



Investment

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Investing for growth

A primary objective of the economic reforms is to improve living standards, of which income is a key component. Thus a successful transition must generate the basis for economic growth. There are three “technical” prerequisites for sustained growth: economies need to invest; the investment should be of good quality, i.e. efficient in terms of cost and directed towards demand; and financing it should be within a country’s long-term capabilities.¹ Investment should be conceived broadly, encompassing additions to physical, human, institutional and technological capital (see Box 3.1). In addition, the political viability of, and social justification for, growth in democracies calls for its fruits to be widely spread,² and any appraisal of the process of investment and growth should take careful account of its effects on other (non-income) aspects of the standard of living, particularly the environment and health.

During the economic transition, investment is important not only to increase a nation’s capital stock, but also to deepen the restructuring of enterprises and the economy as a whole. This is part of the process of reorienting output, production processes and methods of work. More than in other economic circumstances, in transition economies the *quality* of investment should be the focus of attention. The link between restructuring and investment is central to the subject matter of this *Transition Report*. The present chapter intends to place developments at the sectoral and enterprise level within the aggregate context.

How has aggregate investment fared so far during the transition? How much investment is necessary to “catch up” with the Western market economies, and how will it be financed? The available evidence suggests that investment has fallen, but the levels of investment as a share of GDP (the “investment rates”) are generally not low.

Box 3.1

Concepts of capital and investment

Physical investment

Most of the data to be assessed in this and the following chapters relate to the simplest type of investment represented by industrial plant, machinery and structures. Capital goods are not, however, confined to the industrial sector but exist also in the service, household and public sectors. The classification of household expenditures between investment (for example, buying a house or motor car) and consumption (for example, buying a restaurant meal) is not always simple. We normally think of shoes and shirts as consumer goods but they are as durable as some hand tools or pieces of equipment. Some assets are referred to as “social capital”, such as the housing stock, roads, water facilities, power stations and railways, whether these are privately or publicly owned. It is helpful to distinguish them from industrial equipment for three reasons: they are complementary in use, they are intimately related to public policy whether through ownership or regulation, and they are quantitatively at least as important in the aggregate as industrial capital.

Human capital

Households as well as state organisations are involved in health and education expenditures many of which can, at least in part, be regarded as investments in the sense that they confer benefits in subsequent periods. These investments contribute to the stock of skills, competencies and capacities of the labour force, known as human capital. As in the case of physical capital, the valuation of the stock involves not only measuring current expenditure but also depreciation (through retirement, death, incapacity) and obsolescence since unimproved skills can become less valuable as available technology advances.

Technological capital

We can also think of the stock of available technological knowledge as constituting a form of capital and of expenditure to enlarge it as a form of investment. Economies not at the forefront of technological progress can acquire much useful knowledge relatively cheaply by “importing” it from abroad rather than by undertaking original research to extend the frontiers of knowledge. Importation may carry the obligation to pay royalties to the foreign supplier where the knowledge is protected by intellectual property rights.

Some knowledge is only of use in conjunction with particular pieces of equipment in which it is said to be embodied. Disembodied technological advances enable previously installed equipment and previously trained workers to operate more effectively. Perhaps more frequently, technological advances are embodied and can only reduce production costs if supplementary investment is also made in particular forms of physical or human capital. In a distorted and inefficient economy, there are opportunities for better management and organisation (management “technologies”) to raise output or reduce the use of resources quickly with only a modicum of investment, typically in human capital and consulting services.

Institutional capital

Throughout this *Transition Report* a central theme is the importance for the transition of the development of the key institutions of a market economy: from effective and responsible enterprises and entrepreneurship, to legal frameworks and judicial institutions, competition authorities and others. Building these institutions – the essence of the transition – takes time, legislative effort, training and so on, all of which represents investment in appropriate skills, attitudes and habits as well as offices and equipment.

¹ These conditions are captured by the Harrod-Domar growth equation: $g = s/v$, where ‘g’ is the growth rate, ‘s’ is the savings rate (including both domestic and foreign savings), ‘v’ stands for the incremental capital-output ratio (i.e. the investment needed to produce an additional unit of output), and investment should be interpreted to include both physical and other types of capital (see Box 3.1). Thus the growth rate can be increased by increasing the savings rate or decreasing the incremental capital-output ratio (increasing the quality of investment). While Harrod’s formulation came in the late 1930s it is at the heart of much of modern growth theory, which shows that this argument applies even

when account is taken of the limitations on the supply of labour. More recent developments in “endogenous growth” theory show that long-run growth rates can also be affected by the initial levels of human, physical and technological capital when these forms of capital generate positive external benefits. This last point may be relevant in assessing growth prospects for transition economies (see Section 3.3).

² Gross inequalities of income and wealth appear to constrain longer-term growth even in authoritarian regimes. See, for instance, Dornbusch and Edwards (1991).

Investment began falling before reforms had started. Evidence and data on investment are problematic, particularly in transition, where both reality and statistical methods are in a state of flux. It appears, however, that early-reforming countries have seen a more rapid stabilisation and in some cases a turnaround in investment activity.

Sustained high growth rates will be needed for convergence towards Western standards of living. There is reason to believe that the transition economies will be able to tap substantial “productivity reserves” in the form of under-utilised human capital, and close a technology and management gap. This should make returns to investment high and thus investment easier to finance. Nevertheless, for the growth process to be sustained, domestic and, in particular, private savings will have to rise. External financing is bound to represent a limited share of total investment financing. However, external participation, through finance and other channels, can play a crucial role in developing and anchoring reforms and in transferring intangible forms of capital from the West to eastern Europe, the Baltics and the CIS. While public savings should be encouraged, their role in investment finance in the short to medium term will be constrained by other transition-specific pressures on public finances (see Chapter 6 of last year’s EBRD *Transition Report*).

3.1 The investment and savings effort under central planning³

Under the command system, output and investment decisions were, in principle, taken by the planners on the basis of quantitative targets. Consumption and savings were “residuals” which were forced to adjust. Most savings took place within the government-enterprise sector, through direct and indirect taxation and retained earnings of enterprises. Savings were transferred between enterprises to accord with investment plans through the national budget. In market economies a much greater proportion of national income accrues directly to households and, therefore, a larger share of national savings is determined by and accumulated in the household sector. The financial system plays the crucial role of intermediating savings and investment.

