

1 In the frescoes in the Palazzo Pubblico, two mirror-image cities are displayed. One is governed by a prime minister counselled by Justice, Wisdom and Compassion and the other counselled by Pride, Wrath and Avarice. The former city is orderly, happy and prosperous and the latter is poor, corrupt and oppressed.

2 See, for example, Stiglitz (1989), Stern (1989), Stern (1992) and Malinvaud et al. (1997). In their chapters in Malinvaud et al. (1997), Stern and Stiglitz emphasise the importance of partnership between public and private activities, rather than focusing on a single narrow one-dimensional question of public versus private.

The answer to the question is much deeper than the fraction of output which comes, or should be expected, from the private sector. Rather, the issue is one of establishing partnerships between the public and private sectors. These partnerships should build on the comparative advantages of the public and private sectors. They will take different forms in different areas where the government is likely to be involved in a fundamental way, including particularly health, education and pensions. Rather than analyse the structure of these partnerships in detail, we illustrate some of the key issues involved in their design and construction. Some brief comment is provided on two areas crucial to the second phase: pensions and infrastructure.

The example of pensions illustrates the complexity and subtlety of some of the issues. Since the demands, costs and requirements for pensions can vary widely in the population, the market may be well-placed to provide products tailored to the needs of different individuals or households and to invest funds effectively. On the other hand, the government has a comparative advantage in the crucial administrative tasks of following people over time and enforcing payments, for example, through a tax or social security system. Further, private pensions can be opaque, sold in a misleading way, fraudulent or suffer from heavy administrative and selling costs. While such problems can, in principle, apply to most products, they are much more severe where monies are entrusted to pension funds, and obligations incurred, over a long period of time. Regulatory institutions supporting private programmes are essential, but they will have to be built carefully over time. The building of such institutions and private pension funds can have profound and beneficial effects on the working of capital markets, on corporate governance, and on the generation and allocation of savings (see, for example, the 1996 *Transition Report*).

However, it would be a mistake to expect private provision to provide instant solutions to the pension problems faced in transition economies. The more urgent task for the public finances is to control the scale of expectations and obligations that governments have inherited from the past (see the 1996 *Transition Report*). This does not, of course, mean that the development of private funds and regulatory systems should be delayed. Tasks which take time to tackle and that are crucial for the medium term should be started now.

Public-private partnerships are also crucial in the development of infrastructure. Large-scale private involvement, through new entry of enterprises or privatisation, can be established in this sector much more rapidly than for pensions. The gains from competitive private provision can appear very quickly. However, regulation is required to control monopoly power in privatised utilities where competition is not possible. In the transition economies there have already been important examples where private sector participants in infrastructure have won privileged positions from the government (possibly involving illicit means). The result is lower efficiency, higher prices and poorer services both to industries and households. The victim is the final consumer, now and in the future. The answer to the problem of public-private partnership in infrastructure is to exercise vigilance and care in the choice, design and implementation of regulatory structures. These must protect competition and the consumer while allowing reasonable profiles of risk and return to the private investor. Private participation in infrastructure has a great deal to offer the economy in terms of better services to consumers and reductions in pressures on public revenues. It presents real opportunities for the second phase of transition in many countries and was a major topic of the 1996 *Transition Report*.

The examples of pensions and infrastructure are of immediate policy relevance to transition economies and underline the importance of developing and maintaining the right kind of partnership. In particular, public-private partnership should never be confused with collusion between special private sector interests and the government to the detriment of the public at large. In these as in all other areas, it is crucial for the government to lead by example in promoting – in both the public and private sectors – the behaviour that is consistent with a well-functioning market economy. In particular, it must look for institutions, policies and actions that minimise the opportunities for arbitrary, self-interested or corrupt bureaucratic interference. Experience has already shown that such interference can stifle investment and growth in transition economies. Corruption is not only pernicious in itself; it also undermines free competition and therefore endangers one of the fundamentals of transition.

There is much that sound institutional and policy design can achieve in promoting responsible behaviour and limiting corrupt practices. Government structures should, as far as possible, limit the number of licences and permissions required and the discretion of civil servants over the ordinary economic activity of entrepreneurs and consumers. It is when permissions or discretionary decisions start to permeate throughout the economy and society[3] that bureaucratic interference develops and the potential for corruption grows. This results in markets that do not function well and where entrepreneurship, investment and growth are inhibited. Where permissions or discretion are unavoidable, as they will be in a number of important areas of activity, openness and transparency are the key weapons against the misuse of power.

There is a great deal also that private firms and financial institutions, including international financial institutions, can do to limit corrupt practices. This issue is dealt with briefly below and discussed in a little more detail in Chapters 2 (Annex 2.1) and 5.

Corruption is not the only form of criminal behaviour which threatens the development of the open market economy. In many countries of the region organised crime and protection rackets are posing serious problems for business transactions. They impose heavy "tax burdens", limit competition and drive away investment. The fight against organised crime will be a major challenge to the development of the economies and societies of the region.

[3] In India the language of the "permit raj" is sometimes used.

The most prominent example of government activity where good governance is crucial for the functioning of a market economy is taxation. Raising revenue is, of course, fundamental for macroeconomic stability and the provision of basic services and social protection. The establishment of an effective tax system is, as was argued in the 1994 *Transition Report*, a fundamental issue of the transition. Under the old regime, the taxation system was not of over-riding importance since the government could command resources directly. In a market economy most of the resources used by government must be raised in some shape or form from the private economy. The challenge is to do this in a way that keeps distortions and disincentives to a minimum and takes account of the taxpayers' ability to pay. There is no area where the interactions of institutions, policies and behaviour are more important.

Taxation is one of the biggest problems facing foreign investors in a number of countries in the region, particularly in the CIS. The problems lie not in the existence of taxation but in its design and functioning. If taxation is to operate in a way that allows private enterprises to function effectively, it should be even-handed, predictable and based on reasonable definitions of profit, output or income. In practice, it often involves definitions of tax bases and rates which, if applied literally, could drive the honest taxpayer out of existence (for example, definitions of profits which make no allowance for a number of substantial and genuine costs[4]). The result is widespread discretion by both ministers and revenue officers and a plethora of special deals and exemptions. This in turn results in a shredding or demolition of the tax base, still higher rates on those who do pay, large distortions of competition and the allocation of entrepreneurial energies (or covert payments) to securing special privileges.

Investment, be it foreign or domestic, does not need special deals, discretionary or otherwise, and governments should not see the promotion of investment as lying in tax privileges. Research on investment and taxation[5] has shown time and again that it is the stability, transparency and predictability of markets and the prospects for growth that are the main factors stimulating investment in a market economy. Investment and growth will be fostered, therefore, both by the transition itself and by macroeconomic stability. What is required from the tax system is predictability, even-handedness and a broad base, taking into account sensible economic concepts such as, for enterprises, profit or value added. Such a structure will in turn permit the reasonable rates which are required to strike a balance between revenue and disincentives. The establishment of such a tax system is central to the establishment of good governance.

In this discussion of governance, emphasis has been placed on the behaviour and practices of government itself. However, effective governance requires the cooperation and participation of the governed. In particular, in economic affairs it requires sound business practices in enterprises. Sound practices are not only beneficial for the effective functioning of a market economy and the welfare of the population. They are also in the long-term interests of an enterprise devoted to the profits of its shareholders: this is one of the most important facets of the "invisible hand".[6] Sound practices may be expressed in terms of those practices that implement long-term profit maximisation for the benefit of shareholders by maintaining and developing good and honest relationships with customers, suppliers, workers, those who supply finance, neighbours, local and central government, and anyone else who interacts with the enterprise. Indeed, it could be argued that the only effective method of long-term profit maximisation is the implementation of these practices and that a stable and predictable business environment encourages and rewards this long-term perspective. The definitions of, and arguments for, social business practices do not lie only, however, in the interests of the shareholders of the enterprise. Firms are institutions which have both rights and responsibilities. The responsibilities involve basic standards of behaviour and of transparency.

More specific statements of sound business practices can be provided in terms of explicit principles or codes, often specified in terms of checklists which should be followed. Recent years have shown great interest in, and controversy over, such codes. While the precise form of codes may be the subject of argument, the broad principles of maintaining and developing good and honest relationships with those interacting with enterprises is broadly accepted. It should not be assumed that such principles are widely and immediately understood in transition economies. Indeed, it has taken many decades (running into centuries) for them to be established in more advanced market economies. However, it is crucial that these practices become established quickly in transition economies. It is a major task of governments, leading domestic firms, foreign investors, and domestic, foreign and international financial institutions to take a lead in establishing these practices. In particular, the EBRD seeks to lead by example and insists on such standards in all the investments[7] in which it is involved.

Lastly, good governance depends on the establishment and functioning of an effective civil society. Indeed, it could be argued that a key determinant of the performance of government is the effectiveness of civil society. This term refers to a collection of institutions that are neither governmental nor private enterprise, including political parties, voluntary organisations, religious groupings and labour unions. The term may also be taken as including the media (although in many cases the media does and should consist of private enterprises operating for profit) at least in the sense that free and effective media are crucial to the independence of the activities of civil society. It is civil society that helps provide an understanding of the public interest, that can express

4 These definitions can be particularly pernicious in an inflationary environment.

5 See, for example, the 1995 *Transition Report*.

6 The term "soundness of business practices" is sometimes used interchangeably with good corporate governance. The latter term, however, generally has a slightly narrower interpretation in terms of relationships between owners and managers of a firm. We shall not dwell on the distinction here.

7 The EBRD has recently made available a description of sound business practices which was constructed with some of its clients for a seminar at its 1997 Annual Meeting in London.

the wishes of various groups in the population and exercise vigilance over the abuse of power. Civil society was stunted under the old regime where such institutions were focused narrowly on the perceived interests of the state (or rather those in power). The growth and flourishing of civil society are crucial to the success of the political and economic transition.

1.3 Enterprise performance and growth

Growth and restructuring are the special topics of this year's *Transition Report* and are the subject of Part II (Chapters 3 to 6). They represent crucial and linked challenges for the second phase of transition. The central message of our analysis of these issues is that the effective operation of the competitive process, supported by good governance, will be the most powerful force driving the processes of growth and restructuring. The same policies, institutions and behaviour that promote the transition towards an open, competitive market economy will therefore also promote growth and restructuring.

The argument is developed in Part II by combining the basic ideas of the determinants of growth from theory and economic history with an examination of the processes of growth and restructuring in the transition to date. Chapter 3 begins with an analysis of theories of growth, emphasising those features of transition economies that can help us to identify the particular sources of, and obstacles to, growth in those economies.

The focus in this analysis is on the importance of raising productivity and output, not only through investment in plant and machinery but also through the creation and establishment of new methods of organisation and production. Indeed, the processes of investment, reorganisation, and introduction of new technology and methods of work are closely intertwined. It is the competitive process – the search for profit, the reward for entrepreneurial initiative and the risk of elimination if effective methods are not followed – that drives the process of change. In this sense it is the "Schumpeterian"[8] story of growth through innovation, driven by opportunity and competition, that carries the strongest lessons for the transition countries. However, in emphasising the role of innovation, it is necessary to go beyond the technology which was Schumpeter's main focus. For the transition economies it is not simply technology that changes output, but the whole method of work in terms of market-driven methods of organisation and production.

This analysis of the sources of growth emphasises the need to continue to build and consolidate the transition and thereby to establish a strongly competitive environment. Although it can be stated briefly in these terms, this is not, of course, a simple matter. All of the *Transition Reports*, including this one, have emphasised the complex and inter-related nature of the many aspects of transition. All those subjects emphasised in earlier Reports, including international trade, the taxation system, financial institutions, savings and infrastructure, will be part of the story. Of special importance will be the good governance and the absence of bureaucratic interference which has been discussed above. However, in considering all of these many elements and policies, it is helpful to keep in mind the central importance of competition in the whole process.

The growth described above clearly has restructuring – driven by competition – at its heart. Restructuring will indeed come from the process of competition, but real competition must be underpinned by hard budget constraints. A company facing competition without privileged access to special funding will be forced to change and adapt if it is to survive. The speed, effectiveness and social and economic costs of that adaptation will, of course, depend on how the processes of competition and finance function. These in turn will be closely influenced by the policies, institutions and behaviour which develop during the transition.

In Chapters 4 and 5 the process of restructuring in the region is charted and analysed. Many transition economies have seen substantial structural change in the balance of production across sectors, big shifts in the patterns of international trade and important reallocation of resources within sectors. The scale and nature of the structure inherited from the previous regime imply that restructuring will be a long and difficult process. However, substantial restructuring from the production patterns and processes of the old command regime has occurred in many countries. In addition, consistent with the message emphasised above, sectors that have been most exposed to market forces have shown the greatest change.

The balance across sectors has in the first few years of the transition already shifted towards the structure of comparable middle-income countries, with a move from the over-sized manufacturing sector towards services which were neglected under the old regime. There has also been a shift towards agriculture in some low-income transition economies and a widespread increase in the share of non-market services, perhaps reflecting the public sector's role as an employer of last resort.

Within sectors there have been sharp differences in restructuring across the region. In particular, much larger gains in productivity in industrial sectors have been achieved in eastern Europe than in the CIS. At the level of the individual firm there is clear evidence of the powerful influence of competition and hard budget constraints on performance, particularly where these are combined with effective corporate governance and limitation of bureaucratic interference. Where budget constraints have remained softer, especially in parts of the CIS, and prior to the current reforms in Bulgaria and Romania, enterprise adjustment has lagged.

Experience in the region has emphasised that private ownership *per se* is not enough to generate improvements in productivity in the private sector. If competition remains weak, budget constraints soft, management unchanged, and government controls and inter-

[8] See, for example, Schumpeter (1942).

ference pervasive, neither restructuring nor improved performance can be expected. The problems of interference by government in privatised enterprises remain pervasive in many countries of the region, particularly in the CIS.

If enterprises are to break loose from government and find finance for restructuring, they must have access to sound financial institutions and capital markets. If such institutions are to be willing to provide finance, firms must adopt corporate governance practices, including transparency, which allow the financial institutions to feel confident that monies will be well used and loans repaid. While in east European countries and the Baltic states some of the problems of governmental interference in the private sector have receded, severe problems of corporate governance and the soundness of financial institutions remain throughout the region.

The problems of weak corporate governance take on particular importance in large, relatively closed economies, such as Russia, Ukraine and some of the Central Asian republics, where international competitive pressures do not yet impose strong discipline on managers. In this respect the emergence of financial and industrial groups (FIGs) in Russia and Ukraine poses risks, if not properly regulated, of cartelisation and damage to the competitive forces which are vital to the emergence of restructuring and growth. However, FIGs in a competitive and market-driven environment may play a positive role in creating synergies between finance and industry and also in breaking the pattern of dominant insider ownership in many large industrial companies.

The final chapter of Part II examines the prospects for growth in the region in relation to the theories of growth, the initial conditions of the transition countries and the experience of restructuring described in the preceding chapters. A comparison with historical periods of high growth elsewhere, such as in western Europe and Japan in the early post-war period and East Asia in recent years, provides some helpful insights, particularly into the roles of structural change and market-oriented institutions in fostering the growth of productivity. However, the comparison also shows a crucial and fundamental difference between the transition countries of the region and those examples. The transition countries face much more pronounced problems of resource reallocation, in terms of moving resources between sectors and using resources more effectively within sectors, than those which arose in the other historical examples. The old regime with its peculiar priorities left a strange and difficult legacy. That legacy lies not simply in the allocation and quality of the existing plant and machinery and other factors, but also in the attitudes, practices and working methods which it created.[9] Restructuring is therefore central to the process of growth in a way which is very different from earlier examples of other regions.

The institutions and infrastructure which supported the competitive process leading to growth in these earlier examples are also required to deliver the restructuring and growth that is so crucial for the transition countries. However, the analysis reveals that the low quality of institutions supporting the functioning of markets is a key constraint on the growth prospects of transition economies. Unless there are further advances in the rule of law, freedom for enterprises to exit and enter markets, and development of financial institutions and market-oriented infrastructure, growth in transition economies could fall well below their considerable growth potential.

1.4 Enlargement of the European Union

While this Report does not examine in detail the problems of enlargement of the European Union, it is a fundamental part of the process of transition for the region. Enlargement of the EU is of outstanding historical significance both for countries seeking accession and for those that are already members. The requirements for accession are essentially a well-functioning, competitive economy and democratic institutions; in other words, they describe the aim of economic and political transition.[10] The process and requirements represent great challenges and opportunities for reform and investment. Some brief comment is provided below on the events of the past months, which have seen substantial clarification of the likely next steps in the process of enlargement of the EU. In particular, the Amsterdam summit of the heads of government in June 1997 (following the completion of the work of the Inter-Governmental Council – IGC) saw the confirmation of the schedule for enlargement, with detailed negotiations for selected countries set to open in early 1998.

The publication in July of Agenda 2000, and accompanying documents and analyses, provided an assessment of the progress in economic and political transition of the 10 applicant countries. This was in relation to the development of a competitive market economy, the establishment of democratic and other institutions and the preparedness for subscribing to the "acquis communautaire" of the EU.[11] Five of the countries (the Czech Republic, Estonia, Hungary, Poland and Slovenia) were identified as leading candidates in terms of the progress they have made so far.[12] The summit of December 1997 in Luxembourg will examine this assessment and take a decision on which countries can begin the more detailed negotiations for membership with the EU in 1998. The analyses of progress made in establishing market economies, as presented in Agenda 2000, are consistent with the EBRD's assessments of these countries in Chapter 2. In fact, the countries that were highly rated by the European Commission for their achievements in market-oriented transition also score highly in Table 2.1 of this Report.

While the conditions for successful transition and for meeting the requirements of membership of the EU are similar, the latter will

9 And, as described in earlier *Transition Reports* and in Chapter 2, the legacy involved severe environmental problems.

10 Indeed, there is a very striking similarity between the Copenhagen criteria for accession (European Council, June 1993) and Article 1 of the Agreement Establishing the EBRD, which sets out the meaning of transition for the Bank.

11 The "acquis" are the obligations incurred in membership of the European Union.

12 The other five are Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic.

embody a large number of very detailed and demanding obligations. Some of these require the strengthening and adjustment of public institutions, for instance regarding the regulation of product standards or of competition. Others will have strong implications, particularly for infrastructure, enterprises and financial institutions. In infrastructure, there will be emphasis on integrating transport and communication systems to ensure the smooth functioning of the single market. For enterprises, EU rules for health and safety of processes in the workplace and environmental standards will be of particular significance, with major implications for restructuring and investment. Accession will imply that enterprises must conform with the stringent standards of the EU on the safety of products. Investment requirements for municipal services (such as the treatment of waste and water), for power generation and for heavy industries (emission standards) would appear to be especially large.

Financial institutions will be expected to perform to higher standards of financial strength and transparency than at present. They will have to demonstrate that they are well-regulated by government while at the same time showing independence in their allocation of credits. Financial systems are also expected to play a greater role in funding small and medium-sized enterprises than they do at present. Agenda 2000 identifies small and medium-sized enterprises as an important factor in stimulating innovation, competition and growth.

This process of transforming enterprises and financial institutions and of building infrastructure is likely to have important implications for the work of the EBRD and other international financial institutions over the coming years. It must be emphasised that the requirements for the first group of countries in order to begin negotiations for entry into the EU are also likely to apply to future applicants. The task of establishing the conditions for EU membership is therefore faced by all those countries that aspire to join.

Of the EBRD's 26 countries of operations, 16 are not yet applicants to join the EU, and many of these are unlikely to ever become applicants. The enlargement of the EU will have strong implications for them too. It is very important that the EU, enlarged or otherwise, embodies open market and free trade policies in relation to these countries. Indeed, open policies in relation to these countries are not only vital for the advancement of their transition but also for the development of the EU economy itself, its growth potential and the welfare of its consumers.

1.5 Poverty and income distribution

The first phase of transition has, in many countries, witnessed growing inequality in standards of living in the region and a sharp rise in poverty. While the heaviest sacrifices are probably over, there is no doubt that the hardships for substantial sections of the population have been severe and for many will continue. Some of the setbacks have been dramatic and shocking. In Russia, for example, male life expectancy has declined by six years since 1989 and is now below that for India. While the pace of change has been remarkably fast, and faster than many anticipated, the scale of deprivation which would accompany this change in many countries was not widely foreseen.

Data on living standards are limited and problematic but it is clear that experiences vary sharply across countries. For example, in the Czech and Slovak Republics, Poland and Slovenia life expectancy has increased. The identity of the poor also varies. In Russia pensioners in single-person households have been predominant among the poor, whereas in Hungary persistent poverty has been focused on households with children. Some of the available evidence is presented in Annex 2.2 to Chapter 2 and problems of interpretation are discussed.

Another finding of Annex 2.2 is that differences across countries are also marked with respect to developments in income inequality. The starting points in this area are particularly difficult to measure accurately, but a variety of sources point to a substantial increase in inequality in many parts of the CIS to levels well above the OECD average. In contrast, several east European countries, notably the Czech Republic and the Slovak Republic, continue to record low levels of income inequality, partly as a result of an effective social security system. The evidence of increases in poverty and income inequality among the countries of the CIS presents a particular challenge for fiscal policy, which has been weak in most of these countries. The challenge is both to strengthen revenues and to improve the allocation of expenditures, in order to contain social hardship and to lay the foundations for the poor to participate in growth.

1.6 Conclusion

Following the rapid liberalisation and privatisation of the earlier years of transition and the impressive progress in macroeconomic stabilisation, growth is returning in the region as the transition enters a new phase. There is, however, great diversity. While some of the more advanced countries are already into the second phase, a few are still mired in the problems of the first. For all countries, the central challenge of the second phase is building the governance and institutions which will underpin a well-functioning market economy. Most countries of the region are already market economies in some shape or form. It is the next years which will determine whether they develop and deepen the policies, institutions and behaviour that will allow these nascent market economies to function well and to deliver the growth in living standards of which they are capable. The next few years will be crucial in shaping the future development of these economies.

The strengthening of governance and institutions must focus on the development of an environment that promotes the vibrancy, competitiveness and effectiveness of the private sector. This must involve strong infrastructure, sound financial institutions, healthy and active capital markets, and an effective legal system. Above all, it must be oriented towards effective competition, both domestic and foreign. The founders of the EBRD captured succinctly and clearly the key ingredients for a well-functioning market economy in Article 1 of the Agreement Establishing the

Bank, when its purpose was defined as "to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative". The central theme of this Report is that these are the precise ingredients that will deliver restructuring and sustained growth. However, good governance and strong institutions are required if the open market economy and entrepreneurial initiative are to flourish and yield the growth of which the region is capable. Put briefly and simply, the main message of the Report is that good governance and institutions will deliver effective and competitive markets, which in turn will deliver restructuring and sustained growth.

While the message can be put simply, the tasks involved in building good governance and sound institutions are complex, inter-related, difficult and of long duration. The next phase will be no less challenging than the first and will, in many respects, be more subtle and difficult. The challenges will require both leadership and patience. The character of the market economies which will emerge will be determined largely by the policies and actions of the countries themselves. However, there must be major contributions from outside – from policy makers, investors and international financial institutions. Trading partners must keep their markets open. Investors have their part to play, not only in bringing finance and technology but also in demonstrating and building skills, methods of working, reputable behaviour and the sound practices which are associated with a well-functioning market economy. Perhaps the best way of building institutions is to invest in them. That principle is at the heart of the EBRD's activities in the region.

