Seventh Biennial International Conference organised by the
European Community Studies Association (ESCA)
May 31-June 2001
Madison, Wisconsin, USA

How successful transition is paving the way for EU enlargement
A view based on EBRD transition indicators

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* The author relied significantly for the preparation of this paper on the Transition Report 2000, published by the EBRD in November 2000. However, the views expressed are the sole responsibility of the author and do not necessarily reflect those of the EBRD
Enlargement is one of the most crucial challenges that the European Union is facing as it enters the twenty-first century.

Currently thirteen countries are involved at one stage or another in the enlargement process: they are Cyprus, Malta, Turkey, and the ten countries of Central and Eastern Europe that have applied to join the EU since the collapse of the Iron Curtain in 1989, namely Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. This paper will deal only with these ten candidate countries, which have in common to be in transition from a centrally planned economy to a market economy.

The integration of these ten countries in the European Union offers a not-to-be-missed historical opportunity to bring together two parts of Europe, sharing a common historical and cultural heritage, that have been artificially separated as a result of the military situation at the end of World War II, and the imposition for more than 40 years of a communist regime that was alien to the profound aspirations of their populations.

However, this long separation and the differences in economic structures that have resulted meant that the accession process would be a more complex process than was the case in the previous enlargements of the European Union. At the Copenhagen European Council in June 1993, the Heads of State and Government of the Member States of the EU judged that the candidate countries would have to be in a position to satisfy a certain number of demanding political and economic conditions. The “Copenhagen criteria” determined that all applicants would have to provide guarantees of

- The existence of stable institutions underpinning democracy, the rule of law, human rights, respect for minority groups and their protection
- The existence of a viable market economy and the capacity to withstand competitive pressure and market forces within the Union and
- The ability to take on the obligations that come with membership, i.e. the transposition in their legal system of the so-called “acquis communautaire”, the administrative capacity to implement it, as well as the adherence to the broader aims of political, economic and monetary union.

In this paper we will concentrate on the economic conditions spelled out in the second criteria.

Since 1997, the European Commission has assessed each year the progress of each candidate country towards meeting the criteria of Copenhagen. The sub-criteria of the second criterion – the existence of a functioning market economy and the capacity to withstand competitive pressure and market forces within the Union, were more precisely defined in the Commission Communication on Agenda 2000:

- The existence of a functioning market economy requires that prices, as well as trade, are liberalised and that an enforceable legal system, including property rights, is in place. Macroeconomic stability and consensus about economic policy enhance the performance of a market economy. A well-developed
financial sector and the absence of any significant barriers to market entry and exit improve the efficiency of the economy.

- The second criterion ('capacity to withstand competitive pressure and market forces within the Union') depends on the existence of a market economy and a stable macroeconomic framework, allowing economic agents to make decision in a climate or predictability. It also requires a sufficient amount of human and physical capital, including infrastructure. State enterprises need to be restructured and all enterprises need to invest to improve their efficiency. Furthermore, the more access enterprises have to outside finance and the more successful they are at restructuring and innovating, the greater will be their capacity to adapt. Overall, an economy will be better able to take on the obligations of membership the higher degree of economic integration it achieves with the Union prior to accession. Both the volume and the range of products traded with the EU Member States provide evidence of this.

Taking the two sub-criteria together, the European Commission concluded in its most recent assessment of November 2000 that "Estonia, Hungary and Poland are functioning market economies and should be able to meet the second criterion in the near term provided they maintain their current reform path. The Czech Republic and Slovenia can be regarded as functioning market economies and should be able also to meet the second criterion in the medium term, provided that they implement current structural reform programmes and undertake further reforms where necessary. Bulgaria does not meet either criterion but has clearly made further progress towards this objective. Romania has made too limited progress towards meeting the criteria".  

The purpose of this paper is not to examine in the details the assessment made by the Commission but rather, drawing on the research basis and the methodology of the European Bank for Reconstruction and Development (ERBD), as reflected inter alia in the EBRD Transition Report 2000 published November 2000, to assess the progress achieved by the ten candidate countries from Central and Eastern Europe in their transition to a market economy.

The paper is organised as follows. In the first section, we review the EBRD system of transition indicators and its application to the ten candidate countries. In the second section, we try to understand the factors that could explain discrepancies in the progress achieved by individual countries, while, in section three, we reflect on the key role of institutional performance in transition and on the lessons learned as we embark in a new decade of transition. Additional EBRD material is proposed in annexes 1, 2 and 3, dealing with legal, infrastructure and environmental transition.

Annex 1 presents the results of the EBRD’s legal transition survey of practising lawyers in its countries of operations, including the ten EU accession countries. The EBRD’s Office of the General Counsel implemented and analysed this survey, which measures the extent and effectiveness of commercial and financial laws and regulations that are fundamental to investments and financing decisions. They include company law, bankruptcy and secured transactions laws as well as banking

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and securities laws and regulations. The survey examines both the content of the law and the effectiveness of judicial enforcement. It therefore provides a valuable accompaniment to the EBRD’s economic transition indicators.

Annex 2 assesses progress in the development of commercial infrastructure. The analysis focuses on five sectors: electric power, railways, road transport, telecommunications, water and waste water. The infrastructure indicators focus on the areas of tariff reform, commercialisation (including private sector participation) and effective regulation.

Annex 3 examines progress in environmental protection. In particular, it assesses the progress in improving air quality in transition economies using the “pressure-response-state” developed by the OECD.
I. How the EBRD Transition Indicators assess the ten candidate countries of Central and Eastern Europe.

The EBRD was set up in 1991 with as purpose “to foster the transition towards open-market-oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multi-party democracy, pluralism and market economics”.

It is particularly well placed to assess the progress in transition for its 26 countries of operations (27 countries since the accession of the Federal Republic of Yugoslavia to the EBRD in January 2001). The countries of operations of the EBRD are of course a much broader group than the 10 countries of Central and Eastern Europe that have applied for membership of the EU. They include also countries of South Eastern Europe (SEE), namely the ex-republics of Yugoslavia other than Slovenia, as well as Albania and the twelve countries of the Commonwealth of Independent States (CIS).

In 1994 the EBRD started the publication of an annual Transition Report, providing a detailed assessment of progress in transition. The assessment in the annual Transition Report is made for a number of core dimensions of reform that correspond with the main elements of a market economy, markets and trade, enterprises and financial institutions. Progress in each of these dimensions represents an improvement in how well markets, enterprises and financial institutions function. Progress is measured against the standards of industrialised markets economies, recognising that there is neither a perfectly functioning market economy nor a unique end-point for transition. The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from a rigidly planned economy and a 4+ represents a standard that would not look out of place in an industrialised market economy.

Overview

Within the broad categorisation of reforms, the methodology developed by the EBRD has sought to measure specific aspects of transition. On markets and trade, the indicators capture the liberalisation of prices, trade and access to foreign exchange as well as the extent to which utility pricing reflects economic costs. The indicators also assess the effectiveness of competition policy in combating abuses of market dominance and anti-competitive practices. On enterprises, the EBRD indicators measure the extent of small-scale and large-scale privatisation and of enterprise reforms, such as the elimination of production subsidies and the introduction of bankruptcy procedures and of sound corporate governance. On financial institutions, the EBRD indicators capture the extent to which interest rates have been liberalised, two-tier banking systems established and securities markets created. They also assess whether prudential regulations have been raised to international standards and if procedures exist for resolving the failure of financial institutions.

Table 1 presents these indicators extracted from the EBRD Transition Report 2000 only for ten countries of Central and Eastern Europe that are candidates for EU accession.

(Table 1)
(Classification System for Transition Indicators)
### Table 1 Progress in Transition in the Countries of Central and Eastern Europe, Candidates for EU Accession

<table>
<thead>
<tr>
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<td>70</td>
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<td>3</td>
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<td>4+</td>
<td>3</td>
<td>3</td>
<td>4+</td>
<td>3 -</td>
</tr>
<tr>
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<td>10.0</td>
<td>80</td>
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<td>4+</td>
<td>3+</td>
<td>3</td>
<td>4+</td>
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<td>4+</td>
<td>3 -</td>
<td>3</td>
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<td>2+</td>
</tr>
<tr>
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<td>3.7</td>
<td>70</td>
<td>3</td>
<td>4+</td>
<td>3 -</td>
<td>3</td>
<td>4+</td>
<td>4 -</td>
</tr>
<tr>
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<td>38.7</td>
<td>70</td>
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<td>4+</td>
<td>3</td>
<td>3</td>
<td>4+</td>
<td>3</td>
</tr>
<tr>
<td>Romania</td>
<td>22.3</td>
<td>60</td>
<td>3</td>
<td>4 -</td>
<td>2</td>
<td>3</td>
<td>4+</td>
<td>2+</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>5.4</td>
<td>75</td>
<td>4</td>
<td>4+</td>
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<td>3</td>
<td>4+</td>
<td>3</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2.0</td>
<td>55</td>
<td>3</td>
<td>4+</td>
<td>3 -</td>
<td>3</td>
<td>4+</td>
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</tr>
</tbody>
</table>

Source: EBRD Transition Report 2000

\(^1\) 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 formal 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 or 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

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 performances 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 and enterprise 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 no-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 almost 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; WTO membership.