Direct control of consumption and savings allowed the socialist economies to sustain very high savings and investment rates by international standards.⁴ Savings and investment in the countries of eastern Europe, the Baltics and the CIS are estimated to have been on average of the order of 32 per cent of GDP in the period 1977-88. This compares with a world average of about 24 per cent of GDP and an average of 21 per cent in the advanced industrial countries over the same period. However, the efficiency of the investment undertaken by socialist economies was low, both in terms of cost and relationship with demand. Investments were normally not made on the basis of profitability but determined by

the objectives of the central plan, the bargaining power of the different enterprises, and other non-market criteria, which also failed to mitigate in the direction of quality.⁵

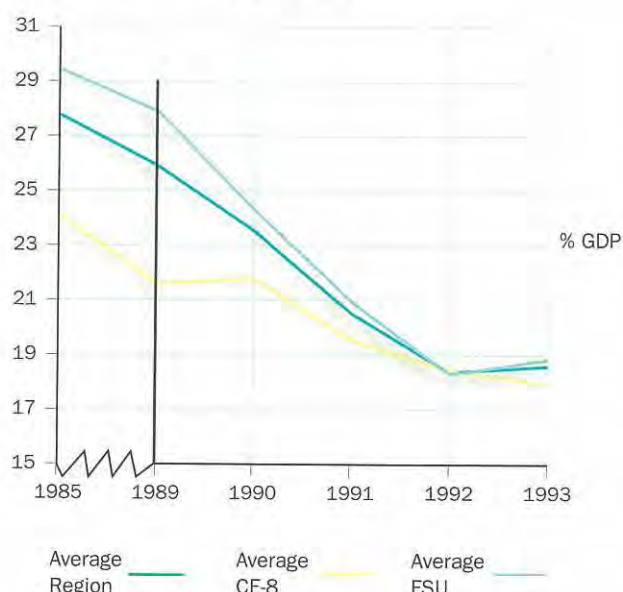
The investment rate in the region began declining during the 1980s, that is, before the collapse of the communist regimes. Chart 3.1 shows falls of approximately 1.5 and 2.5 percentage points between 1985 and 1989 in eastern Europe and in the former Soviet Union, respectively.⁶ Among the possible explanations for this pre-transition decline is the greater enterprise autonomy introduced by perestroika in the former Soviet Union and under reform policies in Hungary and Poland. This autonomy was often used to increase the wage bill to the detriment of investment. There have also been arguments that the high cost of forced savings in terms of foregone consumption, together with the low returns as a result of investment inefficiency, may have gradually raised pressure on politicians to improve consumption possibilities.

3.2 Investment trends during the transition

For the region as a whole, the trend decline in investment rates accelerated after the start of market-oriented reforms. As Chart 3.1 indicates, the average fixed investment/GDP ratio in the east European economies is estimated to have declined from 21.6 per cent in 1989 to 17.9 per cent in 1993. A similar but more pronounced fall can be observed in the Baltics and the CIS (where the ratio fell from 27.8 to 18.8 per cent of GDP).

Chart 3.1

Share of fixed investment in GDP, 1985-93



Source
Table 3.1.

Note
GDP weights from 1993.

³ This section draws partly on Temprano (1995).

⁴ Kornai (1992; pp.160-70) discusses the ideological, political and institutional motivations behind the high savings and investment rates that were observed in socialist countries.

⁵ Chapter 4, Section 4.1 provides evidence on the inefficiency of the capital stock accumulated under central planning. However, both investment and GDP growth were probably overstated (see Annex 11.1).

⁶ The figure presents averages weighted with 1989 purchasing power parity GDP. The eight east European countries are Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic and Slovenia; the average for the former Soviet Union is estimated on the basis of time series for Belarus, the three Baltic states, Kyrgyzstan, Russia and Ukraine.

Table 3.1**Investment in national accounts statistics, 1985-94****Gross domestic investment including changes in stocks (current prices)**

	1985	1989	1990	1991	1992	1993	1994
<i>Per cent of GDP</i>							
Albania	33	32	29	6	10	14	20
Armenia	28	39	32	32	26	14	–
Azerbaijan	–	10	21	11	9	–	–
Belarus	21	30	27	30	32	37	–
Bulgaria	32	33	26	23	20	14	15
Croatia	47	43	31	26	30	15	–
Czech Republic	28	27	29	30	24	17	20
Estonia	33	33	30	17	15	23	–
FYR Macedonia	–	–	32	15	11	10	18
Georgia	34	28	31	28	32	–	–
Hungary	26	27	25	21	15	20	21
Kazakstan	47	40	43	31	–	–	–
Kyrgyzstan	–	–	27	29	53	29	21
Latvia	35	36	40	34	41	9	16
Lithuania	34	34	34	22	19	23	13
Moldova	30	31	26	31	65	7	–
Poland	28	39	26	20	15	15	19
Romania	33	27	30	28	32	30	–
Russia	33	34	30	39	35	26	25
Slovak Republic	32	30	33	35	27	22	17
Slovenia	23	18	17	15	16	25	22
Tajikistan	30	25	16	15	31	–	–
Turkmenistan*	42	25	25	54	42	–	–
Ukraine	27	20	18	22	29	30	–
Uzbekistan	32	32	32	19	25	29	22

* Refers to 'Accumulation'

Gross fixed investment (current prices)

	1985	1989	1990	1991	1992	1993	1994
<i>Per cent of GDP</i>							
Albania	32	31	31	6	10	–	–
Armenia	–	16	11	4	–	–	–
Belarus	–	–	23	23	24	26	28
Bulgaria	26	26	21	18	16	12	18
Croatia	18	15	16	14	11	15	–
Czech Republic	26	26	26	23	25	23	27
Estonia	30	29	24	22	22	23	–
FYR Macedonia	–	–	17	23	23	17	17
Georgia	–	–	23	19	16	6	–
Hungary	23	22	19	19	20	18	20
Kyrgyzstan	–	–	23	17	15	12	13
Latvia	32	32	23	6	11	14	16
Lithuania	32	32	29	19	13	24	20
Moldova	26	22	19	18	14	–	–
Poland	21	16	21	20	17	16	16
Romania	30	30	20	14	17	16	–
Russia	30	32	29	25	20	21	21
Slovak Republic	29	28	31	28	22	27	26
Slovenia	23	18	18	19	18	19	21
Tajikistan	12	19	9	7	5	–	–
Ukraine	27	11	8	6	12	10	9
Uzbekistan	–	31	31	12	7	–	–

Sources

National Statistical Institutes, IMF, OECD, PlanEcon, World Bank, EBRD estimates.

Note

Pre-price liberalisation

Post-price liberalisation

Three countries are missing from the table due to insufficient information: Azerbaijan, Kazakstan and Turkmenistan.

Data issues

Before turning to more detailed evidence, a word of caution is warranted regarding investment data. As is well known, most data series in the transition economies – and historical ones in particular – suffer from a substantial margin of error (see Annex 11.1). Even more than price or output data, however, investment statistics are bedevilled by problems of definition, accounting and coverage.⁷ As a result, estimates from the same source can differ substantially in repeated revisions, and cross-country comparisons should be viewed with more than the usual degree of scepticism. As a general rule, relative magnitudes (i.e. shares of GDP) and nominal data tend to be more reliable than absolute and “real” data. Difficulties with “real” data are due to, among other causes, the difficulty of choosing the appropriate weights in an environment of rapidly changing prices. Even relative magnitudes can present certain puzzles, e.g. the low investment rate in fast-growing Poland compared with the high recorded rate in Russia. While many of these problems cannot be solved here, the data displayed in the following tables reflect informed choices by the EBRD made on the basis of various series available for each country.