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Progress in market-oriented transition

2

2.1 The year in transition 1997

This year has seen serious crises, dramatic turnarounds and reinvigorated reform initiatives in the course of market-oriented transition in eastern Europe, the Baltics and the CIS. Though progress in transition throughout the region has continued at a strong, albeit slower, pace than previous years, the path of change cannot be described as "linear", i.e. as a steady march of progress across all dimensions. Instead, reforms in many countries have proceeded in spurts – advancing, stumbling, and then surging forward again, often with renewed vigour. The year has highlighted the fragility of the hard-won gains of macroeconomic stabilisation, particularly in those countries that have not introduced the necessary reforms at the microeconomic level. Deficiencies or delays in crucial institutional and structural reforms have contributed to financial sector instability and currency volatility. Combined with growing external imbalances, the result has been a series of macroeconomic crises and near-crises. But fortunately, the crises, for the most part, provoked a resolute response that included new commitments to the acceleration of long-overdue structural reforms. In the face of serious difficulties throughout the year, the reform process in many of the transition economies has demonstrated a new level of political robustness that provides encouraging signs for the many challenges ahead.

This "non-linear" pattern of reform characterised countries at all stages of the transition process. Bulgaria and Romania suffered severe macroeconomic setbacks, but the crises triggered new governments in both countries that have begun to implement bold programmes of stabilisation and structural reform. The Czech Republic faced a serious challenge to the stability of its currency arising from concerns over its growing current account deficit and weaknesses in its financial sector, but the government reacted with a renewed commitment to long-delayed structural reforms in privatisation and the capital markets. Political uncertainty surrounding the presidential elections in Russia seriously destabilised domestic financial markets and side-tracked structural reforms, but a reshuffled government in the aftermath of Boris Yeltsin's victory, and his improvement in health, rebounded with a major new reform programme. Albania descended into crisis and chaos in the wake of the collapse of massive financial pyramid schemes. New elections brought a change of government that has expressed its intention to pursue more comprehensive reforms.

This encouraging robustness of the reform process has not been evident in all of the transition economies. In Uzbekistan, balance of payments difficulties led to reversals of earlier reform measures including the reintroduction of a multiple exchange rate regime and a wide range of discretionary state interventions in the economy. In Tajikistan, a sharp depreciation of the national currency led to the reimposition of foreign exchange restrictions, new government interventions in the economy, and a weakening of fiscal and monetary policies. Following a further concentration of political power in Belarus, earlier progress in the development of a privatisation programme was stalled.

Notwithstanding these stops, or indeed reversals, the region overall continues to make substantial progress in the transition to market-oriented economies. The most advanced countries in eastern Europe and the Baltics have begun to make headway in the more complex areas of institutional reform, including: privatisation of banks and infrastructure; development of an effective regulatory framework for financial markets; fiscal reforms; and social security reform. Moreover, progress towards the initiation of accession negotiations with the European Union for a number of east European countries has led to further harmonisation with EU practices and guidelines in many areas.

In the CIS, growth is spreading and taking root; positive growth rates for 1997 are expected for all but Moldova, Tajikistan and Ukraine. Nearly all of the CIS countries have been able to reduce inflation to manageable levels and to maintain greater stability of prices. Mass privatisation has gained pace in countries in which it had long been delayed. Several countries have begun to tighten supervision over the banking sector. Kazakhstan, Moldova, Russia and Ukraine have gained access to international capital markets through Eurobond issues.

Outstanding challenges

Despite the considerable progress in transition over the year, the remaining reform challenges continue to be substantial for countries at all stages of transition. The very successes of the transition to date – which have yielded macroeconomic stability and an acceleration of the recovery – have revealed even more clearly the remaining shortcomings at the microeconomic level. Moreover, this turbulent year for several of the transition economies has demonstrated quite forcefully how inattention to these shortcomings can threaten the hard-won achievements of earlier macroeconomic reforms.

Surplus capacity[1] and the sharp depreciation of the real exchange rate early in the transition provided a "cushion" for enterprises to begin the process of recovery without engaging in fundamental restructuring. However, the acceleration of the recovery and rapid appreciation of the real exchange rate – themselves consequences of determined stabilisation efforts by governments – have, in many countries, begun to deflate those cushions.[2] Continued growth

1 This arose partly from excess labour within enterprises under the old economic system and partly from economic contractions in the initial periods of the transition.

2 The language of "cushions" in describing the process of recovery has been used by Vaclav Klaus, the Prime Minister of the Czech Republic.

depends to a large extent on significant restructuring at the enterprise level, yet progress in this area has been slow. Though financial discipline for enterprises in most transition economies has increased considerably with the elimination of budgetary and off-budget subsidies, this has not been matched by the real improvements in the structure of corporate governance which are required if the hard decisions on restructuring are to be taken in newly privatised enterprises. Outside a group of the most advanced reformers, enterprise restructuring remains generally limited. This suggests that many transition economies could hit a "ceiling of recovery" in which the acceleration of growth permitted and stimulated by the utilisation of surplus capacity and the earlier depreciation of the real exchange rate reaches an upper bound, while the slow pace of restructuring hinders progress in the expansion of exports, further productivity gains, and the development of new internal and external markets necessary for growth.

Macroeconomic stabilisation has also revealed the enduring weaknesses of the financial sector. With less exchange rate volatility, sharply reduced yields on government securities and decreasing interest rate spreads – all induced by stabilisation – the era of easy profitability that fuelled the phenomenal growth of financial institutions has largely come to an end. But in most of the transition economies, the new banks are not yet prepared to provide the basic array of intermediation services to secure their own future and to promote medium- and long-term investment in their economies. Lending to the private sector remains at low levels. Though major strides have been made across the region in strengthening banking and capital market supervision, consolidating weak and undercapitalised banks, and privatising the remaining state-owned banks, there remains much to be done in these areas. The adoption and enforcement of bankruptcy and collateral legislation, as well as creditor protection measures, remain weak, as examined in Box 2.1 of this chapter. Taxation rules in several countries continue to distort the incentives of bankers. As important is the development of a new set of banking skills within these institutions more attuned to the standard operations of banks in more developed economies.

In the early stages of transition, primary emphasis was placed on adopting reforms targeted at establishing markets and private ownership. But it is becoming still more apparent that these newly established institutions require the reform of the administration of government if they are to flourish. Recent surveys provide strong empirical evidence confirming the magnitude of such problems as: excessive and unpredictable taxation, policy uncertainty, arbitrary bureaucratic interventions, and corruption among the post-communist transitions.[3] Indeed, the extent of these problems has been rated greater in the CIS than in any other region of the world.[4]

The detrimental effects of problems in governance on investment and output are increasingly recognised by those studying or commenting on economic development. Yet in the context of the transition economies, where new political and economic institutions are in the very process of formation and development, the consequences have the potential to be far more severe. The governance problems of the region can distort the development of human capital, damage the structure of emerging organisations, and shape the evolution of linkages between government and business with potentially long-term and severe consequences for the path of the transition and the type of economy and society to which it will lead.

The problem of corruption merits special attention. Annex 2.1 provides a review of evidence on the level and pattern of corruption in the region. The threat of corruption to the process of economic transition reaches far beyond its direct effects on investment. Corruption and concentrations of power are mutually reinforcing and can exacerbate the social and political strains on the state, which are already substantial in transition economies. The pervasiveness and visibility of corruption have made it a focal point of the political process in several transition countries with very uncertain consequences. Anti-corruption campaigns have become a prominent feature of electoral politics, in some cases as a means to reverse economic reforms (as in Belarus) and in others to spur on more extensive reforms (as in the recent Bulgarian elections). The Bulgarian case suggests that anti-corruption campaigns in the political arena do not inevitably spark populist reactions against reform. However, high levels of corruption can weaken popular support for the transition.

Perhaps some of the most difficult challenges to the transition derive from the exacerbation of social problems associated with periods of major transformation. Though data on social trends in the transition economies are still highly problematic, it is clear that poverty has increased dramatically across the region as a result of falling incomes, dislocation of employment and reduced or badly directed social transfers. On some estimates, the average incidence of "income poverty" for the transition economies increased sevenfold between 1988 and 1994 – from 4 per cent to 32 per cent – though the extent of the increase varies widely within the region.[5] While poverty rates remain relatively low in the central European countries, they have climbed steeply in the Baltic countries and throughout the CIS. Along with rising poverty have come increases in many of the transition countries in health problems and social maladies, including dramatic increases in deaths from heart disease, higher suicide rates, and the spread of infectious diseases. Life expectancy in a number of countries has dropped sharply and the associated causes would appear to be related to higher stress and deterioration in the provision of public health services. These issues are examined in greater depth in Annex 2.2.

3 See the results of the World Bank's survey of entrepreneurs in 69 countries, reported in Brunetti, Kisunko et al. (1997), as well as the survey of shopkeepers in Poland and Russia reported in Frye and Shleifer (1996).

4 The relative levels of various risk factors across regions of the world – with a particular focus on corruption and government policy instability – are presented in a review of commercial risk ratings and survey evidence in Annex 2.1.

5 Income poverty is measured by low income as distinct from other dimensions of poverty such as health and education. The poverty rate is based on a poverty line of US$ 4 purchasing power parity per person per day. See UNDP (1997), p.34.

Levels of income inequality have also increased throughout the region, in some cases at a pace unprecedented in the post-war period. While this increase has been relatively modest in the central European countries, inequality levels in several of the CIS countries appear to have risen from just below the average OECD level to levels typical of some of the most unequal developing countries in the short span of 5-7 years.[6] Yet the pattern of poverty and inequality in the transition economies suggests that, over the medium term, government policies to promote open and participatory private sector development and establish a well-targeted system of social security – both key elements of the transition – will, if well designed and implemented, be able to contain these problems.

Overcoming the environmental legacy inherited from central planning and establishing adequate environmental policies and processes constitute profound challenges for transition countries. While environmental quality has improved, notably through the reduction in industrial emissions resulting from the slowdown in economic activity, the problems are severe, including oil and chemical damage, the pollution of rivers, lakes and seas, the poor quality of water supplies, and air pollution. The nature of environmental pressures is also evolving with economic restructuring and lifestyle changes, such as the substitution of services for industrial output or increased motor vehicle use. Adequate environmental policies and processes, including environmental impact assessments, are part and parcel of a modern market economy and should be given due consideration in the reform process.

2.2 The transition indicators

In an effort to analyse and compare the progress in market-oriented transition in eastern Europe, the Baltics and the CIS, the EBRD has presented annually since 1994 an appraisal, across a number of dimensions, of the state of the transition. This appraisal provides a snapshot of the cumulative progress in the movement from a centrally planned economy to a market economy. Progress is measured against the standards of advanced industrial economies, recognising that there is no perfectly functioning market economy and that the institutional diversity among market economies does not present a unique end-point for the transition. We have also, since 1994, provided some summary indicators for each dimension in the form of Table 2.1. The numerical indicators in Table 2.1 are intended to serve only as summaries of the detailed qualitative assessments of progress in each area of the transition presented in the country-by-country analyses on pages 148 to 213 of this Report. These country analyses provide a comprehensive assessment of the reform process and describe the nature and effectiveness of the new economic institutions emerging in each country.

This year a number of changes have been made to the transition indicators. First, the classification system has been modified slightly. In an effort to present finer distinctions within the rather broad categories, we introduce a system of pluses and minuses to the standard numerical scores 1 through 4.[7] The pluses and minuses are intended to identify those countries near the borderlines that distinguish the different categories.[8] This distinction has become particularly important as the continued advance of the transition process has led many countries to shift towards the higher categories.

Second, in previous years we have included a measure of the extensiveness and effectiveness of legal rules on investment in the overall transition indicators. However, this year the focus of our survey in this area has narrowed to evaluate a more specific set of laws particularly critical for fostering market-based decision-making and investment, namely pledge law, company law and bankruptcy law. As a result, the classifications this year are not directly comparable to those of previous years, which assessed a range of investment-related laws and regulations from a broader, less precise, perspective. The legal reform indicators are presented separately in Box 2.1. A country-by-country examination of progress on these specific laws is included in the analysis of transition on pages 148 to 213 of this Report. Although the discussion of legal reform is presented separately, progress in this area should be recognised as an integral component of the overall process of transition whose importance is not diminishing with time.

Third, this year we have initiated preparatory work for a future set of transition indicators which will measure the extensiveness and effectiveness of environmental policy reform. Centrally planned economies had very stringent environmental standards, but their overall implementation was very weak. Thus, it is important to examine not only the similarities in environmental legislation between transition countries and Western market economies, but also the extent to which such legislation can be considered effective. Box 2.3 describes our preliminary analysis based on questionnaires and official sources. At this stage, it is intended to provide some initial analysis of the status of key dimensions of environmental reform in transition economies.

The categories covered by the transition indicators in Table 2.1 are selective and do not cover all the relevant aspects of the transition process. They continue to focus on three of the most basic elements of transition: enterprises, markets and trade, and financial institutions. On enterprises, the transition indicators are designed to measure the extent to which enterprises have been shifted into private ownership and have begun to alter their operations and governance structures in response to the market.

6 Income inequality is particularly difficult to measure in the CIS and any data must be treated with caution. For a comparison of income inequality across the region, see Milanovic (1996).

7 In previous years, we have used the score 4* to indicate standards and performance typical of advanced industrial economies in the relevant dimension. In keeping with the new system of pluses and minuses, we replace 4* by 4+ in this year's transition indicators; the score signifies the same classification as previous years.

8 Given that these pluses or minuses represent finer distinctions within the existing categories in comparison to the scores of previous years, the pluses or minuses do not necessarily indicate progress or regress over the preceding year. In many cases, they simply give a better indication of the position that a country has maintained over time within the range of a particular category. In the event that the plus or minus does correspond to real progress or regress over the course of the year, it will be indicated in the supporting text and in the appropriate section of the transition indicators at the back of this Report.

On markets and trade, the transition indicators are intended to gauge how well these markets are functioning. In this regard, they indicate the openness of markets, the extent of competitive practices, and the degree to which prices reflect costs. On financial institutions, the indicators attempt to capture the extent to which the financial system provides financial discipline, effective intermediation between savers and investors, and an efficient payments system. This requires an analysis of the ownership structure of financial institutions, the range of instruments and services they provide, the level of competition among them, their role in corporate governance and enterprise restructuring, and the effectiveness of the regulatory environment in which they operate.

The framework for a well-functioning market economy goes well beyond the areas covered by the transition indicators. Such an economy requires an effective government capable of providing for the security of contracts and property rights, for competition and a stable environment for investment (which includes macroeconomic stability).[9] Indeed the role of government is becoming ever more important as the transition enters the next phase, as described in the previous chapter. Such an economy also both requires and fosters the development of human capital in terms of business, management and accounting skills, as well as entrepreneurship. It should embody appropriate standards of conduct in both private and public affairs if a sound business climate that facilitates long-term investment decisions is to be created.

Lastly, though market economies may make effective use of resources and provide incentives to invest and innovate, they can also leave parts of the population impoverished or excluded without effective government intervention. Education and health services are required if the population is to generate and maintain its ability to participate in market opportunities. If poverty is to be prevented, a social safety net will be necessary for those who are not in a position to participate.

Many of these aspects of a well-functioning market economy are difficult to measure succinctly and systematically in the form of simple indicators. That they are not incorporated into the transition indicators does not reflect an assessment of their relative importance, but rather the complexity of measurement in relation to both the underlying concepts and the information available.

Two remaining caveats concerning the transition indicators must be mentioned at the outset. First, the indicators describe the status of reform in each country as of August 1997 and, therefore, do not necessarily reflect the twists and turns of the reform process throughout the year. In some countries, they may give the impression of a steady, linear progress of reform that masks the reform pattern described at the beginning of this chapter.

Second, the general advance of the summary indicators should not be misinterpreted to mean that countries are converging towards a standard model of the market economy; in fact, they hide the considerable institutional diversity developing as the transition advances. At the start of the transition, these economies had strong institutional similarities – though with a wide range of national variations – rooted in the largely monolithic model of central planning in the region. Yet as the transition progresses, their institutional patterns are increasingly diverging, despite sharing some key features common to all market economies. At the more advanced stages, similar ratings of progress in transition should not be mistaken for similarities in the institutional forms that have emerged as a result of the transition.

[9] See Chapter 1 and, e.g., Stern and Stiglitz (1997) and the World Bank (1997).

A number of aspects of this stage of transition, which do not lend themselves to synthetic "ratings", are presented in much greater detail in the country-by-country analyses on pages 148 to 213 of this Report. They describe the course of reform over the previous year and outline the institutional forms that are evolving in each country. Taken together, they demonstrate the considerable institutional diversity that is emerging from the process of market-oriented transition. Table 2.1 is a short-hand for the more detailed descriptions provided there.

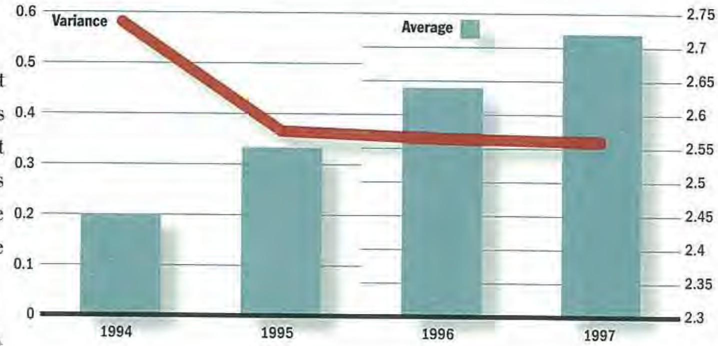
2.3 General trends in transition

The EBRD's transition indicators now cover a four-year period, providing a greater opportunity to examine some general trends in transition over time than was possible in earlier years. In such an analysis some broad-brush descriptions can be provided using the aggregates of scores from the transition indicators, both over all the reform dimensions within each individual country and in comparing different reform dimensions across all the countries. While these aggregate scores provide a crude summary statistic to illustrate some general trends, they must be treated with great circumspection. The aggregation of scores across dimensions by simple addition both allocates equal weight across dimensions and assumes that the distances separating the various thresholds of the 1–4 scale within each dimension are comparable. There are real difficulties in interpreting or justifying either assumption. We therefore confine ourselves to descriptions of general trends and patterns that are not particularly sensitive to how aggregate scores are calculated.

Chart 2.1

Average annual EBRD transition indicators [1]

Average variance [2]



[1] This is calculated as the average across all of the countries in Table 2.1 on all of the dimensions of reform with the exception of private sector share of GDP. Pluses and minuses are calculated as +/- 0.33, e.g. 2+ is counted as 2.33 and 3- as 2.67.

[2] The variance represents the dispersion around the average score across countries and dimensions of reform. A higher variance represents greater dispersion of individual country scores around the average for the entire set of transition economies.

Table 2.1

Progress in transition in eastern Europe, the Baltics and the CIS [1]

Countries [2]	Population (millions, mid-1995)	Private sector share of GDP in %, mid-1997 (rough EBRD estimate) [3]	Enterprises: Large-scale privatisation	Enterprises: Small-scale privatisation	Enterprises: Governance & restructuring	Markets and trade: Price liberalisation	Markets and trade: Trade & foreign exchange system	Markets and trade: Competition policy	Financial institutions: Banking reform & interest rate liberalisation	Financial institutions: Securities markets & non-bank financial institutions
Albania	3.2	75	2	4	2	3	4	2	2	2 -
Armenia	3.7	55	3	3	2	3	4	2	2 +	1
Azerbaijan	7.5	40	2	3	2	3	2 +	1	2	1
Belarus	10.4	20	1	2	1	3	1	2	1	2
Bulgaria	8.4	50	3	3	2 +	3	4	2	3 -	2
Croatia	4.8	55	3	4 +	3 -	3	4	2	3 -	2 +
Czech Republic	10.3	75	4	4 +	3	3	4 +	3	3	3
Estonia	1.5	70	4	4 +	3	3	4	3 -	3 +	3
FYR Macedonia	2.1	50	3	4	2	3	4	1	3	1
Georgia	5.4	55	3 +	4	2	3	4	2	2 +	1
Hungary	10.3	75	4	4 +	3	3 +	4 +	3	4	3 +
Kazakhstan	16.8	55	3	3 +	2	3	4	2	2 +	2
Kyrgyzstan	4.5	60	3	4	2	3	4	2	3 -	2
Latvia	2.5	60	3	4	3 -	3	4	3 -	3	2 +
Lithuania	3.7	70	3	4	3 -	3	4	2 +	3	2 +
Moldova	4.4	45	3	3	2	3	4	2	2	2
Poland	38.5	65	3 +	4 +	3	3	4 +	3	3	3 +
Romania	22.7	60	3 -	3	2	3	4	2	3 -	2
Russian Federation	148.4	70	3 +	4	2	3	4	2 +	2 +	3
Slovak Republic	5.3	75	4	4 +	3 -	3	4	3	3 -	2 +
Slovenia	2	50	3 +	4 +	3 -	3	4 +	2	3	3
Tajikistan	5.8	20	2	2	1	3 -	2	1	1	1
Turkmenistan	4.4	25	2	2	2 -	2	1	1	1	1
Ukraine	51.9	50	2 +	3 +	2	3	3	2	2	2
Uzbekistan	22.4	45	3 -	3	2	3 -	2 -	2	2 -	2

1 The numerical indicators are intended to represent the cumulative progress in the movement from a centrally planned economy to a market economy in each dimension, rather than the rate of change in the course of the year. The classification system is described in detail on pages 15 and 16. This year the legal transition indicators are presented separately in Box 2.1. Selected indicators of environmental policy reform are presented in Box 2.3.

2 This list includes all of the EBRD's countries of operations with the exception of Bosnia and Herzegovina, which has not been assigned scores due to the fact that the economy is still divided into separate enclaves not conducive to a single overall assessment.

3 The "private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available. Here the term "private companies" refers to all enterprises in which a majority of the shares are owned by private individuals or entities. The roughness of the EBRD estimates reflects data limitations, particularly with respect to the scale of informal activity. The EBRD estimates may in some cases differ markedly from available data from official sources on the contribution to GDP made by the "private sector" or by the "non-state sector". This is in most cases because the definition of the EBRD concept differs from that of the official estimates. Specifically for the CIS countries, official data in most cases refer to value added in the "non-state sector" – a broad concept which incorporates collective farms as well as companies in which only a minority stake has been privatised.

Classification system for transition indicators [1]

Transition element	Category	Description of the category
Large-scale privatisation	1	Little private ownership.
	2	Comprehensive scheme almost ready for implementation; some sales completed.
	3	More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.
	4	More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress on corporate governance of these enterprises.
	4+	Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.
Small-scale privatisation	1	Little progress.
	2	Substantial share privatised.
	3	Nearly comprehensive programme implemented.
	4	Complete privatisation of small companies with tradable ownership rights.
	4+	Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.
Governance & restructuring	1	Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
	2	Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
	3	Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g. through privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).
	4	Substantial improvement in corporate governance, for example, an account of an active corporate control market; significant new investment at the enterprise level.
	4+	Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.
Price liberalisation	1	Most prices formally controlled by the government.
	2	Price controls for several important product categories, state procurement at non-market prices remains substantial.
	3	Substantial progress on price liberalisation: state procurement at non-market prices largely phased out.
	4	Comprehensive price liberalisation; utility pricing which reflects economic costs.
	4+	Standards and performance typical of advanced industrial economies: comprehensive price liberalisation; efficiency-enhancing regulation of utility pricing.
Trade and foreign exchange system	1	Widespread import and/or export controls or very limited legitimate access to foreign exchange.
	2	Some liberalisation of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
	3	Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.
	4	Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility.
	4+	Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO.

[1] The classification system is simplified and builds on the judgement of the EBRD's Office of the Chief Economist. More detailed descriptions of country-specific progress in transition are provided in the transition indicators at the back of this Report. The classification system presented here builds on the 1994 *Transition Report*. To refine further the classification system, pluses and minuses have been added to the 1–4 scale this year to indicate countries on the borderline between two categories. The classification 4* which was used in previous years has been replaced with 4 +, though the meaning of the score remains the same.