Competition Policy

1. No competition legislation or 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.

Overall score: The overall score in the third column of the table is the average of the scores given for the two indicators rounded down. A “+” after a number is used to indicate countries that have just made it to the highest tier of one category and are within a few points of reaching the next category in the scale. A “-” indicates countries that are at the bottom of a category where a significant improvement is required for that jurisdiction to fall more comfortably within the middle range for that category.
A first overall result that emerges from Table 1 is that there is indeed a group of front-runners in the accession process, composed of Hungary, Poland, Slovenia, the Czech Republic and Estonia. However, the EBRD Transition Report 2000 points to the fact that in 1999-2000, noticeable progress was achieved in the second group of countries that, at the EU Summit of Helsinki in December 1999, were invited to begin negotiations on EU accession, namely Bulgaria, Latvia, Lithuania, the Slovak Republic and Romania. These countries made progress in 1999-2000 in the areas of privatisation and the financial sectors. While these countries made noticeable strides in reforms, the front runners continued to improve. Reflecting a sound and well-established prudential framework and increased investor confidence and activity, Poland and Hungary are the first transition countries to reach an indicator score of 4 – in the functioning of their securities markets.

**Liberalisation**

There are remarkably wide differences among transition economies in the pace and extent of liberalisation. The countries in Central Europe and the Baltic countries, (as well as other countries such as Albania, FYR, Macedonia, Kyrgyzstan and Moldova) liberalised domestic prices very early in their transition and sustained these reforms. These countries also liberalised trade and access to foreign exchange, albeit more gradually than they freed domestic markets. Table 1 shows that Hungary, Poland and Slovenia are still ahead of the other candidates for EU accession in terms of price liberalisation, while Romania and Lithuania are still behind the rest of the group in terms of trade and foreign exchange liberalisation.

Indeed the rapid and sustained approach to liberalisation in Central Europe stands in contrast to the more uneven progress in much of South Eastern Europe and the CIS. Among these countries, Bulgaria attempted to liberalise both domestic and external markets relatively early in the transition, but temporarily backtracked on these reforms.

The other countries in SEE and the CIS have seen much more gradual progress in price and trade liberalisation. However, even among these countries, there have been reversals in trade liberalisation, one of them being Romania in 1996. The new Romanian government that took over after the elections of 1997 quickly restored the previous level of price and trade liberalisation.

Another important dimension of market and trade reform is the adoption and the implementation of an effective competition policy. Indicators in this area lag behind the other indicators of liberalisation in most candidate countries, Bulgaria, Latvia and Romania being the least advanced.

While initial conditions and political developments early in the transition appear to have lasting effects on liberalisation, the challenge is how to advance liberalisation where progress remains incomplete and to sustain comprehensive liberalisation once it has been achieved. The experience of Bulgaria following the return to power of the former Communist Party in 1994 suggests that a change of government can lead to temporary set backs, but a reform government was again elected in December 1996 and restored the previous level of market liberalisation. In the Slovak Republic a recent change in government has led to an acceleration of reforms.
<table>
<thead>
<tr>
<th>Country</th>
<th>GATT/WTO Membership</th>
<th>IMF Article VIII Status</th>
<th>EU Association Agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>Dec 96</td>
<td>Sept 98</td>
<td>Mar 93</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Jan 95</td>
<td>Oct 95</td>
<td>Oct 93</td>
</tr>
<tr>
<td>Hungary</td>
<td>Jan 95</td>
<td>Jan 96</td>
<td>Dec 91</td>
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<tr>
<td>Poland</td>
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<td>Dec 91</td>
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<td>Romania</td>
<td>Jan 95</td>
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<td>Feb 99</td>
<td>Jun 94</td>
<td>Jun 95</td>
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<tr>
<td>Lithuania</td>
<td>Dec 00</td>
<td>May 94</td>
<td>Jun 95</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Country</th>
<th>Cumulative privatisation receipts as a share of GDP (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>8.7</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>9.1</td>
</tr>
<tr>
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</tr>
<tr>
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<td>13.0</td>
</tr>
<tr>
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<td>3.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>8.4</td>
</tr>
<tr>
<td>Poland</td>
<td>7.9</td>
</tr>
<tr>
<td>Romania</td>
<td>7.7</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>11.0</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2.5</td>
</tr>
</tbody>
</table>

Source: EBRD survey of national authorities
Another way of sustaining the liberalisation of trade and access to foreign exchange is through multilateral commitments, which help to anchor these measures in well-established institutions. The commitments related to WTO accession, IMF Article VIII on currency convertibility and EU Association Agreements, combined with the prospect of EU Accession, tend to reduce the likelihood of policy reversals and add to the transparency and predictability of the trade and payment regimes. The commitments are also likely to contribute to the development of institutions that support markets and private enterprise. Table 2 shows the status of the ten accession countries with respect to these three international institutions. The first country to achieve commitments in the three areas, namely WTO membership, IMF Article VIII Status and EU Association Agreement, was Poland.

Among the most notable progress in this area in 1999 was the accession of Estonia to the WTO. Negotiations with Lithuania were successfully concluded in 2000 and accession took place in December 2000. The EU’s decision in December 1999 to open accession negotiations with Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic is playing a key role in consolidating liberalisation and strengthening institutional performance in those countries. It should be noted in that connection that in the remainder of other transition countries, however, international commitments provide much less impetus for reform. One example is provided by the slow WTO negotiations with countries such as Azerbaijan, Belarus, Central Asia (except Kyrgyzstan), Russia and Ukraine. In the absence of prospects for closer integration, EU association agreements have not exercised significant influence on the reform process in the CIS. Possibly the strongest anchor for liberalisation in this region is the commitment made to the IMF under macroeconomic adjustment loans.

Privatisation

The variety of approaches to privatisation in the transition countries reflects the many objectives (sometimes conflicting) and constraints involved in the reallocation of state assets. The key objectives were to build a critical mass of support for reforms and to remove the state from ownership of enterprises. In some cases, privatisation also aimed to improve the post-privatisation performance of enterprises, to strengthen competition and to generate revenue for the government. Privatisation helps, therefore, to complement liberalisation, sustaining political support for reforms and strengthening the response of enterprises to change. Political constraints on privatisation, however, have been equally important in determining the extent and form of privatisation. In particular, the methods of privatisation often reflected the initial balance of power between the privatisation authority, the ministries controlling the firms, local government, enterprise managers and their employees, often resulting in widespread concessions to insiders (existing managers and workers) in many large-scale privatisation programmes.

Table 1 suggests that Latvia, Lithuania, Romania and Slovenia are somewhat lagging behind in terms of large-scale privatisation. However, a more important finding is the poor score of Bulgaria in terms of governance and enterprise restructuring despite a relatively advanced stage in terms of large-scale privatisation.
Privatisation of large-scale enterprises has indeed achieved mixed success in meeting its objectives. In many countries, privatisation has been one of the most controversial areas of government policy regardless of the methods chosen and their speed of implementation. In some cases, the distribution or sale of state assets to favoured groups in return for political support may have undermined the credibility of reformers and their policies. Moreover, the evidence on whether privatisation has improved the performance of privatised companies is equally ambiguous. The EBRD view is that the only form of privatisation that has clearly contributed to improving post-privatisation performance of enterprises is the sale of assets to strategic investors.

The outstanding challenge for privatisation, therefore, is to implement remaining sales as transparently and competitively as possible and to avoid the suspicion of political favouritism. This can be achieved by using competitive investment tenders or auctions to sell stakes in state companies to strategic investors. In fact, with the transition now in its second decade, most governments have tended to shift away from privatisation programmes towards direct sales through tenders and auctions. In addition, enterprises privatised in ways that did not place priority on post-privatisation performance, including management-employee buyouts and voucher-based mass privatisations, need to be strengthened. One way to strengthen the ownership structures and corporate governance of such firms is through the market for corporate control and the exercise of financial discipline associated with external finance. However, these corporate governance mechanisms do not function well in many transition economies.

As Table 3 shows, cumulative privatisation receipts has varied considerably across the accession countries. This variation reflects both the approaches chosen in large-scale privatisation and the attractiveness of the assets on offer. The highest receipts have been achieved by Estonia and Hungary, which used direct sales as their primary privatisation method. In other countries, however, privatisation revenue was dominated by a few prominent deals, such as the sale of the dominant telecommunications company, power generation and distribution, natural resources and the main banks. The value of these assets depends on the quality of the local business environment as well as the size of the market and its economic potential.

Over the 1999 to 2000 period, Bulgaria, Poland and Romania have been the most active in large-scale privatisation. Bulgaria and Poland have placed greater emphasis on direct sales and raised over US$ 7.9 billion and US$ 250 million in privatisation receipts respectively. Over half of the amount in Poland is from the sale of a minority stake in TPSA, the Telecommunications Company. In addition, the Czech Republic sold stakes in two major banks for US$ 1.7 billion and the Slovak Republic sold minority stakes in its dominant telecommunications companies for just under US$ 1 billion. In contrast, most privatisations in Romania in the 1999 to 2000 period were in the form of management-employee buyouts.

In contrast to the complex challenges in privatising medium- and large-scale enterprises, privatisation of small firms has been much simpler. In the ten accession countries, the task of small-scale privatisation is almost completed, except again in Bulgaria and Romania as suggested by Table 1. Most small firms were in the trade and services sectors, and the power of their managers and employees was not significant. Moreover, the administration of small-scale privatisation, either in the
form of competitive auctions or concessions to insiders, was often devolved to local governments, making rapid implementation possible.

Institutional Performance

Since the start of transition, the development of institutions that support markets and private enterprises has lagged behind progress in liberalisation and privatisation.