Reform and investment ratios

A closer look at the experience of individual countries shows diversity which appears to be linked to the depth and speed of reforms. Measured fixed investment fell sharply in virtually all countries in the late 1980s and early 1990s, both in real terms and as a share of GDP.⁸ There appears to be a link between this decline and the process of liberalisation.

After an initial fall, the share of fixed investment in GDP stabilised in countries that were liberalising comparatively slowly, and turned around in many of the countries that were liberalising more swiftly. The role of reform can be further assessed by analysing the sequence of price liberalisation and changes in the (fixed) investment rate. Table 3.2 shows the association between changes in the investment rate and the timing of the first significant steps in introducing market prices, as described in the transition indicators of Chapter 2 (to distinguish the pre- and post-liberalisation periods in Table 3.1, mildly and strongly shaded fields indicate that prices have been partially and comprehensively liberalised, respectively). An example may help in the interpretation of Table 3.2. In Ukraine the investment share started to fall more than two years before liberalisation (first row) and investment began to pick up in the same year as liberalisation (first column). The evidence does not allow unequivocal conclusions, but it does suggest that liberalisation had a positive effect on the investment rate. Two key observations emerge from Table 3.2.

First, in no country did the investment share begin to drop *after* price liberalisation was initiated. The timing of price liberalisation and investment decline coincided in four countries (see the fourth row); in all others the first significant drop in the investment share preceded price liberalisation. Second, in many cases, including all of the fast-reforming countries, the investment share began to stabilise or to rise contemporaneously with or within a year from price liberalisation.

Table 3.2

Sequence of price liberalisation and changes in the share of fixed investment in GDP

		Investment share picks up/stabilises (after)				
		Same year	1 year	2 years	> 2 years	Continues to fall throughout period covered
Investment share drops (years before liberalisation)	> 2 years	Ukraine	–	–	–	Armenia, Georgia, Moldova, Tajikistan
	2 years	Latvia	Estonia	–	Kyrgyzstan	–
	1 year	Albania, Poland	Lithuania, Romania, Russia	–	Bulgaria, Croatia	Uzbekistan
	Same year	Slovenia (no change)	Hungary, Czech Republic	Slovak Republic	–	–
	na	Belarus	FYR Macedonia	–	–	–

Note

Based on Table 3.1. Three countries are missing from the table due to insufficient information: Azerbaijan, Kazakhstan and Turkmenistan.

⁷ Definitions of what constitutes an investment appear to differ across countries, in particular regarding the borderlines between capital alteration and maintenance, work in progress and investment, and valuation changes on existing assets. For instance, it appears that in certain countries of the former Soviet Union the revaluation of assets that became necessary because of inflation was partially accounted for as “investment”. Accounting problems in an inflationary environment affect estimates of inventories and depreciation. And coverage problems can be severe, especially in estimates of private sector investment activity.

⁸ An exception appears to be Belarus, where broad-based reform has not yet proceeded very far.

The cumulative fall in the investment rate is less severe in countries that have liberalised comparatively rapidly, and the subsequent recovery is stronger. As shown in Table 3.3, countries that were at an advanced stage of transition in mid-1994 experienced on average a fall of 3.4 percentage points in their investment/GDP ratio between 1989 and the trough. The average recovery from the investment trough represented almost two-thirds of the previous fall by 1994. For countries that were at an intermediate stage of transition, these figures were 16 per cent and a quarter, respectively, while in countries at earlier stages of transition the fall represented 14 percentage points and recovery has not yet been reported.

Table 3.3**Variations in the ratio of fixed investment to GDP**

	Cumulative drop after 1989 (1)	Recovery by latest available date (2)	Recovery ratio (2)/(1)
	Percentage points		Fraction
Advanced transition stage as of mid-1994			
Croatia	-4	4	1.00
Czech Republic	-3	4	1.33
Estonia	-7	1	0.14
Hungary	-4	2	0.50
Poland	0	0	0.00
Slovak Republic	-6	4	0.67
Slovenia	0	3	–
<i>Average</i>	<i>-3.4</i>	<i>2.6</i>	<i>0.61</i>
Middle transition stage as of mid-1994			
Albania	-21	–	–
Bulgaria	-14	6	0.43
FYR Macedonia	–	0	–
Kyrgyzstan	-11	1	0.09
Latvia	-26	10	0.38
Lithuania	-19	7	0.37
Moldova	-8	–	–
Romania	-16	2	0.13
Russia	-12	1	0.08
<i>Average</i>	<i>-15.9</i>	<i>3.9</i>	<i>0.25</i>
Early transition stage as of mid-1994			
Armenia	-12	–	–
Belarus	0	5	–
Georgia	-17	–	–
Tajikistan	-14	–	–
Ukraine	-5	3	–
Uzbekistan	-24	–	–
<i>Average</i>	<i>-12.0</i>	<i>–</i>	<i>–</i>

Source
Table 3.1.

Note

The transition stage reflects the average of six scores of progress in reform, as set out in the *Transition Report*, 1994, Table 2.1. Advanced, middle and early transition countries are those whose average score fell in the range 3.0-3.5, 2.0-2.9 and 1.0-1.9 respectively.

In spite of the initial declines, Table 3.4 shows that fixed investment shares remain at fairly high levels when compared with the OECD average (which was 20.6 per cent in 1994). One interpretation could be that the adjustment or market “correction” from the situation of forced savings under central planning has been established fairly quickly, and we may now be observing longer-run investment rates. However, most of the countries for which no recent information on the fixed investment rate is available are likely to be in the “below 15 per cent” category.⁹ Moreover, the data limitations described earlier should invite some scepticism, in particular regarding countries of the CIS. For instance, the continued high measured investment levels in Belarus and Russia have not been reflected in economic growth.

Some brief comments, and caveats, are necessary on changes in stocks; and by extension on the aggregate “domestic investment” series in Table 3.1 (which represents the sum of changes in stocks and fixed investment). Since changes in stocks are subject to serious revaluation difficulties during periods of high inflation and other measurement problems, not too much should be read into available estimates of their evolution over time.¹⁰ Nevertheless, there is clearly a pattern of substantial stockbuilding in the early years of liberalisation in all countries (linked no doubt to the fall in aggregate demand), and of subsequent reductions in stocks. Stocks and fixed investment appear to go through opposite motions, which accords well with aggregate demand based investment theories: when fixed investment falls, stocks rise, and vice versa, except in Poland, the Slovak Republic and Slovenia, where the two variables have at times moved in the same direction.