Classification system for transition indicators [1]

Transition element	Category	Description of the category
Competition policy	1	No competition legislation and institutions.
	2	Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.
	3	Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
	4	Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
	4+	Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.
Banking reform and interest rate liberalisation	1	Little progress beyond establishment of a two-tier system.
	2	Significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.
	3	Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.
	4	Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.
	4+	Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.
Securities markets and non-bank financial institutions	1	Little progress.
	2	Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
	3	Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework.
	4	Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalisation; well-functioning non-bank financial institutions and effective regulation.
	4+	Standards and performance norms of advanced industrial economies: full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation.

1 The classification system is simplified and builds on the judgement of the EBRD's Office of the Chief Economist. More detailed descriptions of country-specific progress in transition are provided in the transition indicators at the back of this Report.
The classification system presented here builds on the 1994 *Transition Report*. To refine further the classification system, pluses and minuses have been added to the 1–4 scale this year to indicate countries on the borderline between two categories. The classification 4* which was used in previous years has been replaced with 4 +, though the meaning of the score remains the same.

Box 2.1

1997 Legal survey

The extensiveness and effectiveness of pledge, bankruptcy and company laws in the EBRD's countries of operations

The table on the right provides an assessment of the progress made to date in legal reforms in three major areas of commercial law: pledge, bankruptcy and company law. The assessment was made on the basis of a survey conducted by the EBRD through the distribution of questionnaires to selected private law firms, academics and other experts familiar with commercial laws in the countries of the region. Private sector lawyers were selected on the basis of their expertise in advising on local law issues, often in the context of the EBRD's own investments.

This is the third time that the EBRD has conducted a legal survey. In 1995 and 1996, it surveyed the extensiveness and effectiveness of investment laws generally in order to evaluate progress made in the reform of the general legal environment for investment in the region. The questions examined issues relating to foreign direct investment and the legal environment that would facilitate such investment. The EBRD conducted the survey for two years in order to chart the progress made in each country and to provide a basis for comparison.

The results of the 1995 and 1996 surveys were included in the *Transition Reports* for these years. These results demonstrated a significant correlation between the extensiveness and effectiveness of investment laws and other dimensions of the transition process.

The 1997 survey marks a shift in emphasis from investment law to three areas of commercial law of particular importance to private sector commercial transactions: pledge law, bankruptcy law and company law. Legislation in these areas must be both extensive and effective in order to facilitate commercial transactions and has a direct impact on the pace of private sector investment activity. The EBRD's Legal Transition Programme has identified the reform of pledge, bankruptcy and company laws and legal institutions relating thereto as a priority.

To complement the three specific topics in the survey, a section on general legal effectiveness has also been included. These questions attempt, as in past years, to gain an understanding of how commercial laws are being enforced and administered in each jurisdiction. Due to the distinct approach of the 1997 survey, it would be inappropriate to compare the 1997 results on extensiveness with those of the surveys conducted in 1995 and 1996, which dealt with investment law generally. The 1997 results should constitute a benchmark against which further reform efforts in the areas of pledge, bankruptcy and company law can be assessed in future years.

The table provides a numerical assessment (as of July 1997) of how closely the laws of the countries of the region approximate those of more developed countries in relation to their impact upon commercial transactions such as secured lending, project finance, debt restructuring, and the formation and governance of joint-stock companies. Pledge, bankruptcy and company laws have been evaluated and scored on the basis of two criteria: (i) the extent to which commercial legal rules approach laws and rules of more developed countries (referred to as extensiveness); and (ii) the extent to which such legal rules are clear and accessible and adequately supported administratively and judicially (referred to as effectiveness). The classification system is explained on page 19.

The table is not based upon a comprehensive survey of all commercial laws and regulations. For example, it does not evaluate banking and taxation legislation, although banking and taxation laws and regulations are pertinent to a well-functioning commercial legal regime. Much of the material that forms the basis of the Table is not readily verifiable and reflects the subjective assessments of survey respondents. Similarly, the information and views provided by respondents were not always consistent, and the EBRD has been selective in using material provided by the survey. Accordingly, while the purpose of the survey and resulting analysis is to give an impression of how conducive the laws in the region are to facilitating commercial transactions, care must be taken in reading and interpreting the results.

Legal transition indicators 1997

Country	Extensiveness	Effectiveness	Overall
Albania	2	2	2
Armenia	3	3	3
Azerbaijan	2+	1	1
Belarus	2	2	2
Bosnia and Herzegovina	2	1	1
Bulgaria	3	3	3
Croatia	4	4	4
Czech Republic	4	4	4
Estonia	4	4	4
FYR Macedonia	2	2	2
Georgia	3	2	2
Hungary	4	4	4
Kazakhstan	2	2	2
Kyrgyzstan	3	2	2
Latvia	3+	3	3
Lithuania	4	3	3
Moldova	3	2	2
Poland	4	4+	4
Romania	3	3	3
Russian Federation	3+	3	3
Slovak Republic	3	3	3
Slovenia	3	4	3
Tajikistan	na	na	na
Turkmenistan	na	na	na
Ukraine	2	2	2
Uzbekistan	2+	2	2

Pledge law

The survey examined a number of key issues relating to the ability of a party to pledge *movable* property as security for credit. In particular, the survey examined whether countries had reformed existing civil codes and/or adopted new laws to provide for the non-possessory pledge of movable property. The survey also examined whether countries had provided for a cost-efficient mechanism for the registration and enforcement of security interests or pledges in movable property.

While the survey confirmed that in most of the countries of operations of the EBRD it was possible to obtain a non-possessory pledge in another party's movable property, the survey indicated that only a few of the jurisdictions had established a functioning central registry for the registration of non-possessory pledges. The absence of such registries undermines the effectiveness of the non-possessory pledge. Such effectiveness may be achieved only through a system whereby the existence of charges over movable property and the priority of competing charges over the same property may be established without undue expense or delay.

Other impediments that are still present in a number of jurisdictions examined are high notary or registration fees relating to the legal notarisation or registration of a pledge or security interest. Notarisation is often the most common method whereby a security interest becomes legally enforceable and binding upon third parties. Another impediment is the absence of "self-help" remedies which permit the beneficiary of a charge to sell charged property in whichever way it considers most appropriate without the need to first obtain a court order.

In May 1997, Hungary introduced a centralised and computerised system for the registration of non-possessory pledges over movable assets, which provides for a reasonably efficient means of registering non- possessory charges and of conducting a search for the existence of charges on specific property. This major change follows Hungary's

1996 amendment to its Civil Code to provide greater flexibility in the area of secured transactions. Poland recently adopted a new pledge law that will come into force in January 1998. Polish regulations implementing a registration system for pledges are being prepared but have not yet been promulgated. Bulgaria, Estonia, Kyrgyzstan, Lithuania and Moldova have also recently introduced new pledge laws. These countries have not yet established efficient centralised systems for the registration of non-possessory pledges.

A middle category of countries has enacted changes to their pledge laws, but has yet to move to a more streamlined system of creation, registration and enforcement of pledges over movable property. Russia, for example, created a pledge law in 1992. This law permits creditors to obtain a non-possessory charge over a wide range of movable assets, both tangible and intangible, and permits parties to agree in the charging document that the charge may be enforced without the need to obtain a court decision. The law also provides that charges must be recorded by the debtor in a charges registry maintained by the debtor and required to be made available for inspection by interested parties. The law, however, does not provide for a uniform or centralised system of registration that would give public notice of the existence of pledges. In addition, burdensome notarisation fees (in Russia's case, 1.5 per cent of the value of the collateral) renders use of the charging instrument prohibitively expensive.

A last category of countries still lacks pledge laws that enable non-possessory security interests to be created over a wide range of movable property.

Company law

With respect to company law, the 1997 survey focused on issues such as the formation of joint-stock companies and the registration of shares. The other major focus of the company law section was corporate governance – that is the duties and responsibilities of directors – and the protections and rights afforded to shareholders.

A number of the countries in the region (the Czech Republic, Estonia, Hungary, Lithuania, Poland, the Russian Federation, the Slovak Republic, Slovenia and Uzbekistan) have enacted modern company laws that include provisions for the protection of shareholders' rights, such as the opportunity to be represented by proxy at meetings of shareholders. The laws of many of these countries now provide, in certain circumstances, that if a third party acquires more than a minimum percentage of the shares of a company, it must offer to purchase all of the remaining shares at the same price or, in some cases, at a price which is not less than the average purchase price for such shares in the six months preceding the acquisition. The Russian Joint-Stock Company Law (enacted 1 January 1996) contains even more extensive provisions that protect shareholder rights and also ensure a greater degree of director accountability. For example, provisions exist which require cumulative voting with respect to the election of the board of directors of a company with more than 1,000 shareholders. This provision enables minority shareholders to pool and direct their votes in an effort to elect one or more directors to represent their interests.

Most countries have enacted legislation which gives shareholders pre-emptive rights in the event that a company issues new shares. Pre-emptive rights protect the shareholders from having their stake in the company diluted.

Many jurisdictions still do not require share registries of companies to be maintained by an independent party.

Bankruptcy law

The bankruptcy section of the survey included questions on reorganisation proceedings (whereby creditors and a debtor can reach a settlement rather than liquidate the company), liquidation and the role of the liquidator/trustee/manager. The survey also examined the efficacy of bankruptcy legislation with a focus on the time, frequency and manner of liquidation proceedings. Many countries have recently enacted new bankruptcy legislation or amended laws that were adopted in the early 1990s. Armenia, Azerbaijan, Croatia, the Czech Republic, Estonia, Latvia, Lithuania and Moldova, for example, are countries that have recently adopted new bankruptcy laws.

Almost all of the countries have laws which provide that a debtor is insolvent when it cannot meet its debts as they fall due. Similarly, most countries provide for some form of reorganisation proceedings whereby a majority (either simple or, in some cases, qualified) of creditors may approve a plan of reorganisation binding on all creditors. The rules for distribution of liquidation proceeds, however, vary in each jurisdiction. In a number of countries, secured creditors do not receive the highest priority in a liquidation proceeding. The costs of liquidation, unpaid employee remuneration, and certain taxes and other charges are examples of the types of claims which may have priority over the claims of secured creditors in liquidation. This is not unique to central and eastern Europe or the CIS. Many jurisdictions in Europe and elsewhere also allow for the payment of liquidation costs and other amounts to be made prior to the payment of secured claims.

In many countries, bankruptcy laws confer on liquidators' wide powers of investigation coupled with relatively extensive powers to deal with the assets of the bankrupt. However, few countries provide for liquidators to be qualified or for their conduct to be regulated (other than by the courts).

In a last category of countries, bankruptcy laws do not provide for certainty or clarity with respect to the definition of an insolvent debtor, the scope of reorganisation proceedings or the priority of distribution to creditors following liquidation.

Effectiveness of laws

To achieve effective implementation and enforcement of new and amended commercial laws and regulations, countries in the region will need to devote substantial resources to the proper administration and enforcement of laws. In many instances, countries have undertaken significant reforms of their commercial laws. These changes, however, have not always been accompanied by effective means for implementation and enforcement. For example, large notary fees continue to impede secured lending in countries that have reformed their civil codes and pledge laws. In some jurisdictions, there are significant disincentives to the commencement of reorganisation or bankruptcy proceedings, including high costs, extensive involvement of the courts at each step of the proceedings, the lack of qualified insolvency practitioners and the lack of certainty of the outcome of such proceedings. Similarly, with secured transactions, many of the jurisdictions surveyed still require that a pledged asset be sold by the court at public auction or permit private sale only in limited circumstances.

On the next page is an explanation of the legal transition indicators used to assess the commercial laws of each country.

Classification system for the legal transition indicators

The extensiveness of commercial legal rules on pledge, bankruptcy and company formation and governance:

1 Legal rules concerning pledge, bankruptcy and company law are very limited in scope. Laws impose substantial constraints on the creation, registration and enforcement of security over movable assets, and may impose significant notarisation fees on pledges. Company laws also do not ensure adequate corporate governance or protect shareholders' rights. Bankruptcy laws do not provide for certainty or clarity with respect to the definition of an insolvent debtor, the scope of reorganisation proceedings or the priority of distribution to creditors following liquidation. Laws in these substantive areas often have not been amended to approximate those of more developed countries and the laws that have been amended contain ambiguities or inconsistencies.

2 Legal rules concerning pledge, bankruptcy and company law are limited in scope and may be the subject of conflicting interpretations. Legislation may have been amended but new laws do not necessarily approximate those of more developed countries. Specifically, the registration and enforcement of security over movable assets has not been adequately addressed, leading to uncertainty with respect to the registration and enforcement of pledges. Pledge laws may impose significant notarisation fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Laws may contain inconsistencies or ambiguities concerning, *inter alia*, the scope of reorganisation proceedings and/or the priority of secured creditors in bankruptcy.

3 New or amended legislation has recently been enacted in at least two of the three areas that were the focus of this survey – pledge, bankruptcy or company law – but could benefit from further refinement and clarification. Legal rules permit a non-possessory pledge over most types of movable assets. However, the mechanisms for registration of the security interest are still rudimentary and do not provide parties with adequate protection. There is scope for enforcement of pledges without court assistance. Company laws may contain limited provisions for corporate governance and the protection of shareholders' rights. Bankruptcy legislation contains provisions for both reorganisation and liquidation, but may place claims of other creditors in priority to those of secured creditors in liquidation.

4 Comprehensive legislation exists in at least two of the three areas of commercial law that were the focus of this survey – pledge, bankruptcy and company law. Pledge law allows parties to take non-possessory pledges in a wide variety of movable property and contains mechanisms for enforcement of pledges without court assistance. The legal infrastructure, however, is not fully developed to include a centralised or comprehensive mechanism for registering pledges. Company laws contain provisions for corporate governance and the protection of shareholders' rights. Director and officer duties are defined. Bankruptcy law includes detailed provisions for reorganisation and liquidation. Liquidators possess a wide variety of powers to deal with the property and affairs of a bankrupt.

4+ Comprehensive legislation exists in all three areas of commercial law that were the subject of this survey – pledge, bankruptcy and company law. Legal rules closely approach those of more developed countries with respect to pledge, bankruptcy and company law. These legal systems have a uniform system for the taking and enforcement of a security interest in movable assets (in most cases a centralised registry) and also provide for adequate corporate governance and protect shareholders' rights, including the rights of minority shareholders in the event of the acquisition by third parties of less than all of the shares of a widely held target company. Bankruptcy law provides in a comprehensive manner for both reorganisation and liquidation. Liquidators possess a wide variety of powers and duties to deal with the property and affairs of a bankrupt entity, including wide powers of investigation of pre-bankruptcy transactions carried out by the debtor. There are specialised courts that handle bankruptcy proceedings. Liquidators must possess certain minimum qualifications.

The effectiveness of legal rules of investment on pledge, bankruptcy and company formation and governance:

1 Commercial legal rules are usually very unclear and sometimes contradictory. The administration and judicial support of the law are rudimentary. The cost of transactions, such as creating a security interest or pledge over a movable asset, is prohibitive so as to render a potentially extensive law ineffective. Also, there are no meaningful procedures in place in order to make commercial laws fully operational and enforceable. There are significant disincentives for creditors to seek the commencement of bankruptcy proceedings in respect of insolvent debtors.

2 Commercial legal rules are generally unclear and sometimes contradictory. There are few, if any, meaningful procedures in place in order to make commercial laws operational and enforceable.

3 While commercial legal rules are reasonably clear, administration or judicial support of the law are often inadequate or inconsistent so as to create a degree of uncertainty (e.g., substantial discretion in the administration of laws, few up-to-date registries for pledges).

4 Commercial law is reasonably clear, and administrative and judicial support of the law is reasonably adequate. Specialised courts, administrative bodies or independent agencies may exist for the liquidation of insolvent companies, the registration of publicly traded shares or the registration of pledges.

4+ Commercial laws are clear and readily ascertainable. Commercial law is well supported administratively and judicially, particularly regarding the efficient functioning of courts, liquidation proceedings, the registration of shares, and the orderly and timely registration of security interests.

Overall score:

The overall score allocated in the third column of the table is the average (rounded down) of the scores given for the two indicators. Pluses and minuses are intended to indicate countries on the borderline that distinguishes the relevant categories.

One broad (albeit crude) measure of overall progress over the past four years is the average of the transition indicators for the region as a whole, depicted in Chart 2.1. The regional average shows steady progress in each year though at a slowing pace (at least according to this measure). This year, 15 countries increased their average scores over the previous year, four remained the same and six registered declines.[10] The change in the average scores for each component of the transition – depicted in Chart 2.2 – shows that over the course of this year, the strongest progress has been made in large- and small-scale privatisation and banking reform. Less rapid improvement has been registered in competition policy and in the development of securities markets and non-bank financial institutions. Price and trade liberalisation have tended to advance more slowly given their rapid progress at the early stages of the transition. The average score for enterprise restructuring shows a slight decrease caused by recent backtracking in this area in Belarus and Uzbekistan.

Chart 2.2 also demonstrates some interesting trends over the course of the transition. Areas in which the transition has primarily involved liberalisation – i.e., the elimination of government-imposed restrictions on prices, trade, and the market for foreign exchange – saw rapid progress early in the transition before reaching a plateau more recently. Areas in which the transition has primarily entailed redistribution of assets – i.e., large- and small-scale privatisation – have on average moved steadily over the period measured by the transition indicators with early advances in some countries and later advances in others producing a fairly consistent increase in the average. Areas in which the transition has required rebuilding – i.e., the restructuring of enterprises, the overhaul of the banking system, the break-up of monopolies, and the establishment of securities markets and non-bank financial institutions – have made slower but not insubstantial progress. The overall achievements in banking reform are particularly notable.

The trends over time also reveal an interesting pattern of variation across countries. Chart 2.1 presents the variance – measuring the dispersion of country scores around the mean across countries – of the average reform scores for all the transition economies in each year. At the start of the transition, the variation would have been very low with all countries showing low scores. By 1994 when the scoring system started, there was already strong variation across countries. At some stage in the future when most or all countries are advanced in the transition, we should expect the variance to decrease again. Yet the variance for the last three years has been virtually constant. This illustrates numerically that, while the transition is beyond the initial stages for most countries, this later stage of reducing variance has not yet begun. Moreover, while the scores do show strong diversity, their crude numerical construction and limited dimensionality conceal a much deeper and broader diversity across countries.

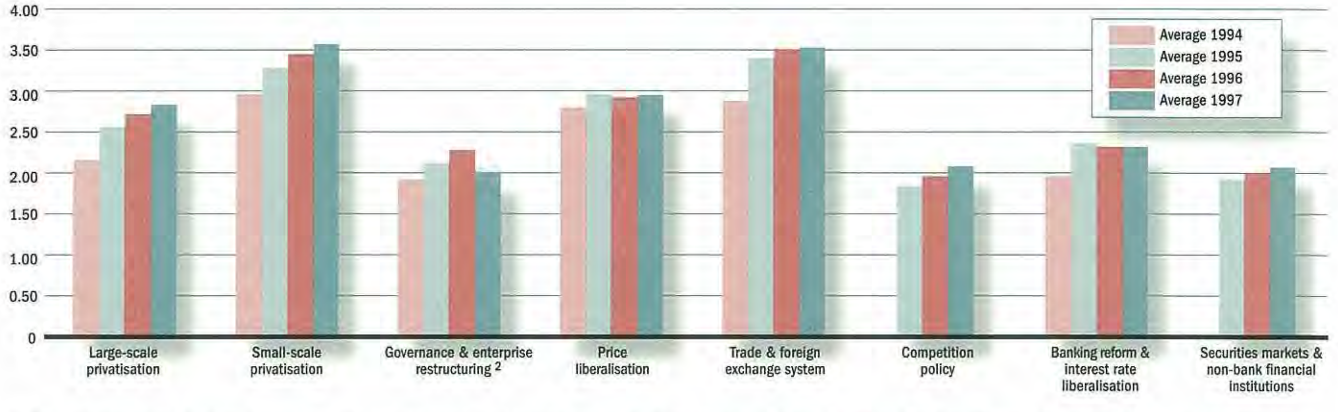
For a further description of patterns of diversity, Chart 2.3 plots the average reform scores for the transition economies grouped by standard regional categories. There is some evidence of a clustering of the scores of countries within each region, though the trend is weaker within the CIS than in eastern Europe, and a strong pattern across the regions. Countries within the same region have tended to reach similar measured levels of economic reform, regardless of the large qualitative variations among their reform efforts. Moreover, this clustering of reform scores has remained relatively stable over time. The extent of variation in the transition indicators within each region has declined or remained stable in every region except the central CIS countries, where the gap between rapid progress in Russia on a number of reform dimensions, slow progress in Ukraine, and regression in Belarus has continued to grow over time.

There are numerous possible explanations for this strong regional pattern of economic transition, among them: historical and cultural links to the market economy; initial socio-economic conditions;

Chart 2.2

Average annual EBRD transition indicators by dimension [1]

1994-97



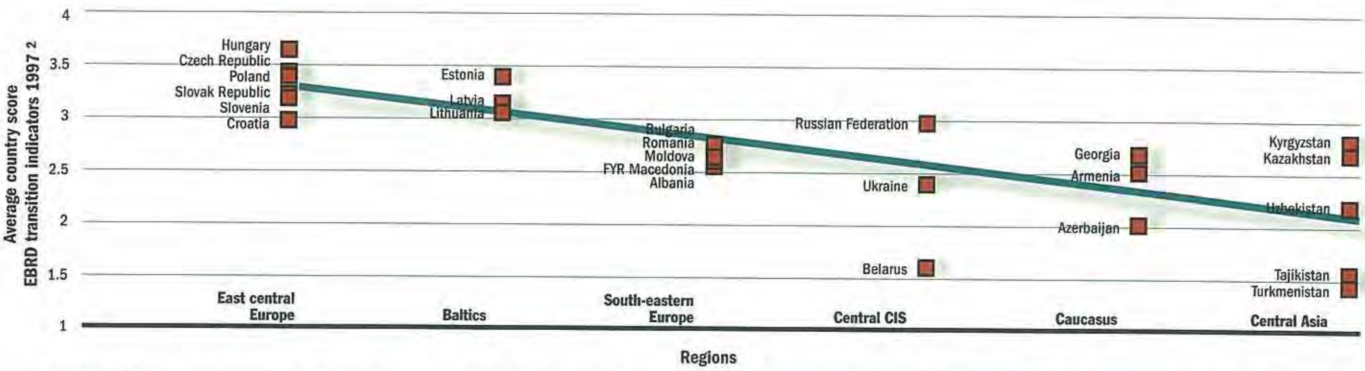
[1] For each dimension of reform in each year, the average score is calculated across all of the countries in Table 2.1 of the *Transition Reports* since 1994. Pluses and minuses are calculated as +/- 0.33. The score of 4* used in previous years is equivalent to 4+ or, according to the above standard, 4.33.

[2] The decline in this dimension from 1996 to 1997 reflects the finer distinctions associated with the introduction of pluses and minuses rather than a reversal of previous progress made in this dimension.

[10] The larger number of declines than in previous years reflects the new grading system, which adds pluses and minuses to the 1-4 scale; for the purposes of aggregation these are calculated as +/- 0.33 (e.g. 2+ is counted as 2.33 and 3- as 2.67). In some cases, declines in the average score will reflect an actual regression in policies, as in Belarus, the Slovak Republic, Tajikistan and Uzbekistan. In other cases, they reflect the recognition that some countries have been near the borderline of certain classifications, though the finer distinctions were not used in the initial categorisations.

Chart 2.3

Regional patterns of reform [1]



[1] The line in this graph depicts the average score on the 1997 transition indicators across all countries in the given region. The placement of each country name represents the distance of that country's average score from the average for the region as a whole.

[2] This represents the average score for each country on the 1997 transition indicators in Table 2.1 on all reform dimensions with the exception of private sector share of GDP. Pluses and minuses are calculated as +/- 0.33.

opportunities for integration with international and regional institutions; regional demonstration effects; the structure of politics and political institutions; and differences among countries in the way in which the previous communist system collapsed. Disentangling these intricately related explanations would be extremely difficult. However, the persistence of this regional pattern of variation in economic reform even as the transition advances suggests an interesting relationship between initial conditions (including the length of the communist period and membership of the Soviet Union), the early patterns of reform and later policy choices. Of course, this does not imply that progress in transition is shaped by some geographical determinism or trapped in an immutable pattern of path dependency. A comparison of the neighbouring states of Russia and Belarus, for example, clearly suggests that policy choices can lead countries to veer away from any regional pattern of reform.