The precise sequence of reforms has also differed sharply among the accession countries. In Hungary almost perfect balance has been achieved between progress in liberalisation/privatisation and institutional reform. Most of the central European countries followed a similar path. In contrast to this Lithuania had a rapid initial liberalisation in the first half of the 1990s followed by strong institutional reform during the second half of the decade.

Progress in institutional reform over the 1999-2000 period show that slow but steady progress in building market-supporting institutions, particularly in the area of financial institutions and markets continued to be made by the Czech Republic, Estonia, Hungary, Lithuania, Poland and the Slovak Republic. A number of these countries have recently strengthened their policies and practices for the resolution of bank failures, privatised some remaining state-owned banks and further aligned banking regulations with international standards, such as the Basle Committee’s core principles on banking regulation. Some have also seen significant improvements in the functioning of their securities markets. In addition, the Czech Republic has strengthened its bankruptcy laws and, to a lesser extent, their judicial administrations, while Slovenia has further aligned its competition law with that of the EU. Among the less advanced transition economies, recent improvements in institutional performance have been sparser. In 1999-2000, Bulgaria has upgraded its banking laws and strengthened practices for resolving bank failures. As shown by Table 1, it nevertheless stays behind, together with Romania, in terms of the reliability of its securities markets and non-bank financial institutions, while Hungary and Poland are the front runners.

Accelerating the slow pace of institutional change in the less advanced transition economies is perhaps the most pressing challenge in the second decade of transition. This remains a significant challenge despite considerable efforts by multilateral and bilateral donors to assist in the modernisation of laws and regulations by following a standard or benchmark of an industrialised market economy. However, as shown by recent research on the reform of company and securities laws and of competition policy, as well as by the EBRD’s survey of legal practitioners (see Annex 1), the problem lies not with the extensiveness of new laws and regulations but rather with weaknesses in their application and enforcement (effectiveness).

Developing the capacity to apply and enforce new laws and regulations inevitably takes time. The government needs to gain command over the necessary resources, and judges, regulators and other bureaucrats must learn new skills and practices. The capacity of the state in transition economies to adapt has differed dramatically across the region, broadly in line with differences in the overall level of economic development and the flexibility of the existing state bureaucracy. Attempting to achieve rapid legislative changes in this context may sometimes have been
counterproductive, as it reduces the opportunity for local judges and lawyers to participate in adapting new laws to local traditions and conditions.
II. Factors explaining discrepancies in transition indicators and lessons about the transition process.

On the basis of the wider sample of countries for which it has measured transition indicators, the EBRD has tried to determine the factors that could explain discrepancies in the progress achieved by individual countries in their transition process. These factors are presented in Table 4. They may also throw some light on the reasons for discrepancies in achieving the economic sub-criteria of Copenhagen. Developments in reform reflect indeed a number of key driving forces: the extent of political and economic competition, the initial political conditions and the extent of turnover in the political elites, and the economic and social conditions at the start of transition. In particular, these initial conditions largely determined the distribution of benefits and costs of initial reforms among various groups in society as well as the resulting distribution of economic and political power.

Economic and political competition

One of the most important findings of the EBRD is that economic and political competition determines the extent to which broad groups emerge that would benefit from the development of market-supporting institutions and thus could provide a constituency for market-based reforms. Political competition also determines to what extent the political process is responsive to these groups as opposed to the demands of narrow vested interests. At the same time, it must be recognised that the process of creating institutions that support markets and private enterprises is an evolutionary process since the institutions need to become widely accepted in society in order to shape economic practices.

The EBRD stresses that, with the simultaneous transformation of both economic and political systems, there was the potential for widely differing transition patterns to emerge. The extent of the redistribution of state-owned assets, and thus of economic power in the transition economies has been unprecedented, while the post-communist states overseeing the redistribution have often been weak. The rewards for individuals, firms and lobby groups that have managed to gain undue influence over the state have therefore been extremely high. Because markets and states are being built simultaneously, moreover, there have been fewer constraints on key decision-makers in government than are typically found in market economies at a comparable level of development. In a number of transition countries, political parties, trade unions and lobbies do not effectively represent collective interests. As a result, demands for political action have not generally been filtered through civic organisations with broad mandates. Instead, individuals and firms have often lobbied and “captured” the state directly to serve their own interests.²

Table 4 suggests indeed a correlation between a low overall indicator of institutional performance (which is the case in Latvia, Bulgaria and Romania), high levels of state capture and fewer years of cumulative democracy and liberalisation. Conversely, Hungary, which has the best indicator of institutional performance, has the lowest

²For evidence and analysis of state capture in transition economies, see Chapter 6 of Transition Report 1999, Hellman and Schankerman (2000), and Hellman, Kaufman and Jones (2000).
Table 4    Transition Paths and Their Determinants

<table>
<thead>
<tr>
<th>Country</th>
<th>Institutional Performance</th>
<th>Initial Conditions Index</th>
<th>Initial Government Turnover</th>
<th>Cumulative Liberalisation</th>
<th>Cumulative Democracy</th>
<th>State Capture Index</th>
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<td>11.0</td>
<td>11.0</td>
</tr>
<tr>
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<td>3.1</td>
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<td>7.0</td>
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<td>10.0</td>
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</tr>
<tr>
<td>Romania</td>
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<td>1.7</td>
<td>N</td>
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<td>8.0</td>
<td>21.0</td>
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</table>

Note: Institutional performance is the unweighted average of transition indicators in 2000 for banking sector, non-banking financial institutions, competition policy, and enterprise reform and corporate governance.

The index of initial conditions is derived from factor analysis and represents a weighted average of measures for the level of development, trade dependence on CMEA, macroeconomic disequilibria, distance to the EU, natural resource endowments, market memory, and state capacity. The index was inverted for the purpose of this table so that higher values of the index relate to more favourable starting positions. See Transition Report 1999, Chapter 2 for further details.

Initial government turnover indicates those countries which had a change in political leadership in the first post-communist government (Y) and those with no change in political leadership (N).

Cumulative liberalisation denotes the number of years in which a country has achieved a score or at least 3 – on price liberalisation and at least 4 – on trade and foreign exchange liberalisation.

Cumulative democracy denote the number of years in which executives and legislators have been freely and fairly elected.

The state capture index is taken from Hellman et al. (2000). It measures the extent to which businesses have been affected by the state of government decisions and policies to private interests. A higher value indicates more “capture”. It is based on the Business Environment and Enterprise Performance Survey implemented in 1999 by the EBRD in collaboration with the World Bank.
(Table 4) 
index of state capture and the longest record of cumulative liberalisation and democracy.

Sustained progress in transition requires indeed institutions and processes that can curb the influence of narrow vested interests. According to the EBRD, two such processes are economic and political competition:

- Economic competition requires indeed sustained liberalisation of markets and trade. It can serve to reduce the economic power of those that have benefited heavily from haphazard liberalisation and from give-away privatisations – be they incumbent “red barons” or “nouveaux riches” oligarchs. Economic competitions can also serve to strengthen the focus of enterprises on earning profits through productive activities in the market place. However, competition only works if uncompetitive firms receive no hand-outs from the state, such as direct subsidies, toleration of tax arrears, cheap bank loans and non-payment of infrastructure tariffs.

- A strong complement to economic competition is, therefore, political competition. Political competition in the form of sustained democratic elections, supported by basic civic liberties and organisations can encourage political decision-makers to focus on the majority of the electorate rather than narrow vested interests. Periodic changes in government can make it more difficult for vested interests to exert undue influence over policy. The threat of a change in power can also deter governments from providing special privileges to narrow interest groups, which could provoke a backlash from the electorate.

Initial political conditions and turnover of political elites.

The EBRD observes that, while political competition can prompt economic policymakers to serve the broader needs of society rather than the interests of a few, the strength of this competition is determined by the political process in each country and the initial political conditions following the end of communist regimes. Although the collapse of communism is usually associated with revolutions in central and eastern Europe, many subsequent governments, particularly South Eastern Europe (and also in the CIS), were led by the same political elites that had ruled under communism. Many of these politicians from the ruling communist parties preferred the status quo, believing that economic and political reforms would undermine their interests. In contrast, new political leaders and the new elite that supported them often had a greater incentive to introduce reforms. In particular, new governments used economic liberalisation and democratic reforms to limit the power of government bureaucrats and enterprise managers and to prevent the re-emergence of a political monopoly.

The EBRD demonstrates that there is, in fact, a significant relationship between the extent to which economic liberalism and democracy have been sustained in the

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4Other factors that can influence reform decisions and their implementation include social cohesion and culture. See Chapter 5 of Transition Report 1999.
transition and the turnover of political elites at the start of economic and political reform. 5

Initial economic and social conditions

Last but not least, the EBRD recognises the importance of the initial economic conditions to explain discrepancies in the transition process. The reasoning is as follows: while the extension of economic and political freedoms at the start of transition served to weaken the opponents of change, the reforms also imposed significant costs on the electorate; the extent of these costs was largely related to the economic and social conditions that prevailed at the start of transition; these initial conditions include the initial level of development (GDP per capita), geographical location (proximity to the EU), distortions in the allocation of employment, extent of macroeconomic imbalances and length of time under central planning.

In general, the more challenging the initial conditions in terms of inherited economic distortions and imbalances, the larger are the costs of adapting to market forces, which can in turn increase the social costs of change for citizens and make reforms more difficult to sustain politically. These initial conditions also encompass the potential economic benefits of geographical location and the country’s norms and values. They can have considerable influence on economic behaviour and, therefore, affect how individuals respond to new economic incentives and institutions. In Table 4, the Czech Republic, followed by Hungary ad Slovenia, is shown to have benefited from the most favourable initial conditions, while the worst conditions were found in the three Baltic states.