Table 3.4**Fixed investment/GDP in 1993-94 (where available)**

< 15 per cent	Georgia, Kyrgyzstan, Ukraine
15-20 per cent	Bulgaria, Croatia, FYR Macedonia, Hungary, Latvia, Poland, Romania
> 20 per cent	Belarus, Czech Republic, Estonia, Lithuania, Russia, Slovak Republic, Slovenia

Source
Table 3.1.

⁹ These countries include Albania, Armenia, Azerbaijan, Kazakhstan, Moldova, Tajikistan, Turkmenistan and Uzbekistan. In all of these except Turkmenistan, investment rates in GDP were extremely low in the last available estimates.

¹⁰ Typically, stockbuilding in OECD countries represents less than 1 per cent of GDP. In many transition economies, it is reported to have reached up to half of GDP in certain years.

Aggregate output and investment

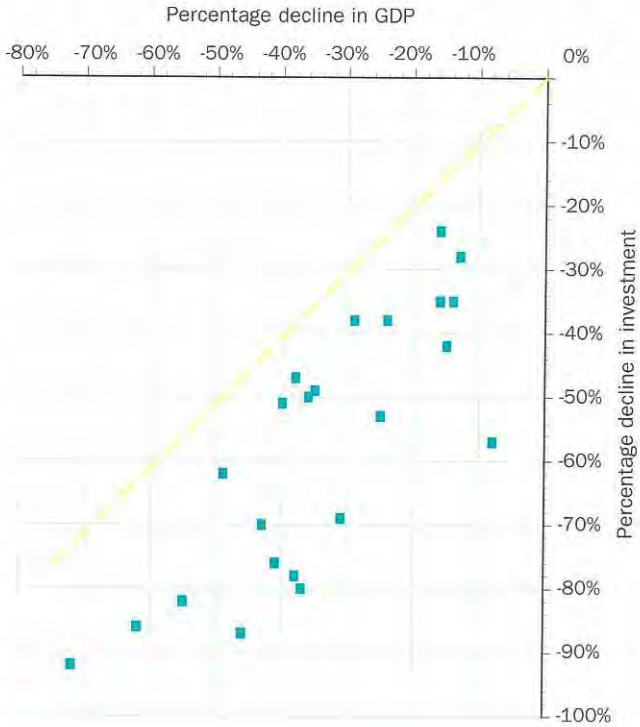
Does the GDP-collapse explain the fall in investment rates? We have seen measured output fall by about 15 per cent in eastern Europe and by about 50 per cent in the Baltics and the CIS, and a fall in investment that was proportionately greater; the points in Chart 3.2 all lie below the 45° line. As is well known, causality between aggregate investment and output can go either way, and they can both be driven by common third factors. Thus, an “autonomous” fall in investment (for instance as a result of uncertainty or a cutback in public investment) reduces aggregate demand and therefore GDP. Low capacity utilisation due to an economic downturn may discourage investment. And impaired coordination of business decisions following the demise of central planning, in the absence initially of functioning markets, can affect both production and investment independently.

The evidence on the relation between GDP and investment is inconclusive and illustrates some of the limitations of the “aggregate approach” in analysing the transition. The sequence of events allows a simple although rough assessment of causality. In the absence of foresight, changes in the “causing” variable would be expected to precede those in the other variable. Table 3.5 classifies countries according to how variations in GDP and in the investment-to-GDP ratio followed each other in time. Along the rows, the classification reflects the sequence during the initial (significant) fall in both series in the early 1990s, whereas the columns record the events during recovery (if any). Thus, for example, in Lithuania the initial investment decline lagged behind the output fall (first row) but the investment rate led in the recovery (second column).

Although the available annual data do not allow a very discriminating analysis, they show a surprising diversity of experiences both during the initial fall and during the recovery. The table nevertheless yields one very important observation: in no country has growth led the investment rate during the recovery. Investment is

Chart 3.2

Change in GDP and gross domestic investment
23 countries (1989-94)



Source
Table 3.1 and Annex 11.1 (Table on GDP growth).

much more likely to serve as a motor for output recovery than vice versa. This emphasises the importance of policies designed to facilitate investment in a strategy to deliver growth in the transition economies. Recall also that investment rates remained moderately high in most of the region. This suggests that investment during the economic transition is driven more by sectoral reallocation

Table 3.5

Change in the fixed investment ratio in relation to GDP growth

		Sequence during recovery					no recovery or no data
		lags	leads	is contemporaneous	is counter-cyclical	is constant	
Sequence during the initial fall	lags	—	Albania, Lithuania	Bulgaria, Czech Republic	Belarus	Romania, Russia	Georgia
	leads	—	Latvia	—	—	—	Armenia, Moldova, Tajikistan
	is contemporaneous	—	Croatia	Estonia, Slovenia	FYR Macedonia	Hungary	Kyrgyzstan, Ukraine, Uzbekistan
	is counter-cyclical	—	—	—	Poland	—	—
	is constant	—	—	—	Slovak Republic	—	—

Source
Table 3.1 and Annex 11.1 (Table on GDP growth). Three countries are missing from the table due to insufficient information: Azerbaijan, Kazakhstan and Turkmenistan.

Table 3.6

Investment by ownership

	1989	1990	1991	1992	1993	1994
<i>Per cent of GDP</i>						
Bulgaria						
Domestic investment	32.9	25.6	22.6	19.9	14.2	14.6
Private investment	1.5	0.9	0.6	0.4	3.1	–
State-sector investment	31.4	24.7	22.0	19.5	11.0	–
Government (budget)	6.9	3.1	2.0	2.7	1.9	1.7
Non-government ¹	24.5	21.6	20.0	16.8	9.1	–
Czech Republic						
Domestic investment	26.8	28.6	29.9	24.0	17.0	20.4
Private investment	1.1	1.5	2.8	3.3	4.1	–
State-sector investment	25.7	27.1	27.1	20.7	12.9	–
Government (budget)	6.2	6.1	5.6	6.5	4.2	4.9
Non-government ¹	19.5	21.0	21.5	14.2	8.7	–
Estonia						
Domestic investment	32.7	30.2	17.1	15.4	22.8	–
Private investment	–	–	–	1.4	1.6	–
State-sector investment	–	–	–	14.0	21.2	–
Government (budget)	–	–	3.1	1.3	2.1	2.0
Non-government ¹	–	–	–	12.7	19.1	–
Latvia						
Domestic investment	35.6	40.1	33.7	41.2	9.2	15.9
Private investment	–	0.7	0.6	2.3	1.3	–
State-sector investment	–	39.4	33.1	39.0	7.9	–
Government (budget)	–	–	–	1.5	1.1	2.0
Non-government ¹	–	–	–	37.5	6.8	–
Lithuania						
Domestic investment	34.1	34.3	22.2	18.1	22.7	13.0
Private investment	6.6	7.0	5.4	5.4	8.3	5.2
State-sector investment	27.5	27.3	16.8	12.7	14.3	7.8
Government (budget)	–	7.4	7.7	4.7	4.0	1.6
Non-government ¹	–	19.9	9.1	8.0	10.3	6.2
Romania						
Domestic investment	26.8	30.2	28.0	32.3	30.1	–
Private investment	–	–	–	2.6	4.7	–
State-sector investment	–	–	–	29.3	25.1	–
Government (budget)	–	7.7	6.0	5.8	4.3	5.7
Non-government ¹	–	–	–	23.5	20.8	–
Russia						
Domestic investment	33.8	30.1	39.1	35.4	25.8	25.0
Private investment	–	–	0.3	0.4	0.9	–
State-sector investment	–	–	38.8	35.0	24.9	–
Government (budget)	–	–	–	4.5	4.0	3.8
Non-government ¹	–	–	–	30.5	20.9	–

Source

National Statistical Offices, Temprano (1995).