Reform groups

The transition indicators have been used in the past to distinguish between countries at different stages of transition. In previous *Transition Reports*, to facilitate discussion, countries have sometimes been classified into three broad groups based on their overall scores: (i) "countries at advanced stages of transition", (ii) "countries at intermediate stages of transition", and (iii) "countries at early stages of transition". Though the division can be useful for some purposes, we have avoided attaching strong significance to these groupings. Further, as the transition progresses, the thresholds distinguishing these groupings have become even less clear. Some countries have moved ahead with reforms, but in an uneven manner, reaching what might be considered an advanced stage in some areas while remaining at an early or intermediate stage in others. Quite naturally, the relevance of the "early" stage has diminished over time as the transition has progressed. Indeed, according to the 1997 indicators, the only countries that would remain at the early stages of transition in the sense used in previous years would be Belarus, Tajikistan and Turkmenistan. This would not constitute a useful grouping for analytical purposes.

This year, the groups have been consolidated to reflect the overall progress in transition throughout the region. For the discussion in the remainder of this chapter, the countries are divided into two groups: (i) "countries at advanced stages of transition" and (ii) "countries at less advanced stages of transition". The allocation of countries into each group is based on their total scores on the indicators in Table 2.1. Countries at the advanced stages of transition include all the central European countries (the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia) and the Baltic states (Estonia, Latvia and Lithuania). Though Croatia has been included in this group in previous years, the introduction of pluses and minuses to the scale this year places Croatia on the borderline of this group. The remaining 17 countries in the region, including all the CIS states as well as south-eastern Europe (Albania, Bosnia and Herzegovina,[11] Bulgaria, FYR Macedonia and Romania) are included in the less advanced group. This year, the Russian Federation is located on the upper boundary of this group and should be considered as a borderline case. It is, of course, of such size and importance that, for many purposes, it is best treated separately. This allocation of countries necessarily involves some degree of subjectivity, since it employs not only indices which involve judgmental assessments but also the specification of an exact cut-off point between the groups which is unavoidably arbitrary. Consequently, this categorisation should be seen primarily as a way to organise discussion of evidence rather than involving some firm predictive or modelling status.

The categorisation of transition economies into advanced and less advanced groups provides a short-hand indication of the cumulative level of progress in market-oriented reform over the course of the transition. However, this measure of cumulative progress is not necessarily the best indicator for analysing or predicting prospective trends in transition, especially in light of the non-linear pattern of reform described earlier. As the transition enters a new and challenging stage, it is increasingly important to examine the robustness and resoluteness of the reform process in each country. We shall use resoluteness to refer to the strength of a

[11] Bosnia and Herzegovina has not been assigned scores in the transition indicators table since the economy is still divided into separate enclaves not conducive to a single overall assessment.

country's commitment to a comprehensive programme of structural reforms and macroeconomic stability and the priority given to its implementation over other policy concerns. Robustness refers to a resolute commitment to reform which is sustained, tested by events, and which has delivered over time. In this sense, resoluteness is a necessary but not sufficient condition for robustness.

Gauging the strength, credibility and resilience of a country's commitment to economic reform, i.e., the robustness of reform, involves an examination of the record of reform measures and of the quality of the institutions governing or underlying the reform process. In distinguishing more from less robust reforms, we should ask: (i) does the institutional framework create enduring incentives for governments to initiate and sustain economic reforms, and; (ii) does the track record of reform thus far suggest that the commitment has been able to survive periods of setbacks and challenges? Such questions cannot be answered from trends in the transition indicators alone. Instead, they require a deeper understanding of the institutions and the patterns of governance that facilitate and reinforce the process of reform – issues that are taken up in greater detail in Chapters 4 and 5.

The track record of the advanced countries suggests that the robustness of reforms in the face of challenges from numerous directions has, in many cases, been impressive. Hungary, for example, faced severe problems associated with growing internal and external imbalances in 1994-95 and responded with a vigorous macroeconomic adjustment programme and intensification of structural reforms that are now showing positive results. More recently, the Czech Republic has endured a sharp fall in the value of its currency linked to a growing current account imbalance and responded by accelerating reforms in privatisation, by strengthening regulation of capital markets, and by seeking to enhance corporate governance. A serious banking crisis in Estonia did not weaken that country's commitment to reform.

The reform process in several of the advanced countries has also been robust in the face of substantial political uncertainty. Poland has maintained a strong commitment to economic reform through six different governments of various reform profiles since the collapse of communism. Estonia has endured five government turnovers and two major cabinet reshuffles and has, nevertheless, kept the reform process moving forward. Slovenia has sustained a consistent reform effort despite the uncertainties of a fragile multi-party coalition government and, more recently, a long delay in the formation of a new government following parliamentary elections in November 1996. Indeed, Slovenia has consistently received the highest country risk ratings of any of the transition economies.

The robustness of reforms in this group of countries – the Czech Republic, Estonia, Hungary, Poland and Slovenia – has been recognised by the European Commission in their "Agenda 2000" which indicates that, together with Cyprus, they are the leading candidates for accession during the next round of enlargement of the EU. The experience of these countries suggests that robustness is associated with three key features of their progress in transition. First, they have implemented a critical mass of economic reforms creating sufficiently large domestic constituencies with a stake in sustaining the reform process. Second, they have a stable and increasingly well-institutionalised system of governance that minimises the risks of extreme policy shifts and constrains the discretionary power of political authorities. Third, they have achieved a high level of integration into world markets and into existing multilateral institutions which generates powerful incentives to maintain and deepen market-oriented reforms. There is considerable variation among the advanced countries with respect to these characteristics, making some transition economies more robust than others, though no absolute distinctions should be drawn. What distinguishes the most robust reformers is a strong foundation of political and economic institutions in support of market-oriented transition which will enable them to meet effectively the remaining challenges and shocks of the reform process that inevitably lie ahead.

While some countries at less advanced stages of transition may exhibit certain features of robust reformers, they have not yet reached the level of institutional development or the degree of integration into world markets that would ensure the resilience of market reforms, nor have they demonstrated a track record of steadfast progress in reform. The less advanced countries do vary quite considerably as to the resoluteness in reform. Within this group, there are countries with governments that have explicitly recognised the need for a comprehensive approach to economic reform and have marshalled the political will necessary to make significant progress in implementing such an approach. However, there are also cases within this group where the commitment is relatively new and major obstacles still exist in the form of political opposition to reform or powerful vested interests seeking to maintain special privileges. Other governments in countries at this transition stage have continued to display a more ambivalent approach towards economic reform and have been more likely to revert to old methods of direct control when problems or challenges arise.

Over the course of this year, Bulgaria and Romania have made new resolute commitments to a comprehensive reform programme in response to severe macroeconomic crises. Russia has reaffirmed its resolve to pursue structural reform with a new commitment to major privatisations, including infrastructure and energy, and to curbing the power of monopolies, although the position of special interests remains very powerful. In the past few years, Armenia, Azerbaijan, Georgia and Kazakhstan have adopted and are continuing to implement substantial reform programmes. The governments of Kyrgyzstan and Moldova have shown a consistently high commitment to reform, though conflicts with less resolute legislatures have slowed the reform process on occasion.

The experience of these countries suggests that there is no single set of factors that might motivate or underpin the resoluteness of government commitments to reform. In some cases, such as Bulgaria and Georgia, the resolve came in response to severe crises that propelled governments to action.[12] In other cases, the resolve has been a function of strong leadership with a consistent commitment to reform. In still other cases, such as Kazakhstan, the commitment appears to have been motivated by the desire to attract foreign investors in natural resource sectors. Consequently, though resolute reformers can be identified by observing and comparing track records of reform, there is no simple, single explanation to account for the variation in this resolve across countries.

The robustness and resoluteness of a country's commitment to economic reform are not qualities conventionally associated with the institution of democratic elections. Elections have often been portrayed as a source of uncertainty in the reform process, as political priorities take precedence over economic pressures and as disgruntled voters have an opportunity to respond to the often high short-term costs of necessary, but difficult, economic reforms.[13] Consequently, robust and resolute reforms are more often associated with committed leaders, states insulated from popular electoral pressures, and governments with concentrated political powers.[14] However, the experience of transition in the post-communist countries – especially some of the events of the past year – suggests that the institution of democratic elections can play an integral role in strengthening the robustness of economic reforms and generating the necessary resolve to implement comprehensive reform programmes.

While particular elections in the post-communist countries have at times introduced considerable short-term uncertainty into the process of economic reform, the evidence from the 6-7 year experience of transition in this region suggests that the institution of democratic elections may, on balance, be associated with accelerated and strengthened reforms. The advanced countries have, on average, held a larger number of democratic elections, have had more frequent government turnovers, and have had shorter government tenures than the less advanced reformers. Since 1990, the advanced countries have held, on average, just over three legislative elections or nearly one every two years. The chief executive has been changed an average 4.2 times in the advanced countries since 1990, while only 1.3 times among the less advanced reformers.[15] The average tenure of individual governments has also been substantially lower among the advanced countries than the less advanced countries.

Some of the most robust reformers in the region – such as Estonia and Poland – have also had the least stable parliamentary governments. The average government tenure in Poland is 396 days, while in Estonia the average tenure is 530 days. In both countries, electoral turnovers raised concerns that economic reforms might be derailed. However, progress in reform has remained steady. Indeed, early concerns that democratic elections might become vehicles for a popular backlash against comprehensive economic reforms have not been realised in any of the advanced countries. Though individual elections have not always produced victories for the most reform-oriented governments, the process of competitive elections over time has proven the robustness of reforms in a number of transition economies.

Recently, democratic elections in a number of transition economies have had a galvanising effect on the reform process, especially in response to economic crisis or prolonged stagnation. Elections in Bulgaria and Romania in the midst of severe macroeconomic difficulties produced strong majorities for reform-oriented parties in both countries, which quickly committed to comprehensive economic reform programmes. The financial collapse in Albania sparked legislative elections which replaced the Berisha regime with a new government promising to revive the reform process. Though presidential elections in Russia generated severe uncertainty, the decisive victory of Boris Yeltsin was followed by a major reorganisation of the government team, which has committed to structural reforms with a renewed vigour. Parliamentary elections in Lithuania triggered an acceleration of the privatisation process, which had stagnated under the previous government. These cases suggest that the electoral process can, in some instances, generate the resolve to respond to existing economic challenges and reinvigorate the reform process.

Of course, each individual democratic election in the region has not necessarily advanced reforms, nor have all transition countries with competitive elections performed well. Yet the fears that difficult economic reforms would not endure in the face of challenges from popular elections have not materialised. This is a remarkable and important feature of the process of transition in the region and one which could not necessarily have been predicted with confidence. Moreover, there is evidence to suggest that the electoral process over time may contribute to the robustness of reforms and serve as a mechanism to generate resolute commitments to reform in response to crisis.

2.4 The key dimensions of transition

The remainder of this chapter summarises the key trends and developments in each of the major dimensions of transition over the course of the year. More detailed descriptions of the developments in each country are presented in the qualitative analyses on pages 148 to 213 of this Report.

The private sector share in GDP

The private sector share in economic activity has continued to grow rapidly. By the middle of 1997, the private sector share had reached or exceeded the 50 per cent mark in 19 of the EBRD's 26 countries of operations. Among the advanced countries, several have already met or exceeded the private sector share in many OECD countries, nearly all of which fall within the range of

12 Drazen and Grilli (1993) argues that economic crises have certain benefits in triggering government macroeconomic stabilisation programmes.

13 For an analysis of the dynamics between elections and economic reform strategies, see Przeworski (1991).

14 See, e.g., the surveys of the politics of economic reform in developing countries in Haggard and Kaufman (1995) and Williamson (1994). More recently, the World Development Report has argued against insulating the state from popular pressures, but instead stresses the advantages of bringing government "closer to the people." (World Bank 1997).

15 The chief executive is defined as the prime minister in parliamentary and mixed systems and the president in presidential systems.

70-85 per cent of GDP.[16] With privatisation nearing completion in the Czech Republic, Estonia, Hungary and the Slovak Republic, the growth of the private sector share in future will come primarily from the formation of new firms and higher growth rates in private enterprises than in remaining state sector entities.

The largest rises in private sector share were among those countries that showed particular resolve in reforms over the past year, including Azerbaijan (from 25 per cent to 40 per cent) and Kazakhstan (from 40 per cent to 55 per cent). This has been the result of initiatives in both large- and small-scale privatisation in both countries, as well as increased capital inflows into the natural resources sector. Relatively large increases were also recorded in Armenia, Georgia, and Kyrgyzstan. In Ukraine, the increase in the share of the private sector is the result of an acceleration in the pace of small-scale privatisation.

The limitations of the data in this category, in particular, must be stressed, especially in making cross-country comparisons. Recent research has begun to provide some indication of the extent of the informal economy throughout the region.[17] The calculation of GDP on the basis of electricity usage data suggests that the share of the informal economy may reach as high as 50 per cent in some of the CIS countries.[18] It is difficult even to define the private sector clearly, much less to estimate its size with a high level of accuracy in many of the transition economies. As the estimates of the informal economy diverge substantially within the region, cross-country comparisons should be made with caution. The EBRD's estimates of the private sector share of GDP are based on official statistics, which tend to underestimate the size of the informal sector.

Large-scale privatisation

The broad-based privatisation of large-scale enterprises has continued to advance at a strong pace in virtually every economy in the region. A wave of mass privatisation programmes – i.e., the largely cashless and simultaneous transfer of a substantial number of enterprises to new owners through the distribution of vouchers – has been completed in a number of countries, including: the Czech Republic, Georgia, Kazakhstan, Lithuania, Moldova, the Russian Federation and the Slovak Republic.[19] These countries are now focusing on the sale of remaining state enterprises or state shares in privatised enterprises through a variety of cash-based methods. Estonia and Hungary, whose privatisations were based largely on such methods, have continued to make progress in the direct sales of enterprises on a case-by-case approach focusing increasingly on public utilities, banks and infrastructure.

The year has also seen a reinvigoration of the process of mass privatisation in a number of countries. New reform programmes in Bulgaria and Romania have restarted once lagging mass privatisation campaigns, as well as direct sales of large enterprises. In Azerbaijan and Croatia, mass privatisation plans have finally moved into the implementation stage after long periods of delay. Limited mass privatisation programmes have even been approved in countries – such as Tajikistan and Turkmenistan – still at the earliest stages of transition. Though delays and setbacks of very different origins have slowed mass privatisation in Albania, Kyrgyzstan and Ukraine, only Belarus continues to postpone any broad-based privatisation effort.

Yet the wide embrace of large-scale privatisation by the transition economies has produced an equally wide array of outcomes on almost all dimensions of the process, including: the share of state-owned enterprises subject to privatisation, the extent of residual stakeholding by the state, the concentration or dispersion of ownership in newly privatised firms, the pattern of distribution to insiders versus outsiders, the access by and participation of foreigners in the process, and the design of intermediary institutions. It is in this considerable spectrum of variation that the seeds of future divergence in the institutional structure and development trajectories of transition economies are most likely to be found, given the critical importance of the pattern of ownership in defining economic systems. Yet it is still too early in this process to specify systematically the implications of these differences across privatisation programmes for the course of transition. Chapters 4 and 5 of this Report investigate this issue further.

Most of the countries that have finished their first wave of privatisation have turned to the privatisation of remaining state ownership in the economy, though with different methods and different priorities. The focus has shifted to the sale of remaining state shares in partially privatised firms and to the privatisation of infrastructure, energy, banking and other "strategic" enterprises that had been excluded from earlier rounds. The dominant methods have been the use of direct sales, auctions and tenders on a case-by-case approach. In many instances, foreign strategic investors have been actively sought. The initial phase of privatisation, in most cases, placed primary emphasis on speed and, where mass privatisation was the primary mechanism, on equitable distribution and the depoliticisation of property;[20] this new stage is more concerned with privatisation revenues for the state budget, with attracting long-term investment into key enterprises and sectors, and with improving corporate governance structures.

Hungary and Estonia have been at the forefront of cash-based privatisation from the beginning. Hungary has made especially active use of global placements in the privatisation of major manufacturing concerns, the country's largest banks and public

16 The estimates for private sector share of GDP in OECD countries are from 1996 as provided by the OECD.

17 See the paper by Kaufman and Kaliberda (1996).

18 The methodology, as well as potential problems, underlying these estimates of the unofficial economy are discussed in Chapter 4.

19 In many of these countries, though, voucher-based privatisation was not the only method used. Cash-based sales were often combined with voucher privatisations and other approaches as well. See the discussion in Chapter 5.

20 Of course, this does not mean that mass privatisation achieved, in practice, an equitable distribution and depoliticisation of property as attested to by the dominance of insider privatisation in many countries that adopted mass privatisation programmes.

utilities. In Estonia, an estimated 30-40 per cent of total assets in industry and services have been privatised to foreigners. Latvia, Lithuania and Moldova have also pursued the path of international tenders, but through more limited programmes and with less success in attracting foreign investors. Kazakhstan has pursued case-by-case privatisation of large enterprises in the power, energy and telecommunication sectors, attracting some foreign investment. Bulgaria and Romania have accelerated the process of cash privatisations with methods specifically targeted at foreign investors. Kyrgyzstan was moving in a similar direction before a price-rigging scandal led to a temporary suspension of further privatisations.

The experience of the Russian Federation has been unique in the role that large domestic financial-industrial groups have played at this stage of privatisation. After some delay, the government has begun to sell its remaining shares in some of the country's most prominent enterprises, including those that were held by commercial banks through the controversial "loans-for-shares" scheme in 1995. Competitive tenders and auctions for these shares have become a high-profile battleground between rival financial-industrial groups, in some cases backed by foreign investors. This process is likely to intensify throughout the year as the government seeks to raise much-needed budgetary revenues through cash privatisations.

For those countries still implementing mass privatisation programmes, the year has seen substantial progress. Georgia and Armenia have had very rapid programmes of voucher-based privatisation covering over half of their medium-sized and large enterprises. In Poland, the exchange of privatisation certificates for shares in National Investment Funds (NIFs) listed on the Warsaw Stock Exchange marked the latter stages of the privatisation programme's implementation. Croatia has also just begun implementation of a voucher privatisation plan to sell residual state shares in enterprises with investment funds as intermediaries. Yet voucher privatisation programmes in Poland and Croatia include only a limited number of enterprises. Bulgaria completed the first round of voucher privatisation covering 13 per cent of the assets of state enterprises with shares to become tradable in the autumn. Azerbaijan completed the distribution of privatisation vouchers in the summer of 1997 and has begun the first voucher auctions for stakes ranging from 10-30 per cent in a large number of enterprises. Ukraine has introduced a new form of vouchers – compensation vouchers – to be exchanged for shares which are intended to compensate individuals for the erosion of their savings. At the same time, the President and legislature continue to disagree over which enterprises will be included in the mass privatisation programme. Tajikistan has also offered vouchers as compensation, in this case for government arrears on wages and pensions, though privatisation has been delayed by political instability.

Despite earlier commitments to a programme for corporatisation and privatisation, the government of Belarus has announced a new plan to "denationalise" enterprises which scales back the number and range of enterprises to be included and largely retains state control of enterprises via special "golden shares" to be held by the state.

Small-scale privatisation

Progress in small-scale privatisation has exceeded that in all other areas of reform, in terms of both speed and comprehensiveness. Most of the advanced countries – with the exception of Latvia and Lithuania – have reached the highest level in this category, i.e., ownership patterns for these firms typical of the advanced industrial countries.[21]

The less advanced countries have also made considerable progress in this area. There has been complete privatisation of small enterprises in Albania, FYR Macedonia, Georgia, Kyrgyzstan and the Russian Federation. Small-scale privatisation of enterprises is virtually complete in Ukraine, while Azerbaijan and Kazakhstan have committed to fulfil their programmes in this area by the end of 1997. The governments of Tajikistan and Turkmenistan have both announced new initiatives in small-scale privatisation. Only in Belarus have reforms stagnated.

Yet the progress in small-scale privatisation does not necessarily mean that it is easy to set up small firms in all of the transition economies. Indeed, there is considerable variation in the growth of small private firms throughout the region rooted, to a significant extent, in differences in the quality of governance across countries. In Poland, this sector has been the engine of the country's steady growth. In contrast, small firms in Russia still face numerous obstacles to entry into the market and to growth due to onerous bureaucratic restrictions.[22]

Progress in the decollectivisation and privatisation of agriculture has been much less consistent across the transition economies. In some cases, such as Albania, Armenia, the Czech Republic, and Hungary, collective farms have been divided up and agriculture has been fully privatised.[23] Yet in many of the CIS countries, agriculture is still largely organised around large-scale collective farms and there are still continued restrictions on the tradability of land rights and the extent of total agricultural land subject to privatisation. In Kyrgyzstan, the sale of 50 per cent of existing land leases to private owners has begun in accordance with a recent presidential decree, yet there remains a constitutional provision prohibiting private ownership of land. A long political stalemate over the private sale of land in Moldova appears to have ended with the approval by parliament of a law allowing the sale and purchase of land, though with a five-year restriction on resale. In Russia and Ukraine, strong agrarian lobbies representing large collective farms have blocked the necessary legislation for the sale of land.

21 Yet problems remain in several of these countries regarding de facto tradability of land rights.

22 See the survey of shop-owners in Warsaw and Moscow in Frye and Shleifer (1997).

23 In some cases, such as Poland and Slovenia, agriculture had not been collectivised during the communist period and thus was fully private at the start of the transition.

Box 2.2

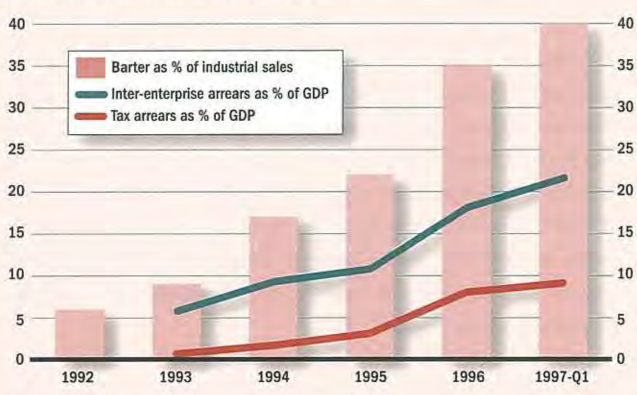
Barter in Russia

One of the most striking features of the transition in Russia has been the widespread emergence of barter as the prevalent method of exchange in industry. Producers of cars, steel, oil, gas, electricity, coal, chemicals, textiles and food have been using their outputs to purchase inputs. These barter deals are typically bilateral. However, since suppliers cannot always directly utilise the goods received as payments-in-kind, they must either sell them or arrange another barter deal to exchange them for their own inputs. Hence, one barter deal induces the next, leading very often to complicated chains of cashless transactions. Debts, as well as taxes and wages, are often settled with payments-in-kind or through mutual write-offs.

While barter has not been very common in central and eastern Europe, it is widespread in the CIS. In Russia, where the problem is most serious, barter has increased continuously over the last few years, coinciding with rising inter-enterprise arrears, as well as wage and tax arrears (see chart). By the beginning of 1997, estimates of the extent of barter in total industrial sales in Russia ranged from 40 per cent to 70 per cent.

Barter imposes large costs on enterprises. When a company earns its revenues in goods, it must be able to sell or barter those superfluous to its needs. This requires additional marketing skills that can be complex and costly to acquire. The information necessary to arrange and coordinate barter chains opens profit opportunities for trading companies, whose services reduce profit margins for industrial companies. Furthermore, the stream of goods may be diverted into more complex and less efficient routes, involving more intermediaries before reaching the final consumer.