It is apparent from the analysis made by the EBRD 6 that more advanced transition economies have benefited from better initial conditions, have been able to sustain liberalisation and democratic electoral systems longer and have lower levels of state capture. For less advanced countries there is more variation across these dimensions, but by and large the foundations for sustained progress in transition are considerably weaker – particularly in South Eastern Europe and in the CIS. This analysis highlights the key challenges for sustaining and accelerating progress in reform in the second decade of transition.

5See Chart 2.3 in the ERBD Transition Report 2000
6See ERBD Transition Report Charts 2.4a and b.
III. Institutional Performance in transition – what have we learned?

Since many of the remaining challenges of transition involve strengthening the performance of market-supporting institutions, it is important to identify factors that have contributed to the progress that has been achieved so far.

Differences in the pace and quality of institutional reform across the region can be traced back to the fundamental forces that influence progress in transition, in particular economic and political competition and the extent to which they have been complemented by privatisation and international integration. Institutional reforms arise from the needs of market participants expressed through the political system and the incentives and capacity of governments to respond. In the context of transition, demands for institutions that support markets and private enterprise have come from individuals who participate in a private market economy. Liberalisation and privatisation, therefore, are instrumental in strengthening the demand for institutional change. Whether market demands translate into institutional change depends on the responsiveness of the state and, therefore, on the nature of the political system. Initial conditions in the form of existing formal and informal institutions as well as external factors can also influence how the governing elite implements institutional reforms.

This analysis suggests that the concept of demand of, and supply of institutions provides a useful framework for the analysis of institutional change and performance in transition. However, in applying this framework, demand and supply need to be seen as dynamic forces. In an evolutionary view of institutional development, it is the interaction of demand and supply factors over time that determines innovation in institutions.

Specifically, the demand for institutions that support markets and private enterprise is likely to increase in line with the length of time that a basic private market economy has functioned. As progress is made in liberalisation of markets and trade and in privatisation of enterprises, new interest groups emerge, which demand the consolidation of markets and supporting institutions. However, the formation of these interest groups, including the emergence of a strong civil society, takes time, partly because of the need to gain experience of a private market economy and of the incentives for individuals with a shared interest to free ride on the efforts of others. While these new interest groups form and gain influence, aspects of the previous regime are likely to persist, such as soft budget constraints for favoured enterprises, barter and bureaucratic corruption, slowing down the transition process and undermining the positive outcomes expected from liberalisation and privatisation. The development of institutions needed to support markets and private enterprise is therefore likely to be slow. These considerations suggest that there is a clear link across the region between the number of years a country has achieved comprehensive liberalisation and small-scale privatisation and the level of institutional performance and also that institutional performance is negatively related with indices of “state capture” and corruption.

Increased trade and foreign direct investment (FDI) are, moreover, likely to intensify competitive pressures on local producers and thereby strengthen their demand for
efficient institutions that can help to reduce their production and transactions costs. In addition, this contact with the outside world helps to expand local knowledge of institutional arrangements and practices in other countries, in particular those of the EU. This knowledge can help to shape the demands for new market-supporting institutions in transition economies. In addition, trade and FDI tend to lead to the introduction of new production technologies. The share of trade with non-transition economies and the number of years that a country has fulfilled the requirements of WTO membership or the IMF's Article VIII (on current account convertibility) are useful indications of the extent and depth of external contact.

The supply of institutions is influenced by the responsiveness of the state to the demands of interest groups and by its command over resources. How a government chooses to allocate resources depends on its responsiveness to interest groups and on how the ruling elite is likely to benefit. Central to persuading the ruling elite in the transition economies to commit to reform has been the transition to democracy and pluralism, in which the interests of workers, investors, pensioners, environmentalists and others gain a meaningful vote and a voice. However, the simultaneous political and economic transition has also seen the emergence of powerful vested interests that have exercised undue influence over political decision-making.

Finally, the capacity of governments in transition economies to provide essential public goods, such as market-supporting institutions, has differed widely in line with variations in government revenues. The sharp falls in output as well as difficulties in shifting the burden of taxation towards indirect taxes and consumption and away from corporate turnover and profits have severely reduced governments' revenue-raising capacities.

Although there are significant links between institutional performance and economic and political competition, this finding does not mean that policy should focus only on economic liberalisation and political rights. Rather, the association underscores the importance of creating conditions under which economic and political competition can be sustained over time. The experience of transition has shown that economic liberalisation is difficult to sustain unless there are hard budget constraints on enterprises and banks. This financial discipline can often be achieved only through comprehensive privatisation. International integration can intensify competitive pressures and help domestic producers respond to them by promoting the introduction of technology, skills and practices that are appropriate to a market economy. Fiscal reforms are needed for the government to gain command over the resources that are necessary for the effective provision of public goods, such as a well-functioning judiciary and public administration, and for basic social protection, including education, health care and assistance for the unemployed.
CONCLUSIONS

One of the key criteria set up by the EU Member States in 1993 for the accession to the EU of candidate countries from Central and Eastern Europe is the existence of a viable market economy and the capacity to withstand competitive pressure and market forces within the Union.

The transition assessments conducted by the EBRD in its countries of operations, including the ten Central and Eastern European countries candidates for EU accession, provide probably the most sophisticated measurement of the progress achieved by these countries in meeting this economic criterion.

The transition indicators published by the EBRD suggest that significant differences exist among the candidate countries in some key areas of the transition process, relating, among others, to large scale privatisation, enterprise governance and restructuring, price and trade liberalisation, competition policy, banking reform, securities markets and non-bank financial institutions.

Furthermore the approaches followed in the privatisation process have been showed to be of crucial importance for the subsequent governance and economic performance of enterprises.

The EBRD analysis concurs with the finding of the European Commission on the emphasis to be placed on the development of the institutions supporting markets and private enterprises. Accelerating the slow pace of institutional change in the less advanced candidate countries such as Bulgaria and Romania is perhaps the most pressing challenge in the second decade of transition. In this connection, there is no doubt that the third Copenhagen criterion, requiring candidate countries not only to transpose in their legislation the "acquis communautaire" but also to develop an effective implementation capacity in their administrative and judiciary systems, constitutes a very powerful incentive for these countries to sustain their institution building efforts.

The EBRD analysis provides also very interesting conclusions about the factors explaining discrepancies in transition indicators. The key driving forces are shown to be economic and political competition, the initial political conditions and the turnover of the political elites as well as the initial social and economic conditions, which largely determined the distribution of benefits and costs of initial reforms among various groups in society. Geographical proximity to the EU appears to be a factor.

More generally, the wider comparison involving the other transition countries shows very clearly that the prospect of EU accession has provided an anchor for transition efforts, increasing the benefits to be obtained through reforms and reducing the pain caused by these efforts thanks to the EU pre-accession programs.

The final section of this report (complemented by the findings in the three annexes) reinforces the general message of this paper that the key for both transition and EU accession is "institutional performance", which in turn should be seen in the context
of the dynamic forces of demand and supply of market friendly institutions. Factors reinforcing the demand for such institutions are again economic and political competition, early and sustained liberalisation, small scale privatisation, integration in world trade, increased foreign direct investment and the emergence of a strong civil society. On the other hand, factors reinforcing the supply of institutions that support the market and private enterprise are the capacity of governments to free themselves from the excessive influence of vested interests as well as the availability of adequate budgetary resources.

Support to these countries in building modern and market friendly tax and social security systems is therefore crucial. Indeed the cost of legal reforms and institution building will be compounded in the accession countries by the cost of upgrading the infrastructure (particularly roads and railways) and of complying with the EU environmental standards, while the worsening demographic profile will be another challenge. Innovative formulas, such as public-private partnerships will need to be found to finance this transition and accession related financing gap. Foreign direct investment will have to play a key role. Support by international financial institutions and by the European Union must match the courageous efforts of the Central and Eastern European countries in achieving the institutional and other transformations that will pave the way simultaneously for their successful transition and for their EU accession.
References


European Bank for Reconstruction and Development (EBRD), Transition Reports, annual editions from 1994 to 2000.


Annex 1. Legal transition indicators.

This is the sixth year that the EBRD has conducted a survey of the views of local lawyers in its countries of operations. Through the Legal Indicator Survey (LIS), the EBRD Office of the General Counsel has developed measures to assess both the extent to which key commercial and financial laws approximate internationally acceptable standards (extensiveness) and the degree to which these laws are implemented or enforced (effectiveness). The survey also provides a basis for analysing the role of legal reform in promoting investment and growth in the region.

The results of the 2000 LIS reflect how lawyers and other experts familiar with the EBRD's countries of operations perceive the state of legal reform in mid-2000. These perceptions do not always correspond directly with the written legislation or regulations that exist in the various jurisdictions. The LIS indicates how lawyers subjectively view and understand legal transition in the region. Table 5 provides an assessment of commercial laws, including pledge, bankruptcy and company law. Table 6 provides an assessment of banking and capital market laws.

The LIS results presented in Tables 5 and 6 for the ten EU accession countries assess perceptions of legal reform based on two criteria: the extensiveness and effectiveness of legal reform. For commercial law, extensiveness was measured based on the impact of a jurisdiction's pledge, bankruptcy and company law on commercial transactions, such as secured lending project finance, debt restructuring and the formation of joint-stock companies. For financial markets, extensiveness was assessed on the basis of whether banking and capital markets' legal rules approach minimum international standards, such as the Basle Committee on Banking Supervision's Core Principles or the Objectives and Principles of Securities Regulation developed by the International Organisation of Securities Commission (IOSCO). Effectiveness of legal reform measures the extent to which commercial and financial legal rules are clear, accessible and adequately implemented, both administratively and judicially.