¹ Derived as public investment minus government investment.

considerations rather than by aggregate supply and demand. These determinants of investment, and the central role investment plays in the reallocation process, are discussed in the next chapter.

Public and private investment

Table 3.6 provides some evidence of a shift from public to private decision-making over investment – while aggregate investment falls, private investment rises moderately in most of the countries covered. As was to be expected, the timing of the shift is closely related to the privatisation process in each country.¹¹ Survey data in Poland provide a detailed picture of enterprise investment that underlines how important the new private sector can be in leading the investment dynamics.¹² In 1993, these data show, the investment-to-sales-ratio of new private firms was more than twice as high (5.8 per cent against 2.2 per cent) as for corporatised state enterprises, with privatised firms (4.4 per cent) and traditional state enterprises (2.5 per cent) in between. However, where privatisation leaves enterprises under weak or inappropriate governance – for instance as a result of insider control or dispersed outside ownership – investment may be delayed. The same effect can arise from delayed privatisation. As underlined in Chapter 8, privatisation in itself is often insufficient to generate the governance and motivations that induce investment, at least in the short run. As management and governance in privatised firms improve and respond to new circumstances with effective restructuring, investment will recover and indeed will play a crucial role in the restructuring process.

Another cause of the switch in the pattern of investment from public to private has been the relative decline in public (budgetary) investment, which has been cut back – often more than proportionately – in line with the collapse of budgetary revenues that has been witnessed in many countries.¹³ Despite this decline, public investment/GDP ratios remain on average at approximately the levels normally seen in industrial countries. Thus, for those countries for which a basic sectoral breakdown of investment is available, the average government investment/GDP ratio was 3.6 per cent in 1993, exactly the same as the average ratio in OECD countries in that year.¹⁴

This similarity in public investment shares may be a worrying rather than an encouraging sign. The appropriate level of public investment may well be higher during the transition than in other circumstances. This is because there are crucial infrastructure demands to sustain the growth of the private sector during the transition. As discussed in Chapter 6, infrastructure plays, through complementarities and forward linkages, a vital role in supporting and stimulating private

sector investments. These benefits cannot always be captured through fees or tariffs. It is important to emphasise, however, that in both the operation and funding of infrastructure there is an often unexploited potential for private sector involvement, which is particularly valuable in the presence of severe budgetary constraints.

Support for infrastructure, including the promotion of commercial operations and private sector provision, will remain a central activity for the international financial institutions. It accounts for around one-third of the EBRD's stock of projects. The countries of the region will continue to require support in this area for a considerable period, given budgetary pressures, the damaging and dangerous environmental legacy of the old regime, the scale of the challenge to provide infrastructural support for a developed market economy, and the "newness" of the issues involved in establishing a commercial basis for infrastructure activity.¹⁵ While the main focus of this year's *Transition Report* is the private enterprise and private investment, this does not imply any lack of emphasis on the importance of infrastructure investment in taking the transition forward. Indeed the private investment necessary to transform the economies and establish growth will not be able to flourish without it. The issue will reappear at many points throughout this Report.

3.3 The possibilities and requirements for growth

How much investment is "needed"? Should investment rise substantially beyond current levels in the transition economies? Though often asked, these are social planners' questions. In a market environment, the focus should be on what makes investing attractive, how constraints on investment can be relaxed, what kinds of investments can lead the processes of transition and growth and how they can be stimulated.

Nevertheless, simple relationships between aggregate investment and growth can be instructive to illustrate the magnitude of the challenge and to guide further analysis. The rate of growth of GDP can be described as the ratio between the investment share in GDP and the incremental capital-output ratio (ICOR).¹⁶ Developing countries with per-capita incomes in the same range as the former centrally planned economies and low population growth had, on average, an ICOR of around 5 in the period 1974-89.¹⁷ Under these conditions, sustained growth of 4 per cent a year would require the transition economies to invest 20 per cent of their GDP. "Catching up" with income levels in OECD countries within a generation would call for substantial sacrifices indeed. Assuming that current average income in the transition economies

¹¹ Again, it is important to stress problems of data quality, which are compounded here by classification problems. Time series may correctly reflect trends, but some of the movements in the data may also reflect changes in statistical methodologies that allow a more accurate estimate of small private activity and housing investments. The increase in the private investment shares in Bulgaria and Romania in 1993 is partly explained by such factors.

¹² Belka et al. (1994).

¹³ Two warnings must be given on the reliability of the data on public investment presented in Table 3.6. For the pre-transition period and for several countries, the government investment statistics shown may include investment actually undertaken not by the state but by state enterprises, which would exaggerate the downward tendency in public investment recorded since 1989. Second, in several countries public investment is overstated (both in the pre-transition and the post-transition figures) because the data also include capital transfers from the state.

¹⁴ Temprano (1995) p.10.

¹⁵ A valuable discussion of these issues is to be found in the World Bank's 1994 *World Development Report*.

¹⁶ An ICOR of "5", for instance, implies that five ECU have to be invested to yield one ECU of annual GDP. All productivity growth is implicitly ascribed to capital. The growth process in this illustration is described by the Harrod-Domar equation (see footnote 1 above), after substituting the investment rate for the savings rate.

¹⁷ This refers to 20 developing countries with annual income levels of US\$ 2,000-6,000 per capita in 1974 and a rate of population growth of less than 2 per cent. Average GDP growth of this group over the 1974-89 period was 4.0 per cent, while the investment-to-GDP-ratio averaged 21.1 per cent (Summers and Heston (1993).

represents one-fifth of the OECD average (in purchasing power parity terms), and that OECD countries grow by 2 per cent a year, investment rates of 36 per cent (growth of 7.2 per cent) would be needed over a period of 30 years to draw even.¹⁸ A closer look at the sources of medium-term productivity growth, however, suggests that this scenario is overly pessimistic. There are various reasons to believe that the ICOR is (or will be) lower in the transition economies than in middle-income developing countries.