Barter and arrears in Russia



Source:
The data on barter is from the *Russian Economic Barometer* (1997). The data on arrears was provided by the Russian European Centre for Economic Policy.

Barter also forces enterprises to become more dependent on each other due to their simultaneous supplier-customer relationship. While this may sometimes reduce market risk, it usually implies a loss of flexibility. It may introduce inertia into production techniques and product development as well as distortions in investment incentives.

Barter also imposes negative costs on the overall economy. Prices used in barter deals do not necessarily reflect the real values exchanged, making it difficult to assess the performance, creditworthiness or value of enterprises. This, in turn, inhibits the functioning of credit and capital markets and slows their development. As barter transactions are often used as a substitute for trade credits (i.e. when the exchange of goods is not simultaneous), commercial banks have fewer opportunities to gain expertise in granting working capital credit.

Furthermore, the lack of transparency in a barter-based system supports the persistence of the informal (or non-official) economy, as transactions through the banking system are avoided, making it easier to hide flows from the tax authorities.

The state plays a paradoxical role in what is often called the "non-payments crisis" in Russia. On the one hand, poor tax collection ratios have strained macroeconomic stabilisation efforts. On the other hand, the state and state-controlled enterprises appear to be part of the problem. Public utilities have accepted goods in return for their output. In public procurement direct payment is often replaced by cancellation of tax debts or debts to public utilities. In some cases, local authorities have even accepted tax payments-in-kind.

There are a number of explanations for the emergence of barter. First, weak enforcement of creditors' rights, particularly in relation to the liabilities of large industrial enterprises, have led to a steep increase in arrears and bad debts, both on tax and commercial credit. The social importance of many larger enterprises on a regional level makes standard bankruptcy proceedings politically difficult to enforce. As non-payments are not fully punished and confidence in the system declines, holding cash becomes generally less desirable for a company since it can more easily delay its payment of debt by pointing to a lack of cash. Thus, barter can become a means to avoid confiscation of assets. The incentive for industrial companies to withhold tax payments is especially strong in the former Soviet economies, where the tax system is heavily biased against industry.

Corporate governance and enterprise restructuring

Much of the enterprise restructuring that has occurred to date in the transition economies has been motivated by increasing product-market competition and hardening budget constraints. Progress in both of these areas has been substantial since the very beginning of the transition in eastern Europe and the Baltic countries. Over the past two years, the CIS countries have followed suit. Most of the CIS countries have eliminated the state's monopoly on foreign trade and removed or reduced quantitative restrictions on imports and exports, thus increasing product market competition substantially. Budgetary subsidies – once the key source of "softness" in budget constraints – have been substantially reduced throughout the CIS, in some cases at an extraordinary pace. Both Armenia and Georgia had virtually eliminated budgetary subsidies by 1996 – down from nearly 13 per cent of GDP in both countries in 1994.

However, the reduction of budgetary subsidies has, in many cases, been accompanied by an increase in off-budget subsidies and other cushions weakening financial discipline. Tax arrears have increased significantly in a number of countries. By the end of 1996, the stock of tax arrears had reached 10.2 per cent of GDP in Moldova and 13.4 per cent of GDP in Bulgaria. In the Russian Federation, high tax arrears have combined with an increasing reliance on barter. The stock of tax arrears (including those to off-budget funds) reached 10 per cent of GDP by the end of 1996.[24] Barter has climbed to alarming proportions in Russia; it is estimated that 40-70 per cent of total industrial sales were conducted through barter in the first quarter of 1997. (See Box 2.2.) Ukraine has a similar pattern of high tax arrears and barter. In several CIS countries, arrears on energy bills have also been a substantial problem.

[24] The stock of arrears continued to increase in the first quarter of 1997, but then decreased in the second quarter due to several one-time payments to clear outstanding arrears by a small number of the largest enterprises. The tax regime in Russia is discussed separately in Box 7.1 in Chapter 7.

A second explanation for barter is that the privatisation process has not yet produced corporate governance structures where profit maximisation is the primary goal of both owners and managers. In many cases, managers and employees have acquired ownership in their firms primarily to try to avoid costs arising from genuine restructuring. All too often maintaining production volumes and employment is the main goal of management. In these circumstances barter can be used both to conceal the true market value of output and inefficiencies in the production process which serve to justify excess production and employment.

The third explanation for barter arises from weaknesses in the financial sector in many transition economies. Uncertainty about the financial viability of industrial enterprises coupled with the lack of adequate expertise in commercial banks has led to relatively high interest rates for working capital credits and restricted availability of long-term loans. In Russia the high cost of credit was exacerbated by the mix of tight monetary policy and large fiscal deficits. To circumvent these credit constraints, enterprises can use trade credits to finance their working capital requirements. This is profitable due to high interest rate differentials and the strong integration of industrial enterprises, which provides greater information about enterprise capacity than would be available to banks. In transition economies, barter is used to collateralise such trade credits. When payments discipline and enforcement is weak, a claim on goods is more concrete and can be more easily enforced than a claim on cash, which many creditors would compete for in the case of liquidation.[1]

There are a number of ways to address the problems underlying the barter crisis. First, payments discipline will have to improve. At a minimum, this requires a more stringent application of bankruptcy proceedings. Second, corporate governance needs to be improved. In particular, shareholders will need to find ways to encourage management to focus more on profit maximisation and less on quantity targets. The latter will be easier if the state takes a more hands-off role in enterprises. Third, the banking sector will have to strengthen its capabilities in financial intermediation. This process will be encouraged by falling interest rates, which forces banks to identify new business opportunities.

Finally, a crucial agent of change will be foreign competition. Barter is virtually non-existent in central and eastern Europe and the Baltics, largely because industry is far more integrated into the world economy, giving firms greater flexibility to generate cash and thus avoid barter. Russia's industrial sector, however, is relatively insular and highly integrated domestically, making barter a more viable option. Russia's continued integration in the world markets should force large industrial enterprises to re-focus their strategies towards non-barter sales.

References

Marin and Schnitzer (1995), "Creating creditworthiness through reciprocal trade", *CEPR Discussion Paper*, No. 1185, May.

Russian Economic Barometer (1997), Vol. 4, No. 1.

[1] The notion that reciprocal trade can be used to collateralise trade credit has been discussed by Marin and Schnitzer (1995) in the context of international countertrade.

Enterprise restructuring has also been slowed by the ineffective implementation of bankruptcy laws in many countries of the region. Though most countries have adopted bankruptcy laws, the number of bankruptcies and liquidations has been relatively small, except in a handful of countries. Hungary continues to stand out because of the very large number of bankruptcy cases that have been brought and the large number of liquidations that have resulted.

An increasingly important element in determining the pace of enterprise restructuring has been the structure of corporate governance, shaped by the privatisation process and the continuing redistribution of ownership rights in new securities markets. Yet the wide variation across transition economies in privatisation strategies and in the organisation and functioning of securities markets has produced a broad range of corporate governance structures, whose effects on enterprise restructuring are only now appearing.

A key factor in analysing evolving corporate governance structures in transition economies has been the extent of ownership transferred to insiders versus strategic investors. In a large number of countries, including most of the CIS and the countries of the former Yugoslavia, the privatisation process has generated largely insider-controlled enterprises. The same is true for a substantial share of privatisations in Poland and the Slovak Republic. In most of the advanced countries, privatisation produced a pattern of corporate governance that gave a greater role to outside institutions, though there has been substantial variation both in the types of institutions established and the extent of their stakeholding in privatised enterprises. These institutions have included: foreign investors, investment funds of various forms, holding companies, banks and financial-industrial groups. While it is still too early in the transition to draw definitive conclusions about the effects of evolving corporate governance structures on enterprise restructuring, some patterns of behaviour and outcomes can already be detected. These are examined in Chapter 4.

Ownership structures and management-owner relationships can change through government or private decisions and through market transactions. Over the past year, it has become apparent that the initial patterns of corporate governance established in transition economies will not necessarily remain stable over time. In Poland, the pursuit of multiple privatisation tracks has weakened the prevalence of insider ownership as stakes in key enterprises have been sold to strategic investors through direct sales and international tenders. In Russia, large banks and financial-industrial groups, in some cases backed by foreign investors, have become major players in the cash sales of state shares in large enterprises and in the secondary market for equity stakes in the increasingly active securities markets. This has led to several high-profile efforts to weaken the control of insiders in these enterprises through the defence of shareholder rights. In the Czech Republic, the completion of the privatisation of state shares in the major banks and the conversion of investment funds into holding and mutual funds companies may have a substantial impact on the initial pattern of corporate governance that resulted from voucher privatisation. In addition, the perception among foreign investors of declining risk in this region opens up the possibility that foreign strategic investors may play a greater role in the new stages of privatisation in Bulgaria, Latvia, Lithuania, Moldova, Romania and elsewhere.

Liberalisation of prices and wages

Prices have been substantially liberalised in virtually every country in the region. There appears to be widespread recognition that price signals – the very foundation of decision-making in the market economy – should be clear and free to move in response to market forces. Most of the transition economies liberalised prices at the very start of the reform process with a consistent approach: the elimination of most price controls and state procurement at non-market prices. Though there have been occasional instances of the reimposition of price controls (such as in Belarus or in Bulgaria under the previous government), backtracking in this area has been relatively rare. The variance in the price liberalisation scores in the transition indicators between 1994 and 1997 has always been lowest among all the areas of reform.

The most substantial remaining price controls can be found in Belarus, Tajikistan, Turkmenistan and Uzbekistan. In Belarus, restrictions on wholesale and retail price margins are still prevalent. Price ceilings were reintroduced prior to the November 1996 referendum on constitutional changes. In Tajikistan, Turkmenistan and Uzbekistan, there remain price controls or state procurement at non-market prices on key agricultural commodities.

In other countries, the implementation of the market approach to pricing has not encompassed all sectors of the economy. Key exceptions include utility prices and housing. Since the pre-reform price levels in these sectors covered only a small fraction of long-term costs, a move to cost-recovery levels required very sharp real price adjustments that were deemed to be politically unfeasible. There has been progress in these areas, but until recently it has been slow.

Many countries have introduced substantial increases in utility prices in 1997. After some initial delays, Hungary has moved furthest in this area. The Law on Electricity and Gas required that utility prices be increased to cost-recovery levels as of 1 January 1997, based on assessments by a group of independent experts. This led to a series of price increases which began in 1995 and, after some delays, are planned to continue through the end of 1997. Similar price increases, though still not reaching cost-recovery levels, have been introduced in nearly all of the countries at advanced stages of transition and in many of the countries at the less advanced stages. Energy commissions to review and regulate the setting of energy prices have been established in Bulgaria, Kyrgyzstan and Lithuania.

Wages in the private sector are largely determined by the market or institutionalised bargaining in nearly all of the transition economies, though administrative wage-setting does continue in countries such as Ukraine. Trade union power in the wage-setting process is relatively weak in the region compared with west European economies. In the early stages of the transition, several countries made use of incomes policies as part of their programmes of macroeconomic stabilisation. Some early taxes on excess wages, such as the *popiwek* in Poland, were abandoned in most cases after privatisation. However, the recent process of recovery has been associated with wage growth that exceeds productivity gains, in some case by substantial margins, as examined in greater detail in Chapter 7. Several countries have responded with the reintroduction of various forms of wage control. The Slovak Republic has recently put forward legislation to curtail wage increases that exceed productivity gains. The government of the Czech Republic has reduced public sector wage growth and has attempted to enforce similar guidelines on enterprises in which it holds a strategic stake. Wage ceilings linked to performance have been set for the state enterprise sector in Bulgaria, while Romania has recently imposed wage ceilings only on loss-making state enterprises.

Trade and foreign exchange liberalisation

The liberalisation of trade has been one of the areas of most rapid reform in the region. At the very beginning of the transition process, most east European countries implemented a drastic liberalisation of their import regimes with few protectionist measures. In the former Soviet Union, the state-order system through which the state maintained control over foreign trade was gradually and almost completely eliminated (with the exception of Belarus, Turkmenistan and Uzbekistan). Though export regimes were initially tight in the former Soviet Union, they too were gradually liberalised and are now mostly free.

However, over time, real appreciation of exchange rates throughout the region began to put competitive pressure on firms, which have exerted pressure on governments for protection. The result has been the emergence of import regimes in both the advanced and less advanced countries with a differentiated structure of tariffs that tends to favour agriculture, automobile producers, defence industries and other sectors deemed to be of structural importance.

Even the most robust reformers in the region – the Czech Republic, Hungary, Poland and Slovenia – have succumbed to protectionist pressures at various times through the raising of tariffs or the introduction of trade defences common in many advanced industrial economies, such as anti-dumping measures. However, in most cases, the discipline imposed by EU Association Agreements, WTO accession negotiations, and other regional trade agreements (CEFTA, BFTA) has generally provided an effective counterweight to protectionist pressures; the trade regimes do not look very different from those in mature market economies.

Not all of the advanced countries have responded to this external discipline. In the Slovak Republic, a new import surcharge and laws against "subsidised" and "excessive" imports have been introduced as part of a package to support the trade balance; this has led to a downward revision this year of the country's trade liberalisation score in the transition indicators. Lithuania has failed to cut back high agricultural tariffs while maintaining a generally liberal trading regime.

Among the less advanced countries, there has been progress in trade liberalisation among the most resolute reformers. In Azerbaijan, Georgia and Kazakhstan, all export duties were abolished this year and import tariffs have been gradually decreasing. Though Romania's agreement with the WTO allowed for exceptionally high individual tariffs in some cases, the Romanian authorities have adjusted most of them to levels broadly in line with other European trade regimes. Yet there has still been some backtracking among the less advanced reformers. Import tariffs were increased in Moldova for key intermediate capital goods inputs, but were subsequently reduced. In Tajikistan, high export taxes have been reintroduced on selected commodities, while Uzbekistan has levied new excise taxes on consumer imports and increased average tariff levels. Ukraine has also reimposed export taxes on some products. While there have been some limited reductions in import duties in Belarus, import and export quotas are still prevalent on a range of different products.

Exchange rate regimes have been generally quite liberal throughout the region. There is now virtually full current account convertibility in nearly all countries, with substantial progress this year in Romania and Ukraine. In Russia, restrictions on the transfer of earned interest on treasury securities are scheduled to be removed by the end of 1997. In most of the other transition economies, certain restrictions do remain on foreign investment by residents, but they have not been effectively enforced. Surrender requirements on foreign exchange earnings have been eliminated in most countries with the exception of Belarus, Russia, Turkmenistan and Uzbekistan. Capital account controls in the Czech Republic, Hungary and Poland are being further liberalised as a result of their accession to the OECD. The Baltic countries have fully liberalised capital flows. Slovenia has increased restrictions on capital inflows to counteract pressures towards real exchange rate appreciation.

Exchange rates are liberalised in most countries of the region, generally through interbank currency exchanges, though significant problems in this area remain in a number of the less advanced countries. There are multiple exchange rate regimes in Turkmenistan and Uzbekistan. In Belarus, the official exchange rate remains overvalued leading to a de facto dual exchange rate regime. Over the last year, Uzbekistan placed new restrictions on access to foreign exchange. The government of Belarus has nationalised the interbank foreign currency exchange and placed it under direct control of the central bank. In Tajikistan, access to foreign exchange has been limited by the infrequency and unpredictability of interbank foreign exchange auctions.

There has been steady progress in 1997 on accession of the transition economies to multilateral trade organisations and agreements. Bulgaria became a member of the WTO in December 1996, while negotiations are well advanced with Armenia, Estonia, Georgia, Latvia and Lithuania. Slovenia and Kyrgyzstan signed agreements with the EU, the former applying the trade-related provisions of an Association Agreement and the latter of a Partnership and Co-operation Agreement.

Competition policy

Progress in competition policy among the east European and Baltic countries has been driven primarily by the incentives of harmonisation with EU policies. Over the course of the year, this has led to new legislation and the creation of new institutions in several countries. In Hungary, Latvia and Romania, new competition laws were adopted based on the EU framework. New administrative structures were also established in Estonia, Latvia and Romania. The legislative framework on competition policy is now largely compatible with EU standards in most of these countries, with the exception of Bulgaria. There have been signs of active enforcement of competition legislation in the Czech Republic, Hungary, Poland, Slovenia and the Baltic countries in terms of case reviews, recommendations and fines, although significant actions to reduce the abuse of market power have still been limited. In most other countries there is a problem of inadequate staffing and training in the administrative structures created to enforce competition legislation.

A major new initiative to regulate monopolies has been introduced in the Russian Federation with the creation of a special commission combining the State Anti-Monopoly Committee and federal regulatory bodies in the energy, transport and communications sectors. While this may not be the optimal institutional solution to this problem, it has in Russia led to a much more proactive stance against abuses of market power by natural monopolies and anti-competitive measures by regional governments. At the same time, the rapid development of financial-industrial groups has raised some concerns about the excessive concentration of market power in key industrial sectors.

Among the less advanced transition economies, rudimentary legal and institutional frameworks to curb the abuses of market power have been created in most countries. However, there has been little evidence of concerted actions to promote a more competitive environment. Monopolies remain a serious problem as do entry and exit restrictions in key sectors.

Banking reform

The wave of high-profile banking crises in several transition economies over the past few years has had a powerful demonstration effect throughout the region. After an initial period of rapid and virtually unregulated expansion, a widespread recognition has emerged among countries at all stages of transition of the need to consolidate and strengthen the banking sector. Most countries in the region have initiated, or have announced plans to begin, a programme of bank restructuring. In addition, impressive progress has been made in enhancing the supervisory capacities of central banks, tightening prudential regulations, and increasing capital requirements to prevent the re-emergence of systemic problems in this sector. However, improved supervision is, by its very nature, a long-term task in which the development of effective human skills is as important as enhanced regulatory structures.

Notwithstanding the recent progress, the banking system in most of the transition economies remains fundamentally under-developed. Most banks in the region are still weak and undercapitalised. If internationally accepted rules on loan loss provisions and write-offs were properly applied, it is estimated that none of the countries of the former Soviet Union – with the exception of Russia – would have an entire banking sector even approaching the size of a medium-sized Western bank.[25] The basic legal and institutional infrastructure in support of banking is seriously deficient. The development and enforcement of collateral and bankruptcy laws has been slow, as demonstrated in the legal indicators presented in Box 2.1. Internationally accepted accounting standards and modern portfolio and management information systems have not been widely introduced. Most importantly, banks in much of the region have not yet developed the skills necessary for the provision of the basic functions of financial intermediation.

As a result of these continuing problems, much of the region remains fundamentally "under-banked" in terms of the small scale of bank lending relative to the size of the economy. In few transition economies have banks reoriented to provide term lending on any significant scale to private enterprises. Moreover, there remains little confidence in the soundness of loans that are being made in many countries. Connected lending to bank shareholders is still common practice in much of the region.

Of course, given the importance of experience, skills, and coherent practices in the financial sector, such institution-building takes considerable time to develop and the progress made to date should not be underestimated. The advanced countries have already implemented bank rehabilitation programmes utilising some combination of write-offs, the purchase or transfer of bad loans, debt-equity swaps and direct recapitalisations. They have focused more recently on the privatisation of banks. Estonia and Hungary have again set the standard in this area. By August 1997, Hungary had privatised all five of the major state-owned banks formed from the initial break-up of the monobank system. In Estonia, the share of foreign ownership in banks has increased to 37 per cent of total bank equity. Latvia's largest state-owned bank was majority-privatised in 1996 and privatisation of the state's remaining interests in the banking sector is under way. After a wave of problems in small and medium-sized banks, the Czech government has finally announced its intention to complete the sale of the substantial state share held in the country's largest commercial banks, which themselves control a number of major investment funds that own large stakes in Czech industry. The government has agreed to sell its stake in Investicni a Postovni Banka to Nomura International and it has approved in principle the sale of state shares in the remaining three major commercial banks. Poland has privatised five of the nine original state-owned banks spun off from the monobank, albeit at a pace far slower than initially announced. Major bank privatisations are also planned in Lithuania and Slovenia.

Among the more resolute reformers of the less advanced countries (including Bulgaria, Georgia, Kazakhstan and Russia), substantial strides in banking reform have been made through the establishment and enforcement of higher capital requirements and capital adequacy ratios. These countries have forced substantial numbers of banks into liquidations or mergers. In Georgia, 174 of the 229 commercial banks operating at the beginning of 1994 were closed or merged after the implementation of new banking standards. After a wave of bank insolvencies in Bulgaria, one-third of the country's commercial banks have been placed under administration or in bankruptcy procedures. Bulgaria also completed its first privatisation of a major state-owned bank – United Bulgarian Bank – with the participation of the EBRD; three more banks are scheduled to be sold through tenders in the second half of 1997. Russia has liquidated or merged more than 400 banks over the past year in conjunction with a major tightening of central bank supervision. In Kazakhstan, the government has forced the merger of two banks which together account for about 20 per cent of the outstanding stock of loans and has closed the country's fourth-largest bank. Substantial bank restructuring programmes under the guidance of the IMF and World Bank are also active in Armenia, Azerbaijan, FYR Macedonia, Kyrgyzstan and Romania. Among other less advanced countries, only limited progress has been made in banking reform. The sector is dominated in these countries by banks owned or controlled either by the state or by state enterprises. In Belarus, for example, directed credits at preferential rates are still channelled through commercial banks. The Government of Belarus also continues to intervene in the banking system, often in an arbitrary way.

Securities markets and non-bank financial institutions

Securities markets and non-bank financial institutions remain the least developed sector of the transition economies. Though rudimentary institutions have been created in most countries in the region, they are still far from fulfilling the key functions of securities markets in the transition process: (i) as an alternative to banks for debt and equity finance to the private sector; (ii) as a secondary market in ownership, and; (iii) as a means to encourage enterprise restructuring as a result of (i) and (ii). Yet these functions are critical to the further progress of transition. Given the very low level of term lending to enterprises by banks and the even lower level of lending to new private firms, an alternative source of debt and equity finance is necessary to promote private sector development. Perhaps even more important is the need for an adequate secondary market in ownership. In the wave of mass privatisations over the past few years, the speed and scope of the process often took precedence over concerns for improving corporate governance which has led to the common phenomenon of insider ownership or de facto insider control in the face of widely dispersed outside ownership. The securities markets, whose emergence was often encouraged by the authorities in the context of voucher-based privatisation programmes, were intended to overcome this problem by creating a means for outside owners to purchase shares and concentrate their stakeholdings. Without effectively functioning securities markets, the process of improving corporate governance has faced serious obstacles.

The problems affecting the development of securities markets are essentially similar throughout the region, though they vary significantly in terms of magnitude. Equity markets are generally thin, highly illiquid with the exception of a small number of "blue

[25] See Siegelbaum (1997).

chip" shares, and poorly regulated. However, the beginnings of a breakthrough have become evident in a small number of securities markets, namely in Estonia, the Czech Republic, Hungary, Poland and Russia, as described further in Chapter 5. The breakthrough is linked to the inclusion of some of the largest and most high-profile enterprises and banks of these countries into the privatisation process. This has attracted the attention of foreign portfolio investors who have spearheaded the enormous expansion of these markets. In Hungary, for example, turnover nearly quadrupled in 1996, while market capitalisation more than doubled in the first half of 1997. Similarly, in Russia share prices more than doubled in the first half of 1997, bringing the market capitalisation above US$ 80 billion. The Warsaw Stock Exchange received a substantial boost with the listing of National Investment Funds in June 1997, contributing a deeper capital base to what was already the most liquid stock exchange among the transition economies. Estonian securities markets have also shown explosive growth, with their share prices soaring by 360 per cent in the first half of 1997. Indeed, the sudden "boom" in several of these markets, which is partly related to their shallowness in comparison with major Western securities markets, has begun to raise concerns about the sustainability of such increases.