Extensiveness scores must be read in conjunction with effectiveness scores to reach a more complete understanding of how commercial legal reform is progressing in any jurisdiction. Large gaps between extensiveness and effectiveness scores (those greater than 20 points on a scale of 100) were taken into consideration in assessing the final indicators.

The legal indicators reported in both tables reflect subjective assessments of respondents to the survey as well as the views of EBRD lawyers with experience in working on commercial and financial market transactions in the region. For a few countries the LIS respondents provided significantly differing assessments. Where there were large discrepancies, the EBRD's in-house knowledge of that country's conditions was utilised to arbitrate among the differing views. Accordingly, while the purpose of the LIS and the resulting analysis is to provide an impression of how local lawyers perceive the quality of laws and how well these laws work in practice, some caution must be exercised in interpreting the results.

(Table 5)
(Classification system for legal transition indicators: commercial law)
<table>
<thead>
<tr>
<th>Country</th>
<th>2000 Overall</th>
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<th>Effectiveness</th>
<th>1999 Overall</th>
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Source: EBRD Transition Report 2000
Classification system for legal transition indicators: commercial law

Extensiveness

1. Legal rules concerning pledge, bankruptcy and company law are perceived as very limited in scope. Laws appear to impose substantial constraints on the creation, registration and enforcement of security over movable assets, and may impose significant notarisation fees on the pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Bankruptcy laws are perceived as unable to 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 are perceived to contain ambiguities or inconsistencies.

2. Legal rules concerning pledge, bankruptcy and company law are limited in scope and are subject to conflicting interpretations. Legislation may have been amended but new laws do not appear to 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 may not ensure adequate corporate governance or protect shareholders' rights. Laws appear to contain inconsistencies or ambiguities concerning, among other things, the scope of reorganisation proceedings and/or the priority of secured creditors in bankruptcy.

3. New or amended legislation has recently been enacted (i.e., within the past five years) in at least two of the three areas that were the focus of the LIS - pledge, bankruptcy or company law - but could benefit from further refinement and clarification. Legal rules appear to permit a non-possessorial pledge over most types of movable assets. However, the mechanisms for registration of the security interest are still rudimentary and appear not to provide parties with adequate protection. There is scope for enforcement of pledges without court assistance. Company laws appear to 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 above 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 is allow parties to take non-possessorial pledges in a wide variety of movable property and contains mechanisms for enforcement of pledges without court assistance. The legal infrastructure, however, 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 appear to be clearly defined. Bankruptcy law appears to include 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 are perceived as closely approaching those of more developed countries. These legal systems appear to have a uniform (that is, centralised registration) system for the taking and enforcement of a security interest in movable assets and also provide for adequate corporate governance and protect shareholders' rights. In particular, the rights of minority shareholders are appear to be protected in the event of the acquisition by third parties of less than all of the shares of a widely held company. Bankruptcy law seems to provide in a comprehensive manner for both reorganisation and liquidation. Liquidators appear to possess a wide variety of powers and duties to
deal with the property and affairs of a bankrupt, including wide powers of investigation of pre-bankruptcy transactions carried out by the debtor. There are specialised courts that handle bankruptcy proceedings. Liquidators are required to possess certain minimum qualifications.

**Effectiveness**

1. Commercial legal rules are usually very unclear and sometimes contradictory. The administration and judicial support for the law is perceived as rudimentary. The cost of transactions, such as creating a pledge over a movable asset, is prohibitive so as to render a potentially extensive law ineffective. There appear to be no meaningful procedures in place in order to make commercial laws operational and enforceable. There also appear to be 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 appears to be often inadequate or inconsistent, creating a degree of uncertainty (for example, substantial discretion in the administration of laws and few up-to-date registries for pledges).

4. Commercial laws are 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 perceived as clear and readily ascertained. Commercial law appears to be 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 in the third column of the table is the average of the scores given for the two indicators rounded down. A "+" after a number is used to indicate countries that have just made it to the highest tier of one category and are within a few points of reaching the next category in the scale. A "-" indicates countries that are at the bottom of a category where a significant improvement is required for that jurisdiction to fall more comfortably within the middle range for that category.
All EU accession countries, with the exception of the Czech and Slovak Republics and of Romania, have achieved a rating of 4 for the extensiveness of their commercial laws. In categories such as pledge law and capital markets, scores achieved by the majority of countries are quite high. By contrast, effectiveness scores are lower for most countries. Because extensiveness scores are rising, the relationship between extensiveness and the effectiveness scores has become increasingly important as a measure of how successfully countries are implementing legal reforms and, in the case of the EU accession countries, how successful they are in reinforcing their administrative and judicial capacity to apply the "acquis communautaire".

The LIS also includes questions about general legal effectiveness in each country. These questions are related to the effectiveness of the legislative system (i.e., whether laws are made available to the public, and how transparent the legislative process is) and the courts as well as to the overall perception of how far the rule of law is entrenched and respected. Most transition countries studied by the EBRD scored within a narrow range of between 40 and 60 (on a scale of 100) on this dimension. While this indicates that general legal effectiveness is not as poor as the implementation of specific laws, a great deal of room for improvement remains.

Hungary and Slovenia are noteworthy as jurisdictions where perceptions of commercial and financial markets legal reform remain consistently high. In contrast, other countries have experienced declines in their effectiveness scores despite having relatively robust legal frameworks. For example, Poland and the Czech Republic, accession countries that have previously received strong scores in commercial law, experienced significant declines in effectiveness in 1999, which lowered their overall scores. In 2000, however, both of these countries have made somewhat of a comeback with an increase in their effectiveness indicators.

The EBRD reports that extensiveness scores for commercial law continue to increase for the majority of Survey countries in 1999-2000. Countries have received the strongest overall scores in pledge law, with company law a close second. Many jurisdictions, for example, have amended their collateral laws to allow parties to take non-possessory pledges in movable property.

Commercial law effectiveness scores remain relatively low in contrast with extensiveness scores, particularly for bankruptcy and pledge laws. By contrast, effectiveness scores for company law appear more robust. In many cases, company law reform occurred at a much earlier phase in a country's transition process so that courts and other institutions have had time to implement the law more effectively.

Shifting scores and an aggregate decline in legal indicators may reflect the greater degree of familiarity that lawyers now have in these jurisdictions with commercial laws. With greater use, the blemishes and shortcomings inherent in any legislation become apparent and respondents may become more critical. In addition, as legal and economic transition progresses, respondents may have heightened standards with respect to the implementation of legal reform.

In contrast to 1999, there was a marked increase in bankruptcy-related legal reform in 2000. Countries are amending their legislation, often enacted in the early to mid 1990s, in an effort to improve the implementation of the law and to encourage greater
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Source: EBRD Transition Report 2000
Classification system for legal transition indicators: financial regulations

Extensiveness

1 Legal rules concerning banking and securities regulation perceived as very limited in scope. For example, capital adequacy standards and restrictions on affiliated lending in banking appear to be non-existent. There may be no functioning stock exchange in this jurisdiction, or the capital markets’ legal infrastructure may be in its earliest stage of development.

2 Legal rules governing financial markets are perceived as somewhat limited in scope. Although regulations in banking may have been amended to accord with core principles, at least one important area of regulation is deficient – for example, capital adequacy, use of international accounting standards or use of consolidated comprehensive supervision. Oversight of securities markets appears limited and regulation of securities intermediaries and investment funds, for example, are either non-existent or rudimentary.

3 Legislation for financial markets is perceived as reasonably comprehensive but could benefit from further refinement in some areas. Banking regulations appear generally to conform with the Basle Committee’s Core Principles, although regulations concerning bank insolvency and deposit protection may not have been adopted. Further refinement to the regulation of securities intermediaries and/or investment funds and the creation of shareholder depositaries and registers seems to be needed to achieve conformity with minimum international standards.

4 Comprehensive financial market legislation is perceived as conforming generally with minimum international standards. However, refinement appears to be needed in at least one important area of either banking or securities regulation. For example, many jurisdictions in this category may need to enact rules concerning money laundering or bank insolvency. Legislation concerning shareholder depositaries and registries seems to be in its early stages of implementation.

4+ Banking and capital markets legislation and regulation are perceived as comprehensive and in conformity with minimum international standards.

Effectiveness

1 Legal rules governing financial markets are perceived as usually very unclear and often contradictory. The regulatory support of the laws is rudimentary. Supervisory mechanisms seem to be either non-existent or poor. There appear to be no meaningful procedures to make financial laws fully operational.

2 Legal rules are perceived as somewhat unclear and sometimes contradictory. Supervision of financial institutions appears to exist only on an ad hoc basis. There appear to be few, if any, meaningful procedures in place to enforce the law. There may be a lack of adequately trained staff in either banking or capital markets regulatory authorities.

3 Although legal rules governing financial markets are perceived as reasonably clear, regulatory and supervisory support of the law may be inconsistent, creating a degree of uncertainty. Although the regulator may have engaged in corrective actions against failing banks and securities market practices, enforcement problems appear still to exist.

4 Legal rules governing financial markets are perceived as readily ascertainable. Banking and securities laws appear to be well-supported administratively and judicially, particularly regarding the efficient functioning of enforcement measures against failing institutions and illegal market practices. For example, the regulator has taken corrective action to liquidate failing banks. Enforcement actions against individuals and securities intermediaries are evident, but might still benefit from more systematic and rigorous enforcement. Courts seem to have adequate authority to
review enforcement decisions or other corrective actions for banks and/or securities firms.