Part of the scope for productivity increases is independent of capital investment. After an initial fall at the beginning of reforms, measured labour productivity rose strongly in many transition economies (see Chapter 11 for discussion). In the east European countries for which data are available, the continuing fall in aggregate employment while production stabilised around 1993-94 suggests that part of the productivity increase was due to the redundancy of previously “hoarded”, unproductive labour. In some countries, such as Poland, labour productivity in manufacturing continued to grow at a fast pace even after employment levels began to stabilise, in spite of relatively low recorded levels of investment. This reflects in part greater production efficiency as a result of improved work incentives, better management, production logistics, etc. – all of which were neglected under central planning. Continued progress during the restructuring process toward Western levels of management quality and incentives can boost productivity growth rates for some time to come.

There is also considerable scope in the transition economies for investment-related (“embodied”) productivity gains, which should reduce the ICOR in these countries. These issues are discussed in more detail in Chapter 4. Since technology lags behind Western countries in many sectors – and is now often commercially available to companies in the region – substitution of new processes or products for technologically obsolete old ones will allow productivity to rise even when only replacement investment takes place. Furthermore, the process of structural change has caused capital scarcity in high value-added sectors, and investment in these can have a high yield and thus, taken together, a substantial effect on growth.

Most importantly, however, the transition economies are endowed with levels of human and social capital that far exceed the norm in their income category (see Table 2.2 for evidence on social indicators, including health and education). The mismatch between these assets and the low-value stock of physical capital represents a productivity reserve that can be tapped by new investment of the right quality. New investment can potentially generate higher value added than in most developing countries because the skilled operators and engineers are there to make it work (often with limited retraining investment). Since much human and social capital is currently “structurally unemployed” as a result of economic dislo-

cation, this value added represents a net gain to these economies. In the longer term, the human capital is a source of technical progress and can thus contribute to ongoing productivity gains.

All these factors should make it possible for transition economies to grow faster than OECD countries in the medium term, even in the absence of very high investment rates, and therefore contribute to some convergence of living standards toward the levels in the West. The human capital “reserve” should also enable productivity growth beyond the levels that characterise most developing countries.

However, the legacy of the old regime has left obstacles to growth, as well as opportunities for it. The credibility of institutions and reliability of commitments, which have characterised the East Asian experience, will take time to achieve in the transition economies. Both macroeconomic stability and institutional development help explain the variation in foreign investment per capita among transition countries and between them and East Asia, including China.¹⁹ Transition has also reduced the effectiveness of government in many countries and constrained its budgetary latitude; the state’s ability to actively promote growth is seriously impeded. Another important factor is that investment and savings rates, though not low in the transition economies, tend nevertheless to lag far behind those of the Asian economies. New or improved financial institutions leading to a better mobilisation and channelling of savings should clearly improve the medium-term growth performance of transition countries.

This discussion suggests that it is reasonable to expect medium-term growth rates above OECD and LDC levels, but still lower than the double-digit performance of the East Asian tigers, in those transition economies that will have completed the necessary macroeconomic and institutional reforms.

3.4 Savings

Despite the potential for large productivity increases, growth and eventual convergence with the Western market economies will require substantial amounts of new investment. A significant investment effort in economies of this size will have to be financed primarily by domestic savings. Investment finance is the topic of Chapter 5, but some considerations regarding the likely development of savings should be useful here.²⁰

Current rates of savings in transition economies reflect to a considerable extent the recession and the initial difficulties linked to the process of systemic transformation. As transition economies gradually strengthen and restructuring in the enterprise and financial sectors proceeds, domestic savings rates should increase. This is particularly clear in the case of corporate savings, since enterprise profitability is likely to improve quickly with the resumption of

¹⁸ According to the *World Bank Atlas* methodology, the average GNP per capita in 1993 was US\$ 4,381 (in purchasing power parity terms) in the 25 transition economies of eastern Europe and the former Soviet Union, while it was US\$ 19,636 in the OECD countries. In addition, this calculation assumes no population growth in both OECD and transition countries.

¹⁹ See also Chapter 4 for a discussion of investor uncertainty and FDI.

²⁰ The following draws partly on Temprano (1995).

growth.²¹ Economic recovery and continued progress in structural reforms is likely to increase public savings, both by increasing revenues and by reducing unemployment benefits and (explicit and implicit) subsidies to loss-making enterprises and banks. The impact of economic growth on the savings rate of households is less clear. The positive influence of economic expansion and structural reform on public and household savings may be at least partially offset by adverse demographic developments unless governments in the transition economies move fast to reform their pension systems. In the short and medium run, therefore, the bulk of the rise in savings necessary to finance higher investment is likely to come from increased corporate savings. Indeed, as in most of the successful economies, much of the new investments undertaken by private enterprises will be directly financed with retained profits (see Chapter 4).

This should, however, not be taken to imply that foreign capital will not play an important role in the financing of investment growth in transition economies.²² According to the forecasts for the region as a whole contained in the IMF *World Economic Outlook* of May 1995, the negative gap between average domestic savings and investment rates to be covered by foreign savings is projected to increase to 6 per cent of GDP by 1996, up from 3.8 per cent in 1994. This is the result in almost equal parts of both a projected rise in investment rates and a continuing decline in domestic savings rates.

When it comes in the form of foreign direct investment, external capital can provide services that extend beyond financing to management abilities, marketing networks and technology. Such “packages”, which cannot always be “unbundled” for selective import, can be particularly useful during the transition both directly by modernising parts of the economy and indirectly by providing demonstration effects and other external benefits.

Official foreign capital flows, lastly, will continue to play a key role in the transition economies. Conditional official assistance linked to sensible reform programmes not only contributes to cover the gap between domestic savings and investment but also acts as a catalyst for domestic and foreign investment by reducing uncertainty and increasing the chances that the reforms will succeed. As systemic transformation proceeds, those countries with a stable macroeconomic framework should be able to increasingly rely (as some are already doing) on private capital inflows to cover the current account gap and any debt repayments.

3.5 Concluding remarks

The picture that emerges from this chapter is that, after a decline reflecting as much the artificially high starting point as the temporary dislocations of reform, the prospects for investment in the transition economies are bright. Fast reform is a condition for dynamic investment, not a brake on it. Aggregate developments do not reveal much about the underlying “story”, which is structural in nature. Our optimism regarding future investment and medium-term growth in the transition economies reflects in part the existence of productivity reserves – such as a large endowment of human capital – that can be tapped by profit-oriented investors. These will be discussed in greater detail in the next chapter. Effective governance in enterprises will be needed to align the incentives of managers with the long-term commercial interests of their firms and to induce high-quality investments (see Chapter 8). Government has an important role to play in facilitating investment, by reducing uncertainty, providing the framework for market-based contracts and complementing private investment with the necessary infrastructure. The chapters in Part II of this Report highlight different aspects of the role of governments. Lastly, domestic savings will be the primary source of finance for the investment effort and there is reason to believe that it will pick up gradually as a result of economic recovery and the strengthening of domestic financial intermediation (Chapters 5 and 10). External finance can complement domestic savings, but it can be particularly valuable by enhancing the quality of investments and the investment process.