The rapid expansion of these markets has been accompanied by some improvements in their regulatory structure. With a new set of amendments to its Securities Law, Poland has taken the lead in this area. After eliminating the legal barriers separating commercial and investment banking, Hungary consolidated the structure for regulating the banking system and securities markets. At the same time, Russia strengthened the enforcement powers of the Securities Commission while granting regulatory power over the securities operations of commercial banks to the central bank. After much debate, the Czech Republic has announced its intention to create an independent securities commission.

Beyond this top tier of securities markets, most of the transition economies remain at a very early stage of development in this area. Treasury bill markets have been relatively active in several countries. The continuing advance of privatisation should give a boost to some markets, such as in Bulgaria, Kazakhstan, Latvia and Lithuania. Kazakhstan has embarked on a particularly interesting approach to the development of equity and security markets and, at the same time, pension reform. The idea is to rely on newly created private and state pension funds to help establish liquidity on these markets. This approach has sparked considerable debate both about the potential stability of share prices and the capacity of these untested markets and regulatory frameworks to handle such sensitive liabilities as pensions.

Serious inadequacies in the legislative and regulatory framework in the financial sector among the less advanced countries resulted in another high-profile collapse of pyramid schemes, this time in Albania. Much like the MMM scandal in Russia and the Caritas collapse in Romania, a large number of Albanian investment funds began to lure deposits with unsustainably high returns, using new deposits to finance interest payments on old ones. However, the ultimate collapse of many of these funds, affecting the savings of nearly 80,000 households, prompted a widespread breakdown of political and social order in Albania.

This year has seen a considerable increase in the activities of transition economies on international capital markets. After a wave of Eurobond issues by Kazakhstan, Lithuania, Moldova, Russia and Ukraine, many of the CIS countries have been actively preparing their own debt issues, as are many regional governments in the Russian Federation. An increasing number of firms in the region have issued American or Global Depository Receipts, which simplify the investment process and lower custody and settlement risk for foreign investors in local securities.[26] Yet the growing use of such instruments is one indication of the continuing weaknesses in transparency, liquidity and custody of domestic equity markets in the region.

Environmental challenges and reform

The decades of central planning and the peculiar priorities and methods it embodied left a legacy of serious environmental degradation, a legacy that will take great time, resources, effort and commitment to overcome. Although environmental policy and management in socialist economies were characterised by very stringent environmental standards and non-compliance fines, the implementation, monitoring and enforcement of such standards and fines were weak. Distorting economic policies and practices focused on industrial output with little attention to economic and social cost further contributed to the poor quality of the environment. The emphasis on the production of heavy industry and material inputs and the failure of the price system to reflect economic costs, for example, greatly contributed to inefficient resource allocation and high energy intensity causing high levels of air and water pollution in the region. Low technical and maintenance standards contributed to increased risks from nuclear plants and led in 1986 to the profoundly serious accident in Chernobyl.

At the very start of the transition, some environmental problems required immediate attention. Exposure to lead and heavy metal dust from smelters and the use of leaded petrol, high levels of particulates from industrial emissions, and drinking water pollution were identified by the Environment Action Programme for Central and Eastern Europe in the early 1990s as the three main environmental risks to human health.[27] In Central Asia two of the most prominent risks were exposure to pesticides and chemical residues and the poor quality of rural drinking water.

This environmental legacy has affected public health and has contributed directly and indirectly to lower economic productivity and standards of living. Declines in average life expectancy in the

[26] ADRs are securities issued by recognised investment banks in the US securities market which are backed by the cash flow of securities issued in other markets. They are subject to US Securities and Exchange Commission approval and have the benefit of the more efficient and transparent securities market infrastructure in the US. GDRs are similar securities listed on other Western markets.

[27] See Hughes (1995).

Box 2.3

Selected indicators of environmental policy reform

Introduction

This box describes aspects of environmental policy reform in the EBRD's 26 countries of operations. The purpose is to enable an initial understanding of the scope of reform, while the ultimate goal will be to assess in the future both the extensiveness and effectiveness of environmental policy reform. The findings are based on information from several sources, including answers to a questionnaire sent to the ministry of environment for each country.

In this box environmental policy reform is described by selected national legislation and a few processes and instruments. The legislation assessed includes framework environmental laws, environmental sector laws and standards, environmental liability, environmental impact assessment, and signature and ratification of international environmental treaties. The environmental policy instruments assessed include the preparation of a National Environmental Action Plan and the development of financial incentive mechanisms.

Environmental legislation

In the past, environmental legislation in transition economies was based on a legal system where the regulator and the regulated were agencies of the same government. This structure has changed to reflect the government's new role as regulator only. In such a context, environmental legislation is evolving at different speeds. In a number of areas environmental legislation is not structured as in western Europe. General legislative instruments, such as framework environmental laws, are frequently used, while technical issues are left to be governed by regulatory instruments. By contrast, Western legislation typically identifies individual sector regulations. The generation, production, utilisation, transport, storage and disposal of waste in transition countries, for example, are usually regulated by a framework environmental law.

All transition countries have framework environmental laws in place, except Bosnia and Herzegovina where new environmental legislation is being introduced following recent political changes. The Polluter Pays Principle is at least partially reflected in the environmental legislation of all countries. In many countries in the region, the environmental impact assessment process has been more or less fully adopted. The extent to which environmental liability is defined in legislation varies from country to country; in many countries, liability for past contamination is not defined. Some countries that have applied for EU membership, notably Bulgaria, the Czech Republic, Hungary, Lithuania and the Slovak Republic, have fully incorporated environmental liability requirements into their national legislation.

The table below contains a set of selected indicators of environmental policy reform. The first six columns examines the degree of adherence to six key international environmental treaties. These are: the Convention on the Wetlands of International Importance; the Convention on International Trade in Endangered Species of Wild Fauna and Flora; the Montreal Protocol for the control of CFC (chlorofluorocarbon) emissions; the Convention on Climate Change; the Convention on

Selected indicators of environmental policy reform

	International treaties						Standards	NEAP	Financial instruments
	1.	2.	3.	4.	5.	6.	7.	8.	9.
	Wetlands	Endangered Species	Montreal Protocol	Climate Change	Biodiversity	Transboundary	Air and Water (Effluent Index)	Status of NEAP or equivalent	Status of financial instruments
Albania	s&r			s&r	s&r	s&r	1	1	
Armenia	s&r			s&r	s&r	s&r	1	2	
Azerbaijan			r	s&r	s		1	2	✓
Belarus		r	s&r	s	s&r	s	1	1	
Bosnia and Herzegovina			r				na	2	✓
Bulgaria	s	r	r	s&r	s&r	s&r	1	2	
Croatia	s&r		r	s&r	s&r	r	2	2	✓
Czech Republic	s&r	r	r	s&r	s&r	s	3	1	✓
Estonia	s&r	r	r	s&r	s&r		2	1	✓
FYR Macedonia	s&r		r				1	1	
Georgia	s&r	r	r	s&r	r	s	1	2	
Hungary	s&r	r	r	s&r	s&r	s&r	3	1	✓
Kazakhstan				s&r	s&r	s&r	1	2	
Kyrgyzstan					r	s&r	1	1	
Latvia	s&r	r	r	s&r	s&r	s&r	2	1	
Lithuania	s&r		r	s&r	s&r	s&r	1	1	✓
Moldova			r	s&r	s&r	r	1	1	✓
Poland	s&r	r	r	s&r	s&r	s&r	3	1	✓
Romania	s&r	r	r	s&r	s&r	s	2	1	
Russian Federation	s&r	r	s&r	s&r	s&r	s	1	1	✓
Slovak Republic	s&r	r	r	s&r	s&r	s	2	1	✓
Slovenia	s&r		r	s&r	s&r	s	2	2	
Tajikistan	*		r				1	2	
Turkmenistan			r	r	r		1	1	
Ukraine	s&r		s&r	s&r	s&r	s	1	1	✓
Uzbekistan	*		r	s&r	r		1	2	

Source by column: 1: IUCN Suisse; 2: Secretariat of the Convention on International Trade in Endangered Species of Wild Fauna and Flora, Geneva; 3: The Ozone Secretariat UNEP, Kenya; 4: Secretariat of Convention on Biological Diversity, UNEP, Quebec; 5: Climate Change Web page: http://www.unfcc.de/fccc/sect/adress1.htm; 6: ECE/ENHS United Nations; 7: Approximation of EU Environmental Legislation, The Regional Environmental Centre for CEE, 1996; EBRD's *Investors' Guidebook for Environment, Health and Safety;* 8-9: Responses of Environmental Ministries to EBRD Questionnaire.

Legend by column: Columns 1-6: See footnote 1: s=signed, r=ratified, s&r= signed & ratified, * means the country has completed part of the adhesion process, Information in columns 1, 2 and 6 as of July 1997; columns 3 and 5 as of June 1997, and column 4 as of May 1997. Column 7: Air and Water Ambient and Emission (Effluent) Standards System: 1 means maximum permissible concentrations (MPC) system in place, broadly based on the former Soviet system; 2 means a new system is being introduced, either as an evolution of MPC or in order to meet EU requirements; 3 means essentially new standards system is in place, often following EU requirements. Column 8: National Environmental Action Plan (NEAP): 1 means prepared or under implementation; 2 means planned or under preparation. Column 9: ✓ = Three or more financial instruments in place.

Biodiversity; and the Convention on Environmental Impact in a Transboundary Context.[1] Some countries have either signed, or signed and ratified, all six treaties: they are Bulgaria, the Czech Republic, Georgia, Hungary, Latvia, Poland, Romania, the Russian Federation and the Slovak Republic. On the other hand, countries such as Bosnia and Herzegovina, FYR Macedonia, Kazakhstan, Kyrgyzstan, Tajikistan and Turkmenistan have ratified three or fewer treaties to date.

In conducting environmental impact assessments (EIAs), many countries in the region use the State Ecological Expertise system. In principle, the scientific basis underlying such systems is similar to that in the West. However, typically, the "Expertise" discussion is required later in the decision-making process than in an EIA system. Several Western and transition country organisations are working on the "harmonisation" of approaches in eastern Europe and the CIS with Western approaches and methodologies related to environmental impact assessments.

Environmental mechanisms

Following the launch of the Environmental Action Programme for Europe (EAP) in Dobris in 1991, National Environmental Action Programmes (NEAPs) are being adopted in the region. A NEAP is a national level plan designed to integrate environmental management into overall development objectives. Particular requirements of NEAPs in the region are public participation processes and the well-balanced combination of regulatory (command-and-control) instruments and economic tools (market incentives).

NEAPs or NEAP equivalents have been either already prepared or are being prepared in most countries of the region. Kyrgyzstan, Latvia, Lithuania, Moldova, Poland, Romania and the Slovak Republic are implementing NEAPs. The Czech Republic and Hungary have prepared and are implementing their own national environmental plans (though these are not termed NEAPs). Albania, Belarus, FYR Macedonia, Russia, Slovenia, Tajikistan and Ukraine had prepared NEAPs or equivalents as of August 1997. Azerbaijan, Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Georgia, Kazakhstan, Tajikistan and Uzbekistan are either starting or planning NEAP preparation.

To assess the extent to which environmental financial mechanisms are used, the EBRD sent a questionnaire to the authorities in charge of the environment in each of the countries of the region. The questionnaire requested information on four instruments: (i) existence of an environmental fund for channelling the money collected in fees and fines to environmental investments; (ii) provision of taxes/other penalties or financial incentives for energy and resource efficiency; (iii) waste and pollution reduction; and (iv) the use of clean technologies. Twenty-one countries have already established environmental funds. These funds are separate from normal government financing mechanisms. They are earmarked to support environmental investments and are operated by semi-independent or independent organisations. Environment-related levies, such as pollution charges and fines as well as fees on the use of natural resources, constitute major revenue sources. Environmental funds have been used for investments in pollution control and prevention technology by industries, for environmental education and research, for the establishment of environmental monitoring systems, and for natural resource conservation. Environmental funds have been disbursed in the forms of soft loans and grants. Countries that are operating three or more of the above-mentioned financial instruments are indicated in column 8.

Concluding comments

The evidence on environmental policy reform presented in this box is clearly too limited in scope for assessing the status of environmental transition. The commitments of industry to environmental improvements or appropriate resource recovery policies, for example, are not captured, nor does the analysis reflect the quality of environmental conditions in the EBRD's countries of operations. An array of legislative measures and mechanisms influence the quality of the environment, but they are not the only factors which determine environmental quality. Other critical factors include the industrial structure and quantity of output, the nature of indigenous fuel supplies, technological advances and population densities. Further work will be required to gain a better understanding of the progress made in environmental management to overcome the legacies of the past and to address new challenges arising in transition economies. Nevertheless, the information presented here suggests that the environmental challenge is being taken seriously throughout most of the region.

References

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1 **Ramsar Convention on Wetlands of International Importance** enables contracting parties to designate particularly important wetland areas and protect them from development.
Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES) establishes worldwide controls on the international trade in threatened species of animals and plants.
The Montreal Protocol for CFC Control requires nations to help protect the earth from excessive levels of ultraviolet radiation by cutting chlorofluorocarbon consumption by 20% over their 1986 level by 1994 and 50% over their 1986 level by 1999.
Convention on Climate Change aims to stabilise atmospheric concentration of greenhouse gases at levels that will prevent human activities from interfering dangerously with the global climate system.
Convention on Biological Diversity seeks to conserve biological diversity by appropriate access to genetic resources and by appropriate transfer of relevant technologies.
The Convention on Environmental Impact Assessment in a Transboundary Context (ESPOO), lays down the general obligation of States to notify and consult each other on all major projects under consideration that are likely to have a significant adverse environmental impact across boundaries.

former Soviet Union over the period 1990-94, for example, have been linked to the reduced capacity of urban residents to cope with some illnesses, which have been exacerbated by exposure to high levels of air pollution.[28] The lack of basic sanitation infrastructure in the villages and small towns of Central Asia, which has deteriorated during the transition with the failure of governments to raise or allocate necessary resources, has contributed to high levels of infant mortality from water-borne diseases. Thus, while environmental pollution exposure is not the only threat to health in the region, available evidence suggests that health damage caused by environmental pollution is significant.

Besides its impact on human health, productivity and standards of living, poor environmental conditions and the lack of environmental infrastructure act as important deterrents to foreign direct investment. Foreign investors are generally reluctant to invest in areas and countries that have a bad environmental record. A recent survey of 1,000 large mining, construction and manufacturing companies in western Europe and North America found that environmental risks are rated as high as exchange rate and political risks in determining the attractiveness of the investment climate.[29] Environmental factors appear most significant regarding plant site. Potential liability from past environmental practices was found to be the most important environmental issue for investors for which they often actively seek indemnification from governments. Investors are equally concerned about the uncertainty surrounding liability for present and future practices as well as that regarding future environmental standards.

To overcome the environmental legacy of the past and aim at achieving an environmentally sustainable development, transition countries have to undergo structural changes which are similar to the economic and legal structural changes associated with the transition indicators in this Report. The process of transition provides an opportunity to correct past failures and put in place adequate environmental policies and processes. This opportunity is created not only by the possibility to use new information and technologies (on energy efficiency, recycling and renewable resources, for example) but also by increased public participation brought about by political decentralisation and enhanced corporate governance. Common goals are cleaning the environment and the establishment of those fundamentals that characterise the environmental policies and processes of a modern market economy.

In some transition countries, notably the Baltic states and eastern Europe, environmental policies and instruments introduced since 1990 have started to bear fruit. The decline in industrial activity has contributed to reductions of air and water pollution in most transition countries. The drop in economic activity was also accompanied by a sharp decline in the use of fertilisers. In countries such as Bulgaria, the Czech Republic, Poland and Romania there have been significant reductions in air emissions of lead and other heavy metals. Similarly, municipal and industrial discharges into water have decreased considerably in some countries.

The challenge for all transition countries is to try to resume economic growth without a resurgence of pollutant emissions. This challenge is what is referred to as the "decoupling" of pollution intensity and economic growth. A recent OECD survey of environmental indicators, which covers a selection of five east European countries as well as Russia, found that in Hungary and Poland (two countries at an advanced stage of transition) there are indications that sulphur dioxide emissions, for example, have started to fall despite the resumption of economic growth.[30] Carbon dioxide emissions in the same countries, on the other hand, have remained relatively stable. In less advanced countries, such as Bulgaria, sulphur dioxide emissions have recently increased, while in Russia the decline in air pollutant emissions still follows the decline in GDP. Nevertheless, available data on ambient air pollution and water quality do not yet show any clear and discernible trends. Given the available air quality monitoring systems in these countries, emissions data tend to be collected from large industrial sites. The less-than-proportional reduction in ambient air quality compared with total emissions may have been largely caused by the relatively small reduction in emissions from small and medium-sized polluters, such as households and commercial establishments, that have substituted domestically produced, low quality coal for gas and other petroleum products following their increases in price.

Overall, despite the efforts and investments of the past seven years to clean up the environmental legacy of central planning, the challenges are major and profound. Energy intensities and air pollution remain between two and three times higher than the OECD average. Additional environmental pressure is likely to arise from economic restructuring, including increased waste and rapidly expanding motor vehicle use. In this context, some countries are taking steps to strengthen their environmental policies and to enhance their capacity for environmental management. The countries seeking accession to the EU, in particular, face the challenge of adapting to EU standards. There is a need to adapt environmental legislation as well as to finance the investments necessary to make technology and production processes compatible with EU environmental standards. Although the true cost of such adaptation is not known, a recent review of available studies estimated that total investment costs of environmental adaptation could amount to ECU 100 billion, an estimate which covers water supply, sewerage, waste-water treatment, air pollution from combination plants and waste management.[31] However uncertain these estimates may be, they reflect the magnitude of the challenge that lies ahead.

28 See the discussion of causes of the fall in average life expectancy in Annex 2.2 of this Report.

29 See Klavens and Zamparutti (1995).

30 See OECD (1996).

31 See European Commission (1997).

Box 2.3 summarises the information obtained thus far regarding a selection of environmental legislation and policy mechanisms. While a distinct divide emerges in the extensiveness of legislation, primarily linked to differing degrees of adherence to international environmental treaties, there is more diversity among the transition economies regarding environmental processes.

Environmental legislation, on the other hand, will not go far in restoring environmental quality if it is not accompanied by adequate policy instruments and processes. While there is no single blueprint for how a modern market economy should choose its policy instruments and processes to address the environment, there are a few basic "dos" and "don'ts" that command widespread acceptance and can help shape environmental policy in transition economies.[32] Given the scarcity of financial resources, it is important to identify priorities in a cost-effective manner so that environmental improvements per unit of resources invested are maximised over time. This is, in principle, the objective of a national environmental action plan (NEAPs). A NEAP is neither a necessary nor a sufficient condition to identify environmental priorities. It can, nevertheless, help to do so and to enhance the process of public consultation. In any case, an adequate selection of priorities should help identify actions and policies where environmental improvements and resource savings can occur simultaneously. The phasing-out of subsidies in the consumption of energy, water and natural resources, for instance, is an excellent example of a win-win policy in that it improves both economic efficiency and environmental policy. Lastly, given their limited institutional capacity and financial means, transition country governments cannot work alone but need the cooperation of others. The private sector, in particular, has a crucial role to play by helping to disseminate best practice in environmental impact assessments, by financing investments in energy efficiency and waste-water treatment, and by helping to jump-start industry producing environment-related products.

2.5 Conclusion

A new phase of reform has emerged in the transition economies in which the focus of change has shifted from liberalisation and stabilisation to restructuring and growth. Over the past year, countries at all stages of transition have concentrated their efforts on building, renewing and improving institutions that shape the incentives of market actors. Consequently, the strongest progress over the year was seen in those dimensions of reform – large-scale privatisation, banking and securities markets – that are critical to the establishment and strengthening of institutions underpinning the market economy, to the effective structure of corporate governance and to the promotion of enterprise restructuring.

With the completion of the "first wave" of broad-based privatisation, many countries have turned to cash sales of remaining state shares in large, high-profile enterprises on a case-by-case basis. Typical privatisation methods at this stage are direct sales, auctions, international tenders and initial public offerings. Priorities have shifted from the depoliticisation of enterprises to the search for strategic investors, the concentration of ownership stakes, and the effort to raise much-needed revenue for state budgets. Such an approach to large-scale privatisation, once thought feasible only for the most advanced reformers, has now spread across the region to such countries as Bulgaria, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Romania and Russia. Foreign strategic investors, domestic holding companies and newly created financial-industrial groups are becoming more active in a wider range of countries and, in the process, breaking the entrenchment of insider control that has been a key obstacle thus far to further enterprise restructuring.

In the financial sector, a broad consensus has emerged across countries at all stages of transition on the need to strengthen and consolidate commercial banks, to introduce international banking standards, and to improve prudential regulation and supervision. Several countries – such as Bulgaria, Georgia and Russia – have been engaged in major efforts to reduce the number of weak banks in their financial systems, through bankruptcies, liquidations and mergers. With the assistance of international financial institutions, central banks across the region have been able to strengthen their institutional capacities and introduce new regulatory standards. Murky patterns of cross-ownership between banks, investment companies and industrial enterprises in some countries are slowly becoming more transparent, as are the relationships between commercial and investment banking within banks. Securities markets have also been subject to tighter regulation. These developments are not only improving, albeit slowly, the provision of basic financial intermediation services, but are also enhancing the role of financial markets as an arena for the secondary reallocation, by sales and purchases, of ownership rights.

Yet in all of these areas, there remains a long road ahead. Building institutions on this scale is, by its very nature, a long-term task, requiring not only the creation of new structures, but also the development of human skills and practices. Moreover, effective institution-building often requires complementary changes in a number of areas, such as the legal system and the organisation of government institutions, that have their own particular dynamics. Lags, delays, inconsistencies and mistakes are all to be expected in this process, even as overall reforms continue to advance.

This year has shown that problems in the development of institutions can have serious implications for sustaining some of the hard-won achievements of the earlier phase of reform. Indeed, as crises in Albania, Bulgaria and Romania demonstrated, the maintenance of macroeconomic stability is still vulnerable in the face of delays and shortcomings in institutional reforms. The process of transition is likely to continue along a complex,

[32] For example, the EBRD's principal environmental policies include: (1) promotion of environmental protection through an appropriate legal, economic and policy framework, particularly via the use of market mechanisms; (2) environmental performance to be monitored and regulations enforced; (3) capacity building for environmental regulation, assessment, management, monitoring and enforcement; (4) particular importance attached to energy and resource efficiency, waste reduction, resource recovery and recycling, use of cleaner technologies, promotion of renewable resources, investments with primarily environmental objectives; (5) implementation of multilateral environmental agreements and contribution to international environmental initiatives; and (6) advancement of appropriate environmental and health and safety standards.

occasionally serpentine path posing many challenges for countries at all stages of transition. However, the experience of 6–7 years of transition in the region has already provided some important lessons regarding the factors that generate a resolute commitment to reform and that strengthen the robustness of that commitment in the face of inevitable challenges. Stable and effective market reforms entail not only the broad transformation of the economy, but also the establishment and reinforcement of a wide range of market-supporting institutions in the government, in the legal system, and in civil society. These institutions that together constitute the broad structure of governance of the market are critical to the success of the new phase of transition and are examined in greater detail in the remaining chapters of this Report.

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Annex 2.1: The level and pattern of corruption in transition economies

Corruption is generally regarded as widespread throughout the developing world and, indeed, the developed world. However, the problem is often regarded as particularly pervasive and severe among the transition economies. Surveys of foreign investors and local entrepreneurs, as well as private risk rating agencies and the assessments of regional analysts, all tend to rate the extensiveness of corruption in the transition economies – especially in the CIS – as among the highest of any region in the world. This disparity raises several questions: Why do the transition economies exhibit such high levels of corruption in comparison with other countries? Is the difference rooted in factors inherent in the process of transition from a command to a market economy? What accounts for differences in the level of corruption among the transition economies? Does transition produce a unique pattern or nature of corruption? The answers to these questions have important implications for the development of effective approaches to combating corruption.