4+ Regulators appear to possess comprehensive enforcement powers and exercise authority to take corrective action on a regular basis. Examination of securities intermediaries and licensing of intermediaries seems to be frequent, as is the use of corrective action, such as prosecution for insider dealing, revocation of bank licences, and liquidation of insolvent banks.

Overall score: The overall score in the third column of the table is the average of the scores given for the two indicators rounded down. A “+” after a number is used to indicate countries that have just made it to the highest tier of one category and are within a few points of reaching the next category in the scale. A “-“ indicates countries that are at the bottom of a category where a significant improvement is required for that jurisdiction to fall more comfortably within the middle range for that category.
(Table 6)
(Classification system for legal transition indicators: financial regulations)

use of bankruptcy procedures. Amendments often refine and clarify issues such as the nature of a bankruptcy trustee’s powers and the authority and role of the judiciary in bankruptcy proceedings.

Romania modified its bankruptcy law in the second half of 1999. Under the amendments, many of the duties previously held by judges have been shifted to the bankruptcy administrator, thus clarifying the division of labour. Despite these recent amendments, Romania only received an average score for the extensiveness and effectiveness of its bankruptcy law. Possibly, practitioners have yet to become well acquainted with the new law and have not had significant experience in utilising the legislation.

In the first half of 2000, the Czech Republic amended its bankruptcy law partly in response to pressure from the EU. Since 1991, there have been more than ten amendments to the law. The frequent amendments have created a perception that the bankruptcy law is ineffective. Delays in bankruptcy proceedings are a persistent problem in the Czech Republic. Some commentators have also noted that under the current law company management is able to strip a debtor of its assets during the lengthy period between the filing of a petition for bankruptcy and the time when the court declares a company officially bankrupt. The Czech amendments reduce that period to ten days.

The Slovak bankruptcy law has similarly needed revision. Revisions adopted in 2000 provide for the replacement of management and prevent the transfer of capital out of an insolvent enterprise without the bankruptcy administrators’ approval. The amendments also provide a reorganisation procedure as an alternative to liquidation.

Pledge law is the area where there has been significant legislative reform in the majority of countries. This corresponds to the stronger extensiveness score received by the majority of LIS countries surveyed. Bulgaria, Latvia, Romania, Poland and Romania received high effectiveness scores for their pledge laws. Except for Romania, each of these jurisdictions has a centralised registration system for non-possessory pledges in movable property.

Despite the enactment of extensive legal frameworks for pledges in movable property in the past few years, the implementation phase is still very much in progress with a number of countries such as Romania, establishing centralised and computerised registration systems. Interestingly, Hungary, which has established centralised pledge registries, has received relatively low scores for pledge effectiveness. For this country, lower effectiveness may reflect raised expectations by registry users and problems in the use of the newly established registries.

In the Czech Republic, new legislation went into effect in 2000 governing the sale of property through public auctions. The legislation transfers the ability to initiate auctions from the courts to private persons. This will allow pledge-burdened banks to auction off property rather than filing a lawsuit or securing the permission of the debtor. However, even with this reform, it remains virtually impossible for creditors to take non-possessory pledges in movable property.
While LIS company law indicators continued to improve in 2000, a large implementation gap remains. The area where respondents seem to perceive the largest effectiveness problem is in the implementation of shareholder rights with respect to the ability to introduce resolutions at an annual meeting, to solicit votes by proxy and to successfully challenge the actions of management through shareholder litigation in the courts. The effectiveness problems generally correlate with the areas in which governments are revising their existing company legislation. A number of jurisdictions have enacted amendments aimed at improving minority shareholder rights and more clearly defining the way in which a company may increase or decrease its basic share capital.

Latvia’s extensiveness score for commercial law has increased in 2000. This likely reflects amendments to Latvia's Law on Joint Stock Companies to provide greater protections for minority shareholders, including new limits on increases in equity capital, changes in the rights of the general meeting of shareholders, and a change in the minimum number of supervisory board members. Lithuania’s company law scores also increased significantly in 2000 in response to amendments made to its company law that tighten rules on related party transactions.

Financial markets indicators, overall, were much higher than those in the commercial law portion of the LIS. To some extent, this may reflect actions on the part of government and financial regulators to move their legislation into conformity with international standards. Additionally, the benchmarks for legislative and other harmonisation with international standards may be clearer in financial markets as compared with commercial law. For both banking and capital markets, principles have been established by international organisations and agreed to by a wide group of nations. Both the Basle Core Principles and the IOSCO Principles of Effective Securities Regulation are examples of measurement tools to which countries can adapt their legislation. Because there is greater consensus about what constitutes effective regulation in financial markets, the perception of LIS respondents tends to vary less as well.

Accession countries have continued to harmonise their financial service legislation with relevant EU directives in order to provide for greater disclosure and transparency in capital markets and to provide for bank depositor protection in the area of banking. These countries topped the charts for extensiveness in the financial markets survey. Of the accession countries, Hungary, Lithuania, Poland and Slovenia also had high effectiveness scores.

There has also been a greater emphasis on consolidated supervision across the financial sector through the formation of "super regulators", which supervise banking, capital markets and insurance sectors. In 2000, Hungary, Latvia and the Slovak Republic enacted legislation that will create these consolidated super regulators.

Capital markets indicators for extensiveness continued to improve in 2000 with a large number of countries receiving high scores, including the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Slovenia. Progress in this area is clearly linked to the EU and the World Trade Organisation (WTO) accession
processes, both of which impose requirements on states with respect to trade in financial services. However, despite these high extensiveness scores, most of these countries still show a marked implementation gap. Effective implementation and enforcement of capital markets laws remains a problem throughout the region, possibly due to the need to create independent capital market regulators.

Lithuania’s scores have increased dramatically in 2000, corresponding to a wave of reform in the capital markets sector. The Lithuanian Securities Commission approved the Rules of Secondary Trading Outside of the Stock Exchange, which regulate securities transactions conducted outside the stock exchange and establish procedures for dissemination of information on these transactions. Lithuania also enacted a new Law on Investment Companies, which will make it easier for such companies to be established.

The Czech Republic’s indicators improved in 2000 in response to Czech efforts to address shortcomings in its capital market regulations. In an effort to improve disclosure on the market, the Prague Stock Exchange tightened its listing rules in the second half of 1999 to require companies to make public information on their subsidiaries, the volume of outstanding loans, the names of creditors and significant changes to management and boards of directors. Listed companies also must report any change in their financial situation that might affect the price of their securities.

Although banking indicators are not as high as those for capital markets, there is less of an implementation gap in the banking scores. According to Survey respondents, banking supervision has been moderately effective throughout the region. This perception may reflect the fact that in many jurisdictions (for example, in the Baltic States and SEE), bank failures have forced regulators to take a more active role in banking supervision and oversight.

The Czech Republic has received lower effectiveness scores in the banking sector than many of its accession counterparts. Czech banks have been criticised for poor corporate governance and the EU has criticised the Czech Government for problems in implementing prudential regulation.
Annex 2. Infrastructure transition indicators.

The transformation of infrastructure services to meet the requirements of a market economy is central to the transition process.

The infrastructure indicators measured by the EBRD focus on three broad areas of reform: tariff reform, commercialisation of infrastructure enterprises, and regulatory and institutional development. Indicators are defined on a scale of 1 to 4+, with specific criteria for scoring in each sector. The rating scales for each sector are based on sector-specific transition challenges and corresponding paths of reform. Each path is broadly defined to encompass alternative reform models that might be appropriate in different contexts, although the criteria do include judgements about the order of reforms.

For example, power sector reform indicators give equal value to competition based on a pool or third-party network access. In either case, market liberalisation will be difficult to implement if electricity tariffs are not first re-balanced to eliminate cross subsidies. In the municipal sector, asset divestment and franchising are given equal value. However, privatisation is regarded as more likely to succeed if it occurs after tariffs have been raised towards the level of long-term costs.

Table 7 presents the infrastructure indicators for 2000. Progress in infrastructure reform has continued to advance in 1999-2000. Most of the progress was concentrated in the advanced countries of Central Europe, where the prospect of EU accession, the need for securing private finance and the raising of receipts through asset sales (particularly in the power and telecommunications sectors) continued to propel reforms. In Poland a new railway law envisages labour restructuring, the unbundling of the railway into separate freight, passenger and infrastructure companies and privatisation. Initial business plans were developed in the Slovak Republic.

The principle of public service obligation (PSO), moreover, is slowly gaining acceptance throughout the region. Under this principle, the state agrees to provide financing for those non-commercial services that the railways are asked to provide for social or other reasons (for example, rural passenger services). PSO introduces transparency into the financial accounts of the railways and increases awareness in government of the cost imposed by loss-making services.

In the electric power sector, private sector participation continued to expand with further asset sales in Estonia. Building on new legislation, Bulgaria and Romania have established independent regulators and have begun to draft secondary legislation (tariff rules, grid codes etc.). However, the independence of the regulators in setting tariffs for privatised companies remains to be tested. Industry restructuring is moving ahead in these three countries, and privatisation of power distribution is expected later in 2000 or in 2001. New legislation has also been passed in Lithuania, and a privatisation adviser has been appointed.