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²¹ Domestic savings represent the aggregate of household, corporate and public sector savings. These different sources of savings are interdependent: for instance, public and corporate savings interact through taxes, public and household savings through the pensions system, and corporate and household savings through the intermediary of capital markets.

²² Note, however, that the growth contribution of foreign capital is smaller in terms of GNP than GDP, the difference being dividends and interest payments accruing to foreigners for the capital services rendered. Foreign and domestic savings as sources of investment finance are thus not equivalent.

Determinants of investment in the transition

4

Economic transition is about change: in the way decisions are made, in the institutions that underlie economic relationships, in the organisation of enterprises, and in the composition of production and consumption. Transition economies are marked by an exceptional range of assets – human, physical and institutional – requiring the radical overhaul for which investment is essential. The focus of this chapter, in contrast with the more aggregate approach of the preceding chapter and the financial emphasis of the next chapter, is on the sectoral and technological aspects of change and investment during the transition.

In transition economies, the process of investment is not merely a question of accumulating a little more, or more sophisticated, equipment. The distortions of the old regime prevented capital and other resources being used in the way in which they might most fruitfully have satisfied wants. Many of the distortions have been eliminated by liberalising prices and trade and by abandoning controls. Prices, costs and returns now guide most investment decisions. However, investment during the transition differs from investment in other circumstances because of its importance in facilitating the reallocation (or rededication) of existing human and material capital from lower to higher value uses while adapting the structure of the capital stock to that required by the market.

During the transition process, many investments should offer a high return as existing assets represent sunk costs¹ and their use may often be upgraded with only minor additional expense. However, the reallocation of resources may encounter obstacles or bottlenecks, including a high level of uncertainty over policies and prices and underdeveloped financial systems which may prevent available funds from flowing to their most productive uses. Since change in the transition is all pervasive, the ability of the “invisible hand” to facilitate and coordinate investment decisions is severely tested, well before the markets themselves have fully matured. Government policy would be similarly strained in attempting to steer these developments. Its first priorities must be in providing the predictable macroeconomic, regulatory and institutional framework needed for investment to respond to the existing opportunities.

In this chapter, we focus on what is “different” about investment during the economic transition. After briefly discussing the nature of the capital stock inherited from the period of central planning (Section 4.1), we analyse the decline in its value as a result of reform (Section 4.2). This capital loss, and its structure, explain the potential for high-yielding investment as a result of scarcity and complementarities with existing assets. Together with a review of

developments in the structure of investment, these arguments are developed in Section 4.3. A discussion of constraints on the response of investment to these “fundamentals” follows in Section 4.4, focusing particularly on the role of uncertainty, and a brief discussion of policy implications concludes (Section 4.5).

Because of data restrictions, most of the evidence and analyses refer to investment in physical capital. For the same reason, and because much of the “story” behind investment during the transition is hard to measure, there will be a focus on principles and examples rather than more detailed quantitative analysis.

4.1 The inherited capital stock

The capital stock that the transition economies inherited was accumulated under central planning, a product of what Kornai describes as “the age of forced growth”.² Among the characteristics of that age were: (i) that consumers had little voice in determining overall investment rates in a system primarily controlled by agents whose interests or inclinations lay in expansion; (ii) that, therefore, investment priorities were geared heavily towards investment and producer goods; and (iii) that incentives were not linked to efficiency, with prices, costs and economic returns playing only a minor role in guiding the structure and technology of the capital stock.

As a result of the first of these characteristics, investment rates as a share of national income were consistently and impressively high, while consumption was suppressed – this was discussed in Chapter 3. As a result of the second, a capital stock was built up over time whose sectoral and technological structure was far removed from that generated in market economies. The third characteristic accounts for an extremely low efficiency of capital in generating value added (even if valued at the distorted prices of the old system). A particularly stark example of inefficiency are the energy coefficients in GDP. Compared with the OECD area, the energy intensity of GDP in 1992 was about four times higher in the east European countries, and more than six times higher in many countries of the former Soviet Union (see Table 4.1).³ While the command system was wasteful of all resources, its lack of attention to prices and opportunity cost made it especially wasteful of resources in which it was particularly well endowed. It is in this sense an unfortunate accident of history that some of the command economies were also those with very large resources of oil, gas and coal.

Chart 4.1 plots investment shares in GDP against GDP growth rates of six centrally planned economies (CPEs) from 1974 to 1989, as

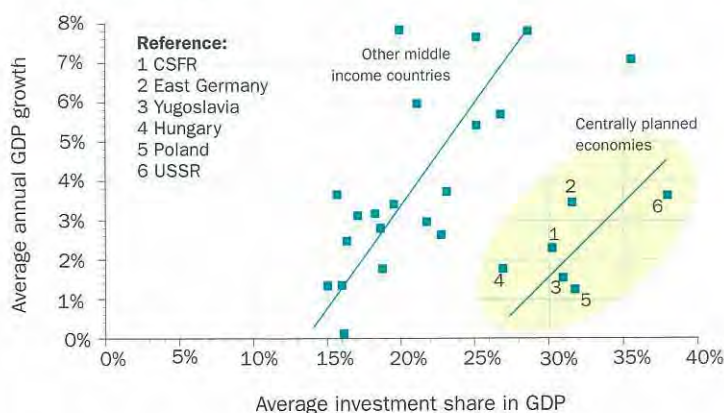
¹ “Sunkness” refers to the fact that these funds cannot simply be converted into another form of asset (e.g. into money) or adapted for a different use without additional investment. Reform can lead to a total loss of value of assets in their previous application; because of sunkness, their opportunity cost then falls to zero.

² Kornai (1992), p. 197.

³ Industrial and geographical structure as well as climate may explain a minor part of the variation.

Chart 4.1

Growth and investment in middle income countries and centrally planned economies, 1974-89



Source
Summers and Heston (1993).

Note
Countries in the sample have the following characteristics:
1. GDP per capita in 1974 – US\$ 2,000-6,000
2. Average annual population growth over the period is less than 2 per cent.

well as those of 20 countries that are broadly comparable in terms of population growth (as a proxy for labour force growth) and income per capita (US\$ 2,000-6,000 annually in 1974). It is evident from this comparison that the CPEs have been singularly unable to translate high investment rates into growth. In fact, fitting lines that relate these two variables, as is done in Chart 4.1, suggests a “rightward” shift in the functional relationship between them in CPEs. It appears that CPEs were not showing the kind of productivity growth that arose from both human and physical capital in other countries.⁴

This is not the place to discuss the causes of this inefficiency and lack of dynamism,⁵ but it is clear that the system induced waste and excessive vertical integration to keep control over supplies, which prevented taking advantage of opportunities for improving productivity. A further result of the priorities of the old system was a systematic choice of technologies that neglected the environment. Lastly, the combination of economic stagnation, very large capital stocks and waste meant that even the high investment ratios could not prevent a lengthening of the average age of the capital stocks in the later years of central planning. At reunification, for instance, this had reached 18 years in East Germany as against eight in the Federal Republic.⁶

This capital stock constituted the initial endowment of the transition economies with which to face the challenge of the market.