Corruption, by its very nature, is extraordinarily difficult to measure. Given the illegality of corrupt transactions, the problem does not lend itself to any objective direct or proxy measurements. Instead, corruption tends to be measured in relative terms across countries on the basis of survey evidence or assessments of country analysts. There are clearly limitations, even in anonymous surveys, to any attempt to get respondents to reveal their own participation in corruption. Survey questions are thus generally phrased to elicit responses about the perception of corruption in a particular field or country, rather than counting the actual instances of corruption in which respondents might be engaged. Similarly, analytic assessments are also based on the relative perception of corruption in different countries. It is important to recognise that the perception of corruption could be influenced by other factors besides the respondents' personal experience of corruption, including the extent of media coverage of the issue, the profile given to corruption in political campaigns, or the general level of trust in government – all of which may not necessarily be perfectly correlated with the actual level of corruption in a given society. Indeed, in some cases, an open press in a moderately corrupt society may lead to the impression that corruption is greater than in a less open, but more corrupt, society.

The most common cross-country measures of corruption are based on assessments of regional and country analysts, often in the context of estimating country risk. The level of corruption is a key element in determining overall country risk for foreign investors, especially those involved in direct investment, and therefore is a factor taken into consideration by several of the commercial risk rating services. Though a comparison of such risk ratings may provide some information on the perception of corruption levels across regions, the potential for measurement error is especially high as country experts – far removed from corruption transactions themselves – are more likely to rely on less direct and potentially biased sources.

Charts 2.1.1 and 2.1.2 present the average corruption ratings for countries grouped by regions provided by the Economist Intelligence Unit (EIU) Country Risk Service and the DRI McGraw-Hill Global Risk Service, which have broad coverage of the transition economies. The EIU asks country experts to assess the "degree to which public officials are involved in corrupt practices" on a 0 (very low) to 4 (very high) scale. Among the 97 countries covered by the service are included 18 transition economies (the service has a greater focus on eastern Europe and the Baltic countries than on the CIS). Based on the survey results for the first quarter of 1997, the average corruption score for the transition economies (3.35) is higher than any other region in the world. All five CIS countries included in the survey (Azerbaijan, Kazakhstan, Russia, Ukraine and Uzbekistan) received the highest rating (4) for corruption among public officials.

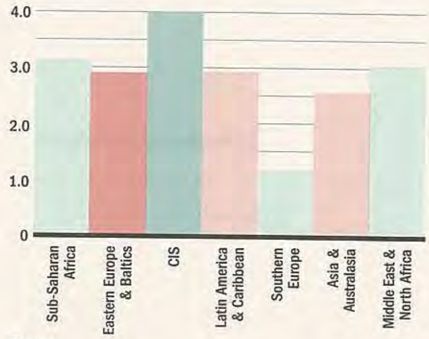
The DRI McGraw-Hill Global Risk Service includes 21 transition economies in its analysis of 33 risk factors in a total of 106 countries. The corruption scores represent the assessment of country analysts of the probability that over a five-year period a company will experience losses or costs due to increases in corruption.[1] For the 12 countries of the CIS included in the survey the average corruption score is 64 per cent, a level only slightly exceeded by the countries of sub-Saharan Africa. Corruption scores for the east European and Baltic countries are substantially lower.

The assessments of local entrepreneurs within these countries confirm the perceptions of high levels of corruption in the transition economies by country analysts, though they suggest a much larger gap between the transition economies and other regions. In a recent cross-country survey of over 3,600 entrepreneurs in 69 countries, entrepreneurs were asked to respond to the following statement: "It is common for firms in my line of business to have to pay some irregular 'additional payments' to get things done."[2] Chart 2.1.3 shows the percentage of respondents divided by region who stated that this is frequently, mostly, or always true. Within the 10 countries of the CIS included in the survey, 65 per cent of the respondents said that this claim is frequently, mostly, or always true. The regional average for the CIS countries is 15 percentage points

Chart 2.1.1

EIU Country Risk Service

Regional corruption scores (First quarter, 1997)

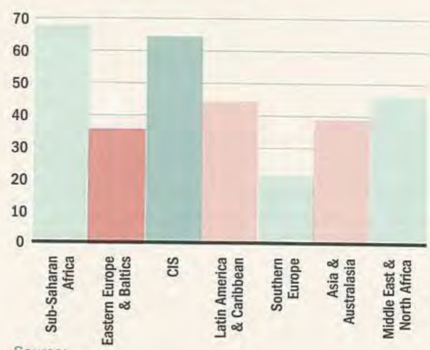


Source:
Economist Intelligence Unit

Chart 2.1.2

DRI/McGraw Hill Global Risk Service

Regional corruption scores (1997)



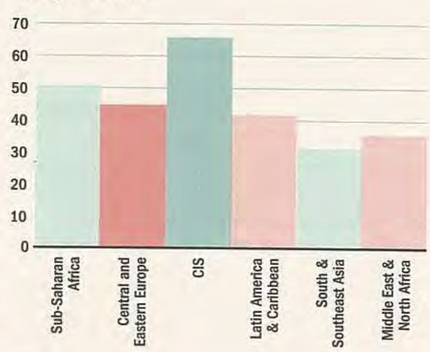
Source:
DRI/McGraw Hill

Chart 2.1.3

World Bank survey of entrepreneurs

(1997)

"It is common for firms in my line of business to pay some irregular 'additional payments' to get things done." Percentage of respondents who answered frequently, mostly or always.



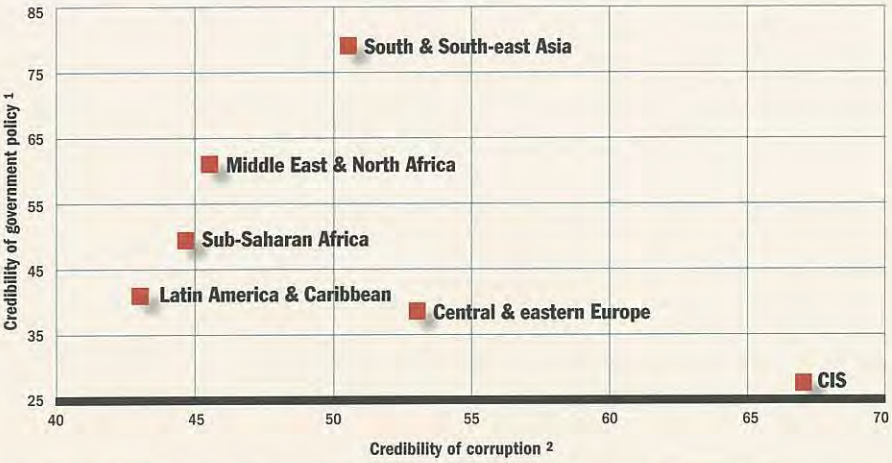
Source:
Brunetti, Kisunko et al. (1997)

1 In an effort to focus on changes in corruption over a longer time horizon, the DRI/McGraw Hill estimates of risk focus on the probability of a sharp and sudden deterioration in corruption, rather than its absolute level. The service does suggest, though, that one would expect the absolute level to be closely correlated with the probability of a deterioration, since an environment of extensive corruption is more likely to be associated with sudden and large changes in its level. Yet given the lack of evidence for this assumption, this data should be treated with considerable caution, though it is highly correlated with other measures of corruption levels.

2 Among the transition economies, the survey included respondents from 10 countries of the CIS and from 11 east European and Baltic countries. See Brunetti, Kisunko et al. (1997).

Chart 2.1.4

Corruption and government policy



1 This is an index based on the responses to two questions in the World Bank's survey of entrepreneurs (Brunetti, Kisunko et al., 1997) concerning the credibility and predictability of government policy towards business. Higher percentages represent greater credibility of government policy.

2 This is an index based on the responses to two questions in the above survey concerning the credibility and predictability of corruption defined as irregular additional payments to get things done. Higher percentages represent greater credibility of corruption.

higher than the next highest region – sub-Saharan Africa – and 24 percentage points higher than Latin America. The cross-country survey of entrepreneurs also provides an opportunity to compare some characteristics of corruption across regions and to relate corruption to other factors affecting the investment climate. The survey included two questions to measure the predictability and credibility of corruption transactions, respectively: (i) "Firms in my line of business usually know in advance about how much this 'additional payment' is", and (ii) "If a firm pays the required 'additional payment' the service is usually delivered as agreed". On the first question, the CIS respondents reported a level of predictability of corruption nearly twice as high as any other region with the exception of eastern Europe. On the second question, more than 80 per cent of the respondents in the CIS and eastern Europe claimed a high degree of credibility of corrupt transactions, though the distinction with other regions is less substantial.[3] On the basis of the responses to these questions, we have created a "credibility index" of corruption for each region, which is shown graphically on the x-axis in Chart 2.1.4. Though the level of corruption is higher in the CIS than in other regions, the predictability and credibility of such transactions are higher as well.

This pattern of corruption in the CIS is in stark contrast to the predictability and credibility of government policies in the region. A similar credibility index of government policy can be created from the responses to the following questions: (i) "Do you regularly have to cope with unexpected changes in rules, laws or policies which materially affect your business", and (ii) "Do you expect the government to stick to announced major policies?" The responses from CIS countries rated the predictability and credibility of government policy substantially lower than in any other region, as shown on the y-axis in Chart 2.1.4.

Comparing the two indices across the regions, as in Chart 2.1.4, reveals an important trend: the CIS combines a high level of very predictable and stable corruption with a high degree of policy instability at the government level. Moreover, this pattern is largely unique to the CIS, though it is evident to a much lesser degree in the countries of eastern Europe and the Baltics. This unique association is also revealed more directly in the survey. When entrepreneurs were asked to rank the most significant obstacles to doing business in their countries, the CIS was the only region in which policy instability and corruption ranked together in the top three. Though corruption was at or near the top in most regions, policy instability was much further down the list, reaching no higher than sixth place (Latin America) in any other region.

Of course, this correlation between the stability of corruption and the instability of government policy does not necessarily imply a causal relationship, nor does it indicate the direction in which a causal relationship might go. However, it does suggest an interesting potential relationship between the two. In an environment of extreme instability of government policy, firms may turn to corruption in their relationships with individual government officials as a "hedge" against the uncertainty of government policies. This would make sense only if corruption transactions between firms and individual government officials were more predictable and more credible than overall government policies towards firms; the responses to the survey questions reviewed above suggest that this is indeed the case in the CIS.

The use of corruption as a hedge against the uncertainty of government policy has strong parallels with practices common under the previous system of central planning. The classic empirical studies of the firm under central planning[4] described how managers developed a network of personal relationships with government officials and with other firms to create parallel markets – often referred to as the "shadow economy". These markets were developed in response to the high degree of uncertainty in the planning process associated with frequent changes in plan targets and supply bottlenecks. This pattern of behaviour may have survived, to a certain extent, under the very different conditions of the transition. The uncertainty of plan targets has been replaced by the uncertainty of government policies towards the market. While the introduction of markets has obviated the need for a shadow economy of this nature,[5] the demand for close personal networks between firm managers and individual government officials may still be high in response to continued policy uncertainty. Corruption is the fuel for such networks.

If the relationship between government policy instability and corruption suggested by the regional comparisons is correct, then it should also hold among the transition economies themselves. Again the difficulties of measurement are severe. To measure the level of corruption across the transition economies, we use corruption indicators developed by the *Wall Street Journal Europe* based on assessments by regional analysts.[6] To measure the level of policy instability, we use the results of a broad survey of foreign investors in the region sponsored by the EBRD in 1995.[7] The investors

3 While the credibility that a service agreed upon through a corrupt transaction will be delivered is high, there is still considerable concern that other officials might ask for additional payments, according to the survey.

4 See Berliner (1957) and Granick (1954).

5 Though there is still a very large informal sector in many transition economies where firms seek to evade government taxation and regulation.

6 The *Wall Street Journal Europe* assembled a panel of regional analysts to rate corruption (among other characteristics) in 25 transition economies on a 1 (most corrupt) to 10 (least corrupt) scale; the average of the scores given by the analysts is used as the overall corruption score for the country. (*CEER* 1995-96) The *WSJ* corruption survey has the most complete coverage of transition economies. Its assessments of corruption among the transition economies is highly correlated with other less comprehensive corruption ratings such as those from the DRI/McGraw Hill Global Risk Service (r = 0.78) and the Economist Intelligence Unit Country Risk Service (r = 0.82).

7 The survey results are reported in Lankes and Venables (1996).

Chart 2.1.5

Corruption and government policy stability in the transition economies

1 These scores are based on an assessment of levels of corruption in 25 transition economies as determined by a panel of regional analysts. The scores have been revised from the original so that higher scores represent higher levels of corruption. Source: *CEER* (1995–96).

2 This is an index based on a survey of foreign investors sponsored by the EBRD. Investors were asked to rate the policy risk associated with unpredictable legal and regulatory processes in each of the transition economies. Higher scores represent greater policy risk. Source: Lankes and Venables (1996).

were asked to rate policy risk associated with unpredictable legal and regulatory processes in each of the transition economies. This can be used as a measure of the perception of government policy instability across the transition economies.

Chart 2.1.5 presents a scatterplot graph relating the level of corruption to the level of government policy instability in the transition economies. Clearly, there is a very strong correlation ($r = 0.94$). The relationship suggested by the regional comparisons holds true among the transition economies alone: countries with high levels of government policy instability tend to have high levels of corruption. Of course, the correlation only suggests an association between two phenomena and not necessarily a clear causal connection. Both phenomena could be caused by some third variable or the correlation could be spurious. Moreover, even if there were a causal connection, it would not be clear from the scatterplot whether government policy instability causes corruption or vice versa. Nevertheless, the pattern is consistent with the view that corruption constitutes a strategy for hedging against government policy uncertainty. The continuity in this pattern of behaviour from the command system to the transition strengthens this view of the causal argument.

Of course, corruption is a multi-faceted problem in which numerous factors play a role, as discussed further in Chapter 5. Yet the evidence presented here suggests that a key element explaining the remarkably high levels of corruption in transition economies in comparison with other regions in the developing world is the comparatively high degree of uncertainty of government policies towards the market in these countries. Managers, especially in the CIS, appear to rely upon corruption – transactions which they regard as relatively predictable and credible – as a means of hedging against the risks associated with the instability of government policy, much as they did under central planning.[8]

Though any implications drawn from this argument must be treated with some caution, the evidence suggests the following hypothesis: improving governance of the market by enhancing the predictability of government regulation and intervention could have a strong impact on reducing the underlying causes of widespread corruption in the transition economies.

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8 This argument is not intended to suggest that corruption leads to net efficiency gains in the transition economy. For a discussion of the efficiency implications of corruption in the medium term, see Rose-Ackerman (1997).

A central purpose of the transition to a market economy in eastern Europe, the Baltics and the CIS is the improvement of general living standards. Despite the large falls in output in most of the region, living standards have improved for many people as rationing and shortages have disappeared, the quality and choice of products has increased, and new opportunities for private initiative have opened up. At the same time, it has to be recognised that in the short term many have suffered. The success and sustainability of the transition process will depend to a considerable extent on the numbers, characteristics and treatment of those who have seen their living standards fall, and indeed on the nature and extent of the deprivation they have experienced. The analysis of who are the gainers and losers, and by how much and in what way they have gained or lost, is an essential part of understanding the transition itself. The analysis in this appendix is based primarily on the results of a seminar on "Poverty and inequality in transition economies", held at the EBRD in May 1997 and supported by the UK Know-how Fund.

Social statistics on the standard of living and the distribution of income in command economies are particularly hard to interpret. Distorted prices, substantial transfers in kind, pervasive queuing and inadequate statistical records under the old regime, together with the difficulties of building new statistical services, make a comparison of social developments over time since the start of transition very difficult. Moreover, even in market economies, measuring the distribution of income poses considerable problems connected to the coverage of surveys, the unit of observation (households or individuals), and the measurement of income itself and of its spending power. Similarly, measures of poverty are faced with the problems of adjustment to different resource requirements for different individuals and social groups. The definition of a poverty line is always to some extent arbitrary, and the measurement of poverty needs to be done in the awareness that there are substantial potential variations in incomes and consumption below such a threshold. For these reasons, the analyst of data on poverty and income distribution in the transition has to apply particular caution. Lastly, it should be noted that poverty has many dimensions, of which income is only one. It is important to recognise these other dimensions, in particular health and education.

While we must be aware of the above caveats, sources of data are increasingly available for the transition period and a variety of indicators for developments in the standard of living can be constructed (see also Transition Report, 1995, Chapter 2). A broad conclusion from the information now available is that poverty has increased across the region as a result of falling national income, rising unemployment, reduced social transfers and declining public services. The increase in poverty differs widely from country to country, however, and in some cases poverty may already have started to decline. The varying patterns of output fall and recovery, together with the efficiency with which the state provides basic investment in health and education and a social safety net, have been crucial determinants of the different developments of living standards in the transition countries.

Developments in poverty

One indicator of the standard of living that has received attention in recent years is the development of life expectancy. Movements in life expectancy are usually fairly informative indicators of movements in health status and they have shown substantial variation across the countries of the region. As shown in Table 2.2.1, life expectancy at birth has declined precipitously in several economies, most notably Russia, where the average life expectancy for men in 1995 at 58.3 years was three years below the level of India, and a stunning six years lower than at the start of transition.[1] The fall in life expectancy in other countries, such as Ukraine and the Baltics, is similarly concentrated among the male population. Recent research indicates that there is a relationship both across countries and regions and over time between declining life expectancy rates in the transition and economic variables such as high labour turnover, rising unemployment and high levels of income inequality.[2] These variables are generally thought to be determinants of psychological stress, which in turn counts as one of the chief causes of increases in cardiovascular diseases and higher death rates from violence and suicides. This evidence supports the claim that for a significant number of people in transition economies the standard of living has fallen as a result of economic dislocations.[3]

Table 2.2.1 also shows that the decline in life expectancy has not been uniform across the region. In the Czech Republic, Poland, the Slovak Republic and Slovenia, life expectancy has increased. These economies have also recorded some of the highest economic growth rates in the region. To some extent, therefore, movements in poverty on the income and health dimensions have been in the same direction.[4] This broad conclusion is supported by other social indicators such as developments in infant mortality and secondary school enrolment (Tables 2.2.2 and 2.2.3), although there are important regional deviations. Infant mortality reflects the health status of children below 1 year (and of their mothers during pregnancy and nursing), which may differ considerably from the average health status of adults, the major force behind developments in life expectancy in the region. Secondary school enrolment rates are a measure of access to education.[5] The central European countries again show an improvement in both indicators. Infant mortality has increased in Albania, the Baltics and the western part of the CIS since 1989, although the change is far less pronounced than that in life expectancy and, at least in the Russian case, the trend has been reversed since 1993. Infant mortality has declined in Armenia and Azerbaijan, a notable achievement against a background of military tensions and large falls in GDP. In contrast to developments in central Europe, secondary school enrolment rates have stagnated or indeed deteriorated sharply in Bulgaria, Romania, the Baltics and the CIS. It is important to note that while the extent of the decline in the social indicators reviewed here has been associated with the severity of the transition-related recession, one cannot assume that these worrying trends will automatically reverse themselves once recovery sets in. Monitoring people's access to health and education and hence their participation in economic growth will remain important for an evaluation of developments in poverty.

The analysis so far has focused on the health and education dimensions of poverty. Concerning the income dimension, Chart 2.2.1 gives a snapshot of the current distribution of absolute poverty across the region, measured as the share of the population living below the UNDP poverty line of US$ 4 per person per day in terms of purchasing power parity (a level commonly used for middle-income countries).[6] The number of poor people is small in most east European countries and increases dramatically as one moves to the poorer CIS countries of the Caucasus and Central Asia. This is to be expected, although there are some significant outliers, such as the Baltics, where in spite of relatively high average income levels

1 The table also reports life expectancy rates for 1980 and 1985. It can be seen that the decline in Russia since 1990 has followed a marked increase during the 1980s (partly as a result of the anti-alcohol campaign) but that the decline since 1989 has been far more pronounced. Cornia (1996) reports econometric times series results that shows a clear break in trend in the crude death rate during the 1990-95 period compared with 1970-89.

2 See Cornia (1996). The same study relates the decline in life expectancy in transition to historical examples of sudden and far-reaching institutional and structural changes such as that brought about by the abolition of slavery in the USA, which caused an initial deterioration in black people's health.

3 It should be noted that recent micro-survey data for Russia show a decline in poverty over the 1992-95 period (Commander et al. 1997).

4 This is generally true for a collection of social indicators collected by UNICEF (1997). Note, however, the exception of the Caucasian countries, where in spite of war and considerable declines in GDP, life expectancy has remained stable or declined much less than in the western parts of the CIS.

5 Children's health in centrally planned economies was promoted through extensive public immunisation campaigns, but deaths from diseases such as tuberculosis have recently been on the increase. Primary school enrolment rates have traditionally been high in command economies and have generally been maintained at a level above 90%. However, there is some indication that pre-primary school enrolment rates (kindergarten) have been falling, often sharply, since the start of transition. See UNICEF (1997) for details.

6 See UNDP (1997).

Table 2.2.1

Life expectancy at birth

(in years)

Country		1980	1985	1989	1990	1991	1992	1993	1994	1995
Czech Republic	Male	66.8	67.3	68.1	67.5	68.2	68.5	68.9	69.5	70.0
	Female	74.0	74.7	75.4	76.0	75.7	76.1	76.6	76.6	76.9
Hungary	Male	65.5	65.1	65.4	65.1	65.0	64.6	64.5	64.8	65.3
	Female	72.7	73.1	73.8	73.7	73.8	73.7	73.8	74.2	74.5
Poland	Male	66.9	66.9	66.8	66.5	66.1	66.7	67.4	67.5	67.6
	Female	75.4	75.3	75.5	75.5	75.3	75.7	76.0	76.1	76.4
Slovak Republic	Male	na	na	66.9	66.6	66.8	66.8	68.4	68.3	68.4
	Female	na	na	75.4	75.4	75.2	75.3	76.7	76.5	76.3
Slovenia	Male	67.4	67.9	68.8	69.4	69.5	69.4	69.4	69.6	70.3
	Female	75.2	75.9	76.7	77.3	77.4	77.3	77.3	77.4	76.8
Albania	Male	67.7	68.5	69.6	69.3	na	68.5	68.5	69.5	na
	Female	72.2	73.9	75.5	75.4	na	74.3	74.3	75.6	na
Bulgaria	Male	68.4	na	68.6	68.4	68.0	67.8	67.7	67.2	67.2
	Female	73.6	na	75.1	75.2	74.7	74.4	75.1	74.8	74.9
Romania	Male	66.5	66.8	66.6	66.6	66.6	66.1	65.9	65.7	na
	Female	71.8	72.8	72.7	73.1	73.2	73.2	73.3	73.4	na
Estonia	Male	64.0	65.0	65.7	64.6	64.4	63.5	62.4	61.1	61.7
	Female	74.0	75.0	74.7	74.6	74.8	74.7	73.8	73.1	74.3
Latvia	Male	63.6	65.5	65.3	64.2	63.8	63.3	61.6	60.7	60.8
	Female	73.9	74.5	75.2	74.6	74.8	74.8	73.8	72.9	73.1
Lithuania	Male	65.0	66.0	66.9	66.6	65.3	64.9	63.3	62.8	63.6
	Female	75.0	75.0	76.3	76.2	76.1	76.0	75.0	74.9	75.2
Belarus	Male	65.9	66.7	66.8	66.3	65.5	64.9	63.8	63.5	62.9
	Female	75.6	75.5	76.4	75.6	75.5	75.4	74.4	75.0	74.3
Moldova	Male	62.4	63.1	65.5	65.0	64.3	63.9	64.3	62.3	61.8
	Female	68.8	69.5	72.3	71.8	71.0	71.9	71.1	69.8	69.7
Russia	Male	61.5	63.8	64.2	63.8	63.5	62.0	58.9	57.6	58.3
	Female	73.0	74.0	74.5	74.3	74.3	73.8	71.9	71.2	71.7
Ukraine	Male	64.6	66.0	66.0	66.0	66.0	64.0	63.5	62.8	na
	Female	74.0	74.0	75.0	75.0	75.0	74.0	73.0	73.2	na
Azerbaijan	Male	64.2	65.3	66.6	67.0	66.3	65.4	65.2	65.2	63.4
	Female	71.8	73.1	74.2	74.8	74.5	73.9	73.9	73.9	73.5
Armenia	Male	69.5	70.5	69.0	68.4	68.9	68.7	67.9	68.1	na
	Female	75.7	75.7	74.7	75.2	75.6	75.5	74.4	74.9	na
Georgia	Male	67.1	67.4	68.1	68.7	na	na	na	na	na
	Female	74.8	75.1	76.7	76.1	na	na	na	na	na

Source:
UNICEF (1997).