Power industry privatisation is high on the reform agenda in the Slovak Republic, which has hired privatisation advisers, but the enabling legislation and implementation plans remain undeveloped.
The road sector has seen some developments over the past year in the area of road financing. In some transition economies it is not unusual to find road user charges based on taxes unrelated to road use, such as a company turnover tax. Such arrangements are inefficient in that the payments required from road users do not relate to the cost they impose on the road. Some EU accession countries still need to introduce vehicle taxation (for example, Estonia). Most still have to review their existing vehicle taxation to harmonise it with EU legislation, which is based on a combination of gross vehicle weight, axle loads and suspension systems.

Road funds continue to show mixed success. They can be found across the region – in Bulgaria, the Czech Republic, Latvia, Lithuania, Poland, Romania and the Slovak Republic. Most road funds serve primarily as a vehicle for collecting revenue from road user charges. However, many have suffered recent setbacks. Hungary recently abolished its Road Fund (road revenues far exceed spending, and there is political pressure to divert funds elsewhere).

In the water and waste-water sectors, there have not been major changes in rules and enforcement practice in most countries. In Bulgaria, however, the municipality of Sofia has chosen a comprehensive private sector solution by awarding in December 1999 a concession agreement to an international operator for the operation of the Sofia water and waste-water system. In Lithuania a new independent regulatory commission responsible for tariff calculation and increases was also established in December 1999.

Across all transition economies the telecommunications sector has been characterised by extensive reform and ongoing investment to upgrade and expand networks and to introduce new services (particularly in the segment of enhanced services, such as the Internet and data transmission services). In Poland a new telecommunications law was introduced in 2000, and TPSA (the dominant fixed-line operator) was partially privatised through an initial public offering.

(Table 7)
(Classification system for infrastructure indicators, 2000)
Table 7  Infrastructure Transition Indicators

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Source: EBRD Transition Report 2000
Telecommunications

1 Little progress has been achieved in commercialisation and regulation. There is a minimal degree of private sector involvement. Strong political interference takes place in management decisions. There is lack of cost effective tariff-setting principles, with extensive cross-subsidisation. Few other institutional reforms to encourage liberalisation are envisaged, even for mobile phones and value-added services.

2 Modest progress has been achieved in commercialisation. Corporatisation of the dominant operator has taken place and there is some separation of operation from public sector governance, but tariffs are still politically set.

3 Substantial progress has been achieved in commercialisation and regulation. There is full separation of telecommunications from postal services, with a reduction in the extent of cross-subsidisation. Some liberalisation has taken place in the mobile segment and in value-added services.

4 Complete commercialisation (including privatisation of the dominant operator) and comprehensive regulatory and institutional reforms have been achieved. There is extensive liberalisation of entry.

4+ Implementation of an effective regulation (including the operation of an independent regulator) has been achieved, with a coherent regulatory and institutional framework to deal with tariffs, interconnection rules, licensing, concession fees and spectrum allocation. There is a consumer ombudsman function.

Electronic power

1 The power sector as a government department. There is political interference in running the industry, with few commercial freedoms or pressures. Average prices are below costs, with external and implicit subsidy and cross-subsidy. Very little institutional reform has been achieved. There is a monolithic structure, with not separation of different parts of the business.

2 The power company is distanced from government. For example, it operates as a joint-stock company, but there is still political interference. There has been some attempt to harden budget constraints, but management incentives for efficient performance are weak. Some degree of subsidy and cross-subsidy exists. Little institutional reform has been achieved. There is a monolithic structure, with no separation of different parts of the business. Minimal, if any, private sector involvement has occurred.

3 A law has been passed providing for full-scale restructuring of the industry, including vertical unbundling through account separation and setting-up of a regulator. Some tariff reform and improvements in revenue collection have been achieved, and there is some private sector involvement.

4 A law for industry restructuring has been passed and complemented, with separation of the industry into generation, transmission and distribution. A regulator has been set up. Rules for cost-reflective tariff-setting have been formulated and implemented. Arrangements for network access (negotiated access, single buyer model) have been developed. There is substantial private sector involvement in distribution and/or generation.

4+ Business has been separated vertically into generation, transmission and distribution. An independent regulator has been set up, with full power to set cost-reflective tariffs. There is large-scale private sector involvement. Institutional development has taken place, covering arrangements for network access and full competition in generation.
**Railways**

1. Monolithic organisational structures still exist. State railways are still effectively operated as government departments. Few commercial freedoms exist to determine prices or investments. There is no private sector involvement. Cross-subsidisation of passenger service obligations with freight revenues is undertaken.

2. New laws distance rail operations from the state, but there are weak commercial objectives. There is no budgetary funding of public service obligations in place. Organisational structures are still overly based on geographic or functional areas. Ancillary businesses have been separated but there is little divestment. There has been minimal encouragement of private sector involvement. Initial business planning has been undertaken, but the targets are general and tentative.

3. New laws have been passed that restructure the railways and introduce commercial orientation. Freight and passenger services have been separated, and marketing groups have been grafted onto traditional structure. Some divestment of ancillary businesses has taken place. Some budgetary compensation is available for passenger services. Business plans have been designed with clear investment and rehabilitation targets, but funding is unsecured. There is some private sector involvement in rehabilitation and/or maintenance.

4. New laws have been passed to fully commercialise the railways. Separate internal profit centres have been created for passenger and freight (actual or imminent). Extensive market freedoms exist to set tariffs and investments. Medium-term business plans are under implementation. Ancillary industries have been divested. Policy has been developed to promote private rail transport operations.

4+ Railway law has been passed allowing for separation of infrastructure from operations, and/or freight from passenger operations, and/or private train operations. There is private sector participation in ancillary services and track maintenance. A rail regulator has been established. Access pricing has been implemented. Plans have been drawn up for a full divestment and transfer of asset ownership, including infrastructure and rolling stock.

**Roads**

1. There is a minimal degree of decentralisation, and no commercialisation has taken place. All regulatory, road management and resource allocation functions are centralised at ministerial level. New investments and road maintenance financing are dependent on central budget allocations. Road user charges are based on criteria other than relative costs imposed on the network and road use. Road construction and maintenance are undertaken by public construction units. There is no private sector participation. No public consultation or accountability take place in the preparation of road projects.

2. There is a moderate degree of decentralisation, and initial steps have been taken in commercialisation. A road/highways agency has been created. Initial steps have been undertaken in resource allocation and public procurement methods. Road user charges are based on vehicle and fuel taxes but are only indirectly related to road use. A road fund has been established but it is dependent on central budget allocations. Road construction and maintenance is undertaken primarily by corporatised public entities, with some private sector participation. There is minimal public consultation/participation and accountability in the preparation of road projects.

3. There is a fairly large degree of decentralisation and commercialisation. Regulation, resource allocation, and administrative functions have been clearly separated from maintenance and operations of the public road network. Road user charges are based on vehicle and fuel taxes and fairly directly related to road use. A law has been passed allowing for the provision and operation of public roads by private companies under negotiated commercial contracts. There is private sector participation either in
road maintenance works allocated via competitive tendering or through a concession to finance, operate and maintain at least a section of the highway network. There is limited public consultation/participation and accountability in the preparation of road projects.

4 There is a large degree of decentralisation of road administration, decision-making, resource allocation and management according to government responsibility and functional road classification. A transparent methodology is used to allocate road expenditures. A track record has been established in implementing competitive procurement rules for road design, construction, maintenance and operations. There is large-scale private sector participation in construction, operations and maintenance directly and through public-private partnership arrangements. There is substantial public consultation/participation and accountability in the preparation of road projects.

4+ A fully decentralised road administration has been established, with decision-making, resource allocation and management across road networks and different levels of government. Commercialised road maintenance operations are undertaken through open and competitive tendering by private construction companies. Legislation has been passed allowing for road user charges to fully reflect costs of road use and associated factors, such as congestion, accidents and pollution. There is widespread private sector participation in all aspects of road provision directly and through public-private partnership arrangements. Full public consultation is undertaken in the approval process for new road projects.

Water and waste water

1 There is a minimal degree of decentralisation, and no commercialisation has taken place. Water and wastewater services are operated as a vertically integrated natural monopoly by a government ministry through national or regional subsidiaries or by municipal departments. There is no, or little, financial autonomy and/or management capacity at municipal level. Heavily subsidised tariffs still exist, along with a high degree of cross-subsidisation. There is a low level of cash collection. Central or regional government controls tariffs and investment levels. No explicit rules exist in public documents regarding tariffs or quality of service. There is no, or insignificant, private sector participation.

2 There is a moderate degree of decentralisation, and initial steps have been taken in commercialisation. Water and wastewater services are provided by municipally owned companies, which operate as joint-stock companies. There is some degree of financial autonomy at the municipal level but heavy reliance on central government for grants and income transfers. Partial cost recovery is achieved through tariffs, and initial steps have been taken to reduce cross-subsidies. General public guidelines exist regarding tariff-setting and service quality but these are both still under ministerial control. There is some private sector participation through service or management contracts or competition to provide ancillary services.

3 A fairly large degree of decentralisation and commercialisation has taken place. Water and wastewater utilities operate with managerial and accounting independence from municipalities, using international accounting standards and management information systems. A Law of Municipal Finance has been approved. Cost recovery is fully operated through tariffs and there is a minimum level of cross-subsidies. A semi-autonomous regulatory agency has been established to advise on tariffs and service quality but without the power to set either. More detailed rules have been drawn up in contract documents, specifying tariff review formulae and performance standards. There is private sector participation through the full concession of a major service in at least one city.
A large degree of decentralisation and commercialisation has taken place. Water and wastewater utilities are managerially independent, with cash flows -- net of municipal budget transfers -- that ensure financial viability. A Municipal Finance Law has been implemented, providing municipalities with the opportunity to raise finance. Full cost recovery exists and there are no cross-subsidies. A semi-autonomous regulatory agency has the power to advise and enforce tariffs and service quality. There is substantial private sector participation through build-operate-transfer concessions, management contracts or asset sales to service parts of the network or entire networks. A concession of major services has taken place in a city other than the country's capital.