Note:
Life expectancy at birth gives a summarisation of the mortality rates across all age groups. It may be understood as the theoretical length of the life of a newborn taking all mortality rates in this year as constant.

Table 2.2.2

Infant mortality during transition, 1980-95

(per 1,000 live births)

Country	1980	1985	1989	1990	1991	1992	1993	1994	1995
Czech Republic	18.4	14.0	10.0	10.8	10.4	9.9	8.5	7.9	7.7
Hungary	23.2	20.4	15.7	14.8	15.6	14.1	12.5	11.5	10.7
Poland	25.5	22.0	19.1	19.3	18.2	17.3	16.1	15.1	13.6
Slovak Republic	na	na	13.5	12.0	13.2	12.6	10.6	11.2	11.0
Slovenia	15.3	13.1	8.2	8.4	8.3	8.9	6.8	6.5	5.5
Albania	50.3	30.1	30.8	28.3	32.9	30.9	33.2	43.2	na
Bulgaria	20.2	15.4	14.4	14.8	16.9	15.9	15.5	16.3	14.8
Romania	29.3	25.6	26.9	26.9	22.7	23.3	23.3	23.9	21.2
Estonia	17.1	14.1	14.8	12.4	13.4	15.8	15.8	14.5	14.8
Latvia	15.4	13.0	11.1	13.7	15.6	17.4	15.9	15.5	18.2
Lithuania	14.4	14.2	10.7	10.3	14.3	16.5	15.6	13.9	12.4
Belarus	16.3	14.5	11.8	11.9	12.1	12.3	12.5	13.2	13.3
Moldova	35.0	30.9	20.4	19.0	19.8	18.4	21.5	22.6	21.2
Russia	22.0	20.8	17.8	17.4	17.8	18.0	19.9	18.6	17.6
Ukraine	16.6	15.7	13.0	12.8	13.9	14.0	14.9	14.5	14.4
Azerbaijan	30.4	29.4	26.2	23.0	25.3	25.5	28.2	25.2	22.6
Armenia	26.2	24.8	20.4	18.3	18.0	18.9	17.8	14.7	14.2
Georgia	25.4	23.9	19.6	15.8	13.7	12.4	18.3	25.2	na

Source:
UNICEF (1997).

Note:
Annual number of deaths of infants less than 1 year of age per 1,000 live births. The definition of live births has changed in a number of countries over the sample period. For details see UNICEF (1997).

Table 2.2.3

Secondary school enrolment ratio, 1980-95

(% of relevant population)

Country	1980	1985	1989	1990	1991	1992	1993	1994	1995
Czech Republic	na	na	na	79.6	79.3	88.4	88.5	88.5	97.4
Hungary	69.0	72.0	74.9	74.5	74.6	75.5	78.2	81.4	91.1
Poland	77.0	78.0	78.9	77.8	78.1	79.3	80.6	82.0	83.1
Slovak Republic	na	na	88.7	88.2	88.0	92.2	93.2	90.2	91.7
Slovenia	na	na	79.3	80.3	83.1	81.9	82.9	84.7	82.5
Bulgaria	84.0	102.0	78.2	77.0	74.2	73.0	70.6	65.0	76.1
Romania	71.0	84.0	91.1	81.9	75.4	71.3	75.2	75.5	76.9
Estonia	na	na	na	88.8	87.8	86.0	83.7	84.6	78.6
Latvia	na	na	84.7	83.5	80.7	79.4	79.0	81.2	81.0
Lithuania	na	na	na	93.4	na	84.5	82.7	83.3	85.4
Belarus	na	na	88.7	86.0	85.3	83.8	84.0	84.2	84.4
Moldova	na	na	92.0	90.0	88.0	86.0	85.0	82.0	92.0
Russia	95.6	98.9	96.3	95.3	93.6	92.3	91.4	91.8	92.0
Ukraine	na	na	62.2	61.2	55.2	55.8	44.8	54.8	na
Azerbaijan	na	na	76.0	76.0	77.0	77.0	75.0	76.0	68.0
Georgia	91.0	99.9	94.2	94.9	94.4	87.8	75.9	76.0	na

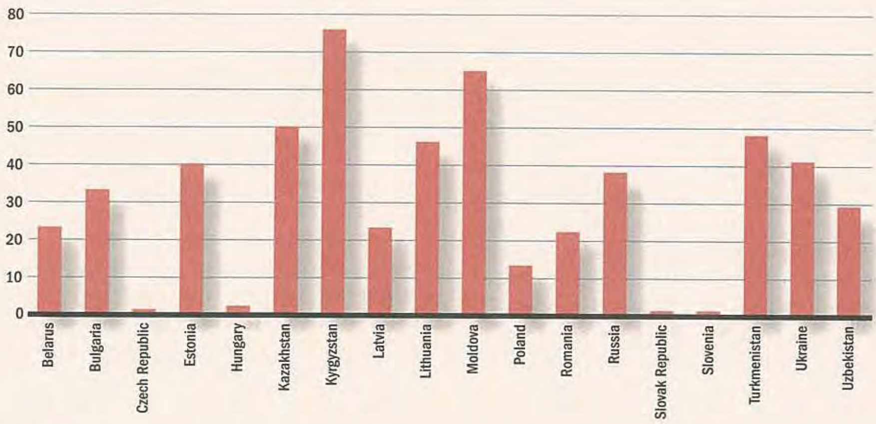
Source:
UNICEF (1997).

Note:
Total number of children enrolled in secondary schools as a percentage of the relevant age group. The figures refer to gross enrolment rates, which may include children below or above the relevant age (for instance, children who repeat a year at school or enrol early). The enrolment rate may thus exceed 100%.

Chart 2.2.1

Population in poverty (%)

($4 per day PPP$)



Source:
UNDP (1997)

and a good growth performance in recent years, a large proportion of the population seems to suffer from absolute poverty. This corresponds to the Baltics' deteriorating record in the social indicators reviewed above.

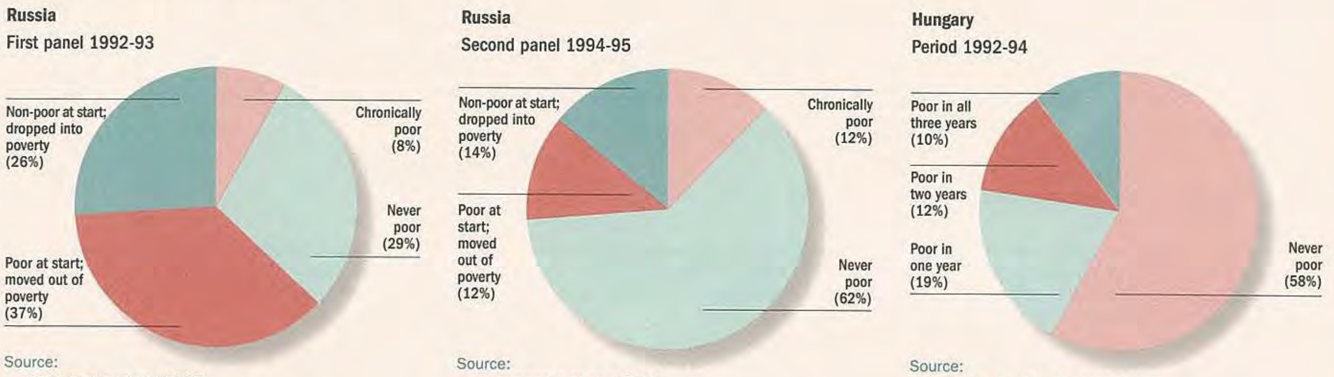
A crucial question for understanding what has happened and thus for social policy is, who are the poor? International evidence[7] and basic economic theory suggest that the incidence of poverty falls on those groups of the population with no independent source of income and/or low personal "entitlements" such as access to education, social transfers or public goods. Further, for the transition economies, it is important to distinguish spells of poverty from persistent poverty. In a period of rapid structural change, people may be expected to move in and out of poverty, particularly if poverty is measured by short-term rather than longer term incomes. By pooling information from several observations in time one may reduce the likelihood that poverty is mismeasured due to temporary shocks to income, or the possibility that certain income sources occur at discrete time intervals while their use is spread over time. The share of the persistently poor in the population is typically small even in a country such as Russia, where over 30 per cent of the population may fall below the poverty line in any given year (Chart 2.2.2).[8] For Russia and Hungary, an analysis of the incidence of persistent poverty (defined as falling below the poverty line in every year or survey period) among various groups of the population reveals strikingly different results. In Russia, mainly single person households (a large proportion of which are pensioners) are affected, as the budgetary crisis led to an erosion in the real value of pensions, particularly during the very rapid inflation of 1992-93. In Hungary, pensions have been indexed to average wages relatively successfully (replaced in 1997 by an index combining wages and the consumer price index), the average ratio of pensions to wages has been high (around 60 per cent) and only 1.5 per cent of old age pensioners were permanently poor over the 1992-94 period. In this country, persistent poverty affected mainly children, recipients of child allowance and other dependants, such as recipients of disability pensions. In both countries, educational and professional status is an important determinant of poverty, with unskilled labourers faring much worse than white collar workers. There is a strong regional element to persistent poverty, with rural and less industrialised regions losing out relative to the metropolitan centres. Additionally, in Hungary, almost half of the Roma population (an ethnic minority prominent in south-eastern Europe) suffers from persistent poverty. In general, the quality of data and different interpretations and treatment of data can lead to sharply differing conclusions concerning the number and identity of the poor. So too can different specifications of the poverty line. Hence, one must avoid placing too much emphasis on specific numbers. Nevertheless, the general picture described here does seem to be consistent with the variety of sources available.[9]

Income inequality

There is a close relationship between poverty and income inequality.[10] Among the central European countries in 1992, the more equal societies had fewer poor people and the poor were generally closer to the average income

Chart 2.2.2

Distribution of poor by duration



Source:
Commander et al. (1997).

Source:
Commander et al. (1997).

Source:
Andorka and Speder (1997).

[7] See Dreze and Sen (1989).

[8] In many existing studies, the poverty line is defined in relation to average incomes and may thus vary over time. The data for Hungary give the number of people falling below the official subsistence level. For Russia, Commander et al. (1997) construct a poverty line based on a basket of 35 commodities transformed into monetary values using regional prices. These two countries are used here because they were the only cases for which evidence on persistent poverty was presented at the EBRD conference.

[9] For instance, the result that educational and professional status as well as location are important determinants of poverty is generally confirmed by studies looking at the characteristics of the poor in any given year (e.g. Bailey, 1997). The particular vulnerability of children during the transition process is highlighted by UNICEF (1997). This report finds that for every percentage point increase in the headcount poverty rate, poverty amongst children tends to increase by 1.4-1.6 percentage points.

[10] This is so by definition, when poverty is defined relative to an average income level or to some percentile of the distribution.

earner (Table 2.2.4). However, income inequality is an issue of importance in its own right. Even when the incidence of poverty is low, substantial income inequalities can cause political instability and may depress economic growth through the effect inequality may have on human capital accumulation and investment.[11] At the same time, poor but relatively equal countries, including some in East Asia during the 1960s and 1970s, have grown rapidly on the basis of relatively stable political regimes and large investments in physical and human capital. In the event, their high rates of growth have led to substantial reductions in the incidence of poverty.

The transition economies started their reform process from very different initial conditions with respect to income inequality. Although special caution is warranted in using the available data, Chart 2.2.3 nonetheless suggests that the ideological emphasis on equality in command economies was not always reflected in the reality of the old regime. Most countries of the region probably fell somewhere between the lowest and the mean level of inequality recorded in the OECD, although Czechoslovakia and Hungary apparently had some of the lowest degrees of inequality in the world. In terms of earnings inequality, which is better measured than personal incomes, Russia by the late 1980s appeared to show greater inequality than Germany and France and was roughly on a par with the UK.[12]

There is no doubt that inequality has since increased substantially throughout the region. But again, this increase is far from uniform. Because starting points are often unreliable,[13] comparisons over time are particularly difficult. The broadest data base is provided by a collection of household budget surveys for a large number of countries and years presented by UNICEF.[14] These data point towards the emergence of three groups of countries, distinguished by the pattern of inequality over time. In the first group, the Czech Republic, Hungary, the Slovak Republic and Slovenia, inequality was historically low and has risen moderately, for reasons explained below. In the second group, Poland, Romania and the Baltics, inequality was slightly higher at the start of the transition and has since increased to levels at or above the OECD average. In the third group, primarily Russia and Bulgaria and perhaps including other CIS countries, inequality has shot up dramatically from moderate levels to reach levels typical of the more unequal developing countries.[15]

Comparisons across countries and over time are particularly affected by the measure of inequality chosen and the data quality issues raised above. The comparisons made here with other parts of the world are meant to be indicative of various patterns of change rather than an attempt to establish clear rankings. In some countries, data on income inequality calculated from official budget surveys have been challenged by the results of recent independent surveys. This Annex reports the most recent results available to us for Bulgaria, the Czech Republic, Hungary, Russia and the Slovak Republic. The data come from either independent or official household surveys and have been used to analyse some of the underlying causes of the increase in inequality in transition economies (Table 2.2.5). Two qualifications to the general pattern sketched above emerge from these data. First, inequality in Russia as early as 1992 was probably much larger than is usually recognised by the official surveys. Second, Hungary similarly may have been initially less equal than previously thought. However, the broad trends over time in the five countries shown appear to correspond to those in the grouping above.

The increase in inequality during transition has a number of causes. First, the changing structure of economic activity may increase income inequality as workers leave the state sector either voluntarily to take higher paid private sector jobs or reluctantly to join the pool of unemployed.[16] Second, earnings are likely to become more dispersed as the market system allows rewards to be more closely associated with risk-taking, training, individual talent and effort. The design of reform policies may also open new possibilities for opportunistic behaviour (such as rent seeking associated with remaining distortions), thereby contributing to increased earnings inequality. A major influence on changes in income distribution appears to have been changes in wages distribution. Somewhat surprisingly, the empirical evidence also suggests that increases in income inequality have been only moderately related to a rising premium for well-educated workers. Idiosyncratic factors, such as location or access to a private sector job (e.g. through family relations) so far outweigh individual characteristics such as the level of education and skills as determinants of personal incomes. In this respect, both theoretical reasoning as

Table 2.2.4

Poverty indicators for Visegrad countries

	Poverty rate (%)	Poverty gap (%)	Poverty indicator	Gini
Czech Republic 1992	6.0	15.0	0.90	0.2047
Hungary 1991/92	14.7	26.7	3.93	0.2812
Hungary 1994/95	14.2	31.1	4.42	0.3233
Poland 1992	16.3	26.0	4.24	0.2914
Slovak Republic 1992	5.8	15.4	0.89	0.1868
Average 1992	10.7	20.8	2.49	0.2410

Source:
Luxembourg Income Survey microdata basis; Foerster and Toth (1997).

Notes:
The poverty rate is defined as the proportion of persons in households with incomes below 60% of median income. The poverty gap is the difference between the average income of the poor and the poverty line, defined as a percentage of that line. The poverty indicator is defined as poverty rate * poverty gap * 100. The Gini coefficient is derived from the cumulative distribution of incomes across the population, ranked by per capita incomes - the so-called Lorenz curve. It is defined as one half of the mean difference between any two observations in the income distribution divided by average income.

11 See Benabou (1996) for a survey of the theoretical literature linking inequality to growth. Papers addressing this issue at the EBRD seminar on Poverty and Income Inequality in Transition include Ferreira (1997), Alesina (1997). The impact of inequality on macroeconomic volatility is analysed in Aghion et al. (1997).

12 The decile ratio (defined as the ratio of the 90th percentile to the 10th percentile of the distribution) for earnings of full-time workers in Russia was 3.36 against 4.40 in Canada, 3.40 in Britain, 3.02 in France, 2.45 in Germany and 2.44, 2.64 and 2.77 in Czechoslovakia, Hungary and Poland respectively. See Flemming and Micklewright (1997).

13 For a discussion see Milanovic (1997).

14 See UNICEF (1997), Table F.3.

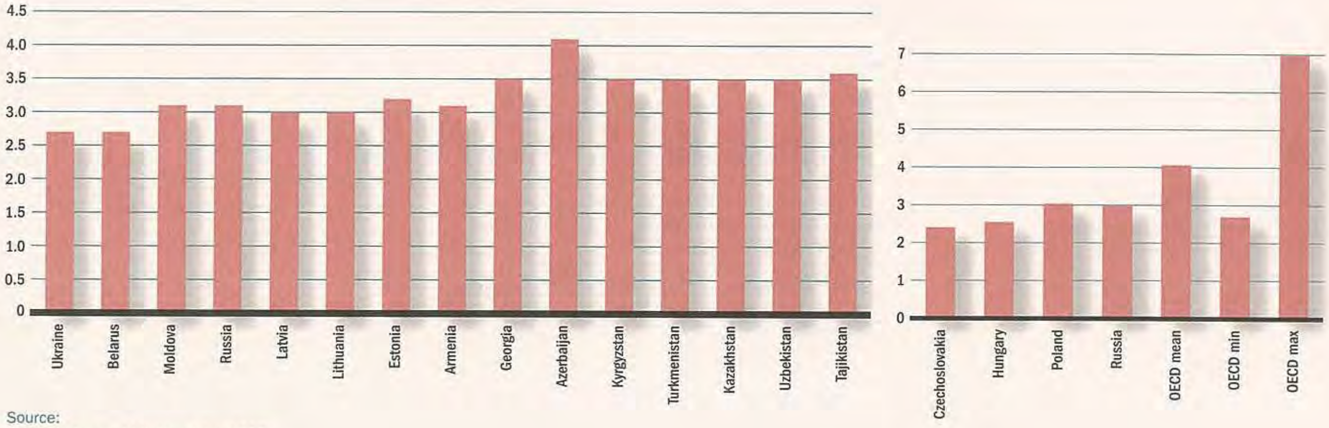
15 For instance, Russia in 1995 recorded a Gini coefficient of 0.46 (see Table 2.2.3), close to the Gini coefficients recorded in countries such as Thailand and Mexico (see World Bank, 1997). The Gini coefficient is a measure of inequality that can be derived from the cumulative distribution of incomes across the population, ranked by their income level – the so-called Lorenz curve. It is defined as half the mean difference between any two observations divided by the mean. Data are unavailable for the Caucasus and Central Asia. Inequality here was high to begin with (Chart 2.2.3) but there is no information on whether and by how much it has increased since independence.

16 See for instance Commander et al. (1997) and Coricelli (1997). The empirical evidence draws on Commander et al. (1997) for Russia, Bailey (1997), Galasi (1997), and Garner and Terrell (1997) for central Europe, and Kotzeva and Woergoetter (1997) for Bulgaria.

Chart 2.2.3

Initial inequality in transition economies differed

USSR, 1989; and Central Europe, Russia, OECD – mid-1980s



Source:
Flemming and Micklewright (1997).

Note:
The decile ratio is defined as the ratio of the income of the 90th percentile to the 10th percentile of the distribution.
The decile ratio is computed for per capita incomes.
OECD refers to 16 countries.

well as the available evidence suggest that policies which promote rapid private sector development and thus create new income opportunities for workers displaced by the relative shrinking of the state sector may also contribute to lowering inequality after an initial upward adjustment.

One additional factor that is expected to raise inequality over time is the redistribution of wealth and hence changes in the distribution of capital incomes. The privatisation of state assets in transition economies has profound implications for wealth distribution. The empirical evidence concerning the effect on income distribution so far is very limited. In Russia, changes in the distribution of capital incomes have contributed only little to the overall rise in income inequality. However, the distribution of wealth in addition to generating capital incomes (which in many cases will not be properly recorded) is important in its own right: it may influence individuals' ability to borrow and invest, and more generally to command resources. It also has important dynamic implications for economic growth in the presence of capital market imperfections, which are likely to receive continuing attention as the transition proceeds.[17]

A particularly interesting aspect of changes in income inequality concerns the impact of government redistribution through the tax and benefit system. The efficiency of social targeting differs tremendously across countries. In some cases, the relatively richer parts of the population have benefited disproportionately from social benefits and inequality has increased as a result of redistribution.[18] The need for efficient social targeting is crucial in many CIS countries, where the collapse of government revenues severely limits their ability to counteract growing inequality in gross earnings through redistributive policies (see in particular Chapter 7 on the fiscal situation in the CIS). More generally, choices over cuts in fiscal expenditures should bear in mind the particular dependence of poorer segments of the population on the provision of basic public services, such as health and education.

In sum, poverty and income inequality have increased in most transition economies since the late 1980s. Some increase in income inequality in the region, even in the long run, is probably an unavoidable consequence of the introduction of market-based rewards. The scope of structural change and economic dislocation may introduce some additional temporary inequality. However, as the varying developments across the region suggest, the major determinants of the rise in poverty and

Table 2.2.5

Inequality has generally increased but to different degrees – Gini coefficients

Russia (1992-95)	**Round 1**	**Round 2**	**Round 3**	**Round 4**	**Round 5**	**Round 6**	
Gini	0.426	0.419	0.441	0.439	0.465	0.458	
Source: Russian Longitudinal Monitoring Survey							
Bulgaria	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**
Gini	0.217	0.228	0.235	0.331	0.337	0.366	0.378
Source: Bulgarian Household Business Survey							
Hungary	**1992**	**1993**	**1994**	**1995**	**1996**		
Gini	0.283	0.284	0.287	0.3	0.302		
Source: Hungarian Household Panel (TARKI)							
Czech Republic		**1989**	**1993**				
Gini		0.183	0.187				
Slovak Republic							
Gini		0.176	0.185				
Source: Family Business Survey							

Notes:
Russia: Gini on per capita basis, Commander et al. (1997).
Bulgaria: Gini on per capita basis, Kotzeva and Woergoetter (1997).
Hungary: Gini grouped by deciles, Galasi (1997).
Czech Republic and Slovak Republic: Gini per capita, Garner and Terrell (1997).

For definition of the Gini coefficient see Notes to Table 2.2.4.

For Hungary, the Gini coefficient is computed for decile averages only. For all other countries the calculations are on a per capita basis.

[17] See Ferreira (1997); Benabou (1996).

[18] Bulgaria seems to be a case of regressive transfers (Kotzeva and Woergoetter, 1997). An interesting contrast can also be established between the Czech and Slovak Republics, both of which run a relatively extensive and efficient redistribution system. However, relative to the resources expended, the Czechs seem to have been more successful in targeting the poorest parts of the population. Possibly in part as a result of this difference, inequality since 1989 has increased by less than in the Slovak Republic (Garner and Terrell, 1997).

inequality are probably the severity of the output falls and differences in the willingness and ability of the state to maintain the provision of basic public services and an efficiently targeted social safety net. Creating an investment climate conducive to private sector development and resolving the budgetary crisis in many countries of the region remain two crucial policy challenges, not just for generating economic growth, but also to allow for an improvement in the standard of living of those who have so far borne a disproportionate burden of the costs of transition.

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