Water and wastewater utilities are fully decentralised and commercialised. Large municipalities enjoy financial autonomy and demonstrate the capability to raise finance. Full cost recovery has been achieved and there are no cross-subsidies. A fully autonomous regulator exists with complete authority to review and enforce tariff levels and performance quality standards. There is widespread private sector participation via service management/lease contracts, with high-powered performance incentives and/or full concessions and/or divestiture of water and wastewater services in major urban areas.
Annex 3. Environmental transition indicators

The transition countries cover a vast and diverse region with different geographical, environmental and socio-economic conditions. Environmental transition indicators have to take into account that these countries are moving towards market-based economies as well as trying to achieve sustainable development. They take into consideration, therefore, both economic efficiency and environmental sustainability, which are fully realised only when market, institutional and environmental reforms come together.

The assessment in this annex is based on a survey among environment ministries in the region. Following a similar analysis in 1997, the survey aimed to obtain information about the development of environmental policies, environmental liabilities, environmental regulations, institutional capacities and participation by civil society.

Pressure on the environment

The slump in economic activity in the early phases of transition led to a reduction in most environmental pressures. One of the few exceptions is municipal waste generation, where waste volumes remained constant, probably due to the early adoption of western consumer behaviour in urban areas and industrial reform. As domestic wealth increases, municipal waste management will become increasingly important. T For other sectors, the question is whether transition will result in sufficient efficiency gains to prevent economic growth leading to an adverse impact on the environment.

A definite answer is not yet possible. Nevertheless, initial data for advanced transition countries show that economic growth has intensified pressure on the environment in some respects, but not in others. The burning of fossil fuels for power generation in industries and in the domestic sector is the most significant cause of air pollution.

Transition economies still have exceptionally low levels of energy efficiency. In Central Europe and the Baltic countries and in SEE countries energy efficiency is still only half of the level in Western Europe, although it is improving. In CIS countries energy efficiency is over four times lower than the standard of Western Europe. However, in countries such as Poland and the Slovak Republic energy use has started to decrease owing to efficiency-enhancing restructuring, the shift from an industrial to a service-based economy, increased energy tariffs and more rigorous collection.

At the same time, the installation of modern pollution abatement technology, the switch to cleaner fuels and the replacement of old boilers have reduced emissions. The preparation for EU accession, and the adoption of EU environmental standards is also leading to additional investments in the environment. The overall result has been a noticeable reduction in air pollutants, such as SO₂. In other transition countries lower air emissions are mostly due to reduced economic activity.

Of course, the emission reductions already achieved may not be sufficient to ensure sustainable development, and they could be reversed. Growing wealth associated with the steady progress in transition will result in more consumption-related
environmental pressures. The increase in private car ownership in advanced countries is already putting renewed pressure on urban air quality, in particular NOx, and is aggravating traffic congestion. Car ownership (in terms of passenger cars per 1,000 people) in some transition countries, such as Slovenia (403), the Czech Republic (358) and Estonia (312), is now equal to that in west European countries, such as Belgium (435), France (392) and Portugal (309).

Response to environmental problems

Transition countries are implementing various policy, economic, legal, institutional and social responses to address environmental problems. The challenge of transition is to develop a system of environmental control that is compatible with a market economy (for example, by providing price incentives) and create an effective institutional framework that can enforce compliance and ensures the non-discriminatory application of rules. The quality of this framework depends on the factors listed below.

Measuring progress in environmental policy is difficult. National Environmental Action Plans (NEAPs) and the participation in, and implementation of, international environmental treaties have been used as indicators of environmental policy reform. According to this measure, transition economies have made further progress over the last year. All EU accession countries have prepared a NEAP.

Past contamination is a pressing issue across the region, especially soil contamination related to large industrial plants and military bases. The issue of liability for this contamination raises complex legal, financial and commercial questions and is considered problematic even in Western countries. In the context of privatisation, there are broadly two ways of dealing with environmental liabilities. The first is to assign sole responsibility to the former owner (the state), who then indemnifies the new owner. The second way is to share the cost of mitigation between buyer and seller, based on an environmental audit and assessment of the likely risks. Under this system, the mitigation costs are deducted from the purchase price, and the new owner takes over environmental liability for the contaminated property. Both approaches are common in the region (see Table 8).

The amount of money spent on environmental protection is an indicator of commitment and institutional capacity. In transition economies environmental issues are relatively low on the list of government priorities, and state budgetary allocations are correspondingly low. A number of countries have, however, established environmental funds, which are fed from environmental charges (for example, on pollution or resource use) and fines. If these funds are included, environmental expenditure in Hungary (0.6 per cent in 1996), Poland (1.0 per cent in 1996) and Slovenia (0.7 per cent in 1997) as a percentage of GDP is comparable to the level in high-income OECD countries.

Many transition countries have comprehensive systems of permits, pollution charges and non-compliance fees (see Table 8). In most cases, their main objective is to raise revenue for environmental funds. The effect of emission and effluent charges is undermined by the low level of energy and water tariffs and poor collection rates in many transition economies. This reduces the incentive for consumers to make
<table>
<thead>
<tr>
<th>Country</th>
<th>NEAP Completion</th>
<th>Economic Instruments</th>
<th>Liability for Past Contamination</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>All Emissions</td>
<td>Water Pollution</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Emission Charge</td>
<td>Effluent Charge</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Non-Compliance Fee</td>
<td>Non-Compliance Fee</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Estonia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Hungary</td>
<td>Yes</td>
<td>No</td>
<td>n.a</td>
</tr>
<tr>
<td>Latvia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Poland</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Romania</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: EBRD Transition Report 2001
efficient use of resources. One exception is Poland, which has among the highest pollution charges in the world for certain pollutants (for example, SO\textsubscript{2}).

The right of organisations and individual citizens to voice their views on development proposals, plans and policies is an indispensable element of a democratic society. All transition countries have in place basic environmental laws and rules for environmental impact assessment (EIA). However, clear and transparent EIA procedures, including public participation, are limited to a handful of transition countries (for example, Bulgaria, Hungary and Poland). Public access to environmental information has not yet become the norm in any transition country. The ratification of the Aarhus Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Matters is expected to improve the situation in the medium term. By August 2000, 20 countries in the region had signed the convention.

Non-governmental organisations (NGOs) make an important contribution to civil society, and their role in influencing environmental policy is increasing across the region. NGOs played a prominent role, for instance, in the preparation of NEAPs. According to one survey, there are now over 3,000 environmental NGOs in CEB and SEE -- almost a third of them in the Czech Republic, Hungary and Poland.

**State of the environment**

Transition entails changes in economic structure and output, consumption patterns and social and policy responses. These changes have repercussions on the environment, although reliable data to document the relationship between transition and the state of the environment is scarce. Improvements in environmental quality have been reported, for example, in the Czech Republic, Hungary, Slovenia and Poland in spite of overall economic recovery and growth. The Baltic States and the Slovak Republic appear to follow this trend. In most other transition countries the reduction of total emission and effluent tends to be linked to the reduction of total output.

Table 9 reports data on one indicator: urban air quality in some of the major cities of the region. It shows that the air quality in most cities is more or less on a par with that of Paris, New York or Tokyo. Many exceed air quality guidelines of the World Health Organisation (WHO) for at least some periods during the year. Moreover, it should be noted that air pollution in many industrial towns is much higher than in the capital cities.

This annex has illustrated the complexity of the relationship between economic transition and environmentally sustainable development. Although some advanced countries have experienced improvements in environmental quality, the region still faces major challenges to improve its environment and to attain sustainable development.
Table 9  Air Quality in Major Cities

<table>
<thead>
<tr>
<th>Country</th>
<th>City</th>
<th>SO2 ug/m³</th>
<th>Year</th>
<th>NO2 ug/m³</th>
<th>Year</th>
<th>Particulates ug/m³</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>Sofia</td>
<td>17</td>
<td>1999</td>
<td>21</td>
<td>1999</td>
<td>132</td>
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<tr>
<td>Czech Republic</td>
<td>Prague</td>
<td>35</td>
<td>1997</td>
<td>75</td>
<td>1997</td>
<td>59</td>
<td>1996</td>
</tr>
<tr>
<td>Estonia</td>
<td>Tallinn</td>
<td>1</td>
<td>1999</td>
<td>32</td>
<td>1999</td>
<td>93</td>
<td>1999</td>
</tr>
<tr>
<td>Latvia</td>
<td>Riga</td>
<td>43</td>
<td>1997</td>
<td>75</td>
<td>1997</td>
<td>100</td>
<td>1996</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Vilnius</td>
<td>9</td>
<td>1997</td>
<td>42</td>
<td>1997</td>
<td>95</td>
<td>1997</td>
</tr>
<tr>
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<td>Warsaw</td>
<td>12</td>
<td>1997</td>
<td>25</td>
<td>1997</td>
<td>81</td>
<td>1995</td>
</tr>
<tr>
<td>Romania</td>
<td>Bucharest</td>
<td>11</td>
<td>1997</td>
<td>96</td>
<td>1997</td>
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<td>WHO Standards</td>
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</tr>
</tbody>
</table>

Source: EBRD Transition Report 2000