Table 4.1

Energy intensities in eastern Europe and the former Soviet Union, 1992

	TPES ¹ /GDP ratios (tonnes oil equivalent per US\$ 000)	TPES ¹ per capita (tonnes oil equivalent)
Eastern Europe²	1.49	2.56
Bulgaria	1.62	2.14
Croatia	na	1.29
Czech Republic	1.70	4.17
Hungary	0.82	2.47
Poland	1.24	2.43
Romania	1.72	1.86
Slovak Republic	1.85	3.55
Slovenia	na	2.82
Former Soviet Union¹	2.78	4.79
Azerbaijan	4.33	3.69
Belarus	1.29	3.76
Estonia	1.70	4.74
Kazakhstan	3.44	5.74
Russia	2.69	7.24
Turkmenistan	3.02	3.45
Ukraine	2.98	4.94
Uzbekistan	3.70	3.11
OECD countries³	0.40	4.84
Canada	0.55	7.88
France	0.37	4.03
Germany	0.41	4.22
Italy	0.32	2.75
Japan	0.26	3.63
United Kingdom	0.41	3.74
United States	0.43	7.78

Source
CEPII, IEA, PlanEcon.

1. Total primary energy supply.

2. Unweighted average.

3. Weighted average all OECD.

4.2 Structural change and the capital stock

Transition “shocks” to the value of capital

Despite its general lack of efficiency, the inherited stock of assets was valuable to enterprises under the set of relative rewards imposed by the central planners. Reform severely disrupted the existing structure of rewards, even though large quasi-fiscal deficits in many of the transition economies are evidence that the impact on enterprises was partly cushioned by the financial system. The inherited capital stock was exposed to several “shocks”: shifts in relative prices and allocations, a radically different structure of demand, changes in environmental and other regulations, and exposure to superior technologies. None of these shocks is “exclusive” to the transition. However, their suddenness, magnitude and pervasiveness during the transition are unusual.⁷

⁴ The regression lines are defined in terms of the rate of growth (dependent variable), the investment share in GDP (independent variable) and a shift factor. This is obviously a simplification of what is in reality a very complex relationship, and there are a number of possible underlying theories. However, an analysis of the roots of low productivity growth under central planning is not our main focus here.

⁵ See, for instance, Le Houerou (1995); Kornai (1992).

⁶ Eickelpasch (1995). In Poland in 1993, 37 per cent of the fixed capital of enterprises surveyed in a World Bank research project was older than 15 years, and 57 per cent older than 10, in spite of a rebound in investment activity that had begun by that time (Belka et al. 1994).

⁷ They are also accompanied by new forms of institutions and behaviour – a “shock” which does distinguish the transition.

These shocks are discussed in the following since they are important for subsequently deriving the structure and productivity of investment. The plausible assumption is made here that capital and its embodied technology are mostly irreversible, once installed.⁸ Were it not for this feature, capital could simply migrate to the sectors now favoured by the new prices or demand, and mutate into new technologies and shapes with no obvious consequences for its value.

Relative price shocks

Relative prices of products and inputs into production have re-adjusted as a result of price liberalisation, foreign competition and the elimination of subsidies. Even at a very aggregate level, these shifts can be dramatic. For components of the consumer basket, Table 4.2 shows that, except for Bulgaria among the countries selected, the price of services has risen much faster since the beginning of liberalisation than other prices. For industrial sales prices, the selection in Table 4.3 illustrates that prices of raw materials and intermediate goods into production have often left prices in sectors that manufacture final products far behind. To pick an extreme example, in Russia the prices of energy and fuels rose by factors of 6 and 7, respectively, relative to the price of textiles.

We should expect the value of the capital stock to fall in those sectors in which input and output prices and subsidies move so as to reduce real net cash flows, and vice versa.⁹ While the market value of capital services falls in some sectors, however, this is not equivalent to retirement of the capital (scrapping) except where cash flows insufficient to finance wages force installations to close down.¹⁰ Even where this is not the case, we should often see equipment operating at below capacity (if this helps to reduce operating costs) and the scrapping point brought forward.

Box 4.1

Relative prices and the value of capital

The valuation of capital is central to this chapter and deserves some analytical clarification. Capital goods can be valued at the cost of producing or releasing them (supply price) or at the value they represent to users (demand price). In principle, this applies to all forms of capital, but we will here concentrate for simplicity on physical, commercial assets.

In the short run, the supply of capital goods is often inflexible and the market-clearing price will tend to reflect the “user value” of existing capital stocks. In the longer run, especially where capital goods imports are an option, it will be the supply price that determines market values, but supply and demand prices will also show some tendency to converge as stocks of assets increase (or decline) over time. As a result, in transition economies, assets in certain sectors suddenly “favoured” by demand may rise steeply in value initially, and fall behind general price increases later on, and vice versa.

The demand price of capital goods is perhaps the most difficult of these concepts. It reflects the expected stream of net income that can be derived from their application in production, the variability of that stream (risk) in conjunction with the degree of irreversibility of an investment, as well as the discount rate at which future income is discounted to its present value. The determinants of the net income stream include on the one hand the prices of outputs, material inputs and non-material inputs such as labour, in short the structure of relative prices in the economy. On the other, the efficiency with which the capital goods help transform units of inputs into units of output – i.e. their technical coefficients (as well as management ability). The discount rate will generally be dictated by the returns to funds in alternative, relatively risk-free investments (such as US Treasury Bonds). Lastly, risk – with respect to relative price movements, regulations, etc. – in a transition environment is to a large extent a function of the speed and decisiveness of reforms, a point that is addressed in Section 4.4.

Table 4.2

Relative prices of consumer goods, selected countries*

	Bulgaria ¹	Hungary ²	Kazakstan ²	Latvia ³	Poland ¹	Russia ¹
(Consumer Price Index = 100)						
Food	109	100	114	91	74	102
Beverages & tobacco	38	87	–	66	87	35
Non-food	–	–	84	–	110	79
Clothing	64	87	–	67	–	–
Housing, electricity, heat	73	142	–	145	–	–
Services	86	106	172	249	175	307

* Change in price over the period relative to the average consumer price index.

Sources
OECD short-term economic indicators; *Russian Economic Trends*.

- 1 1990-94.
- 2 1989-94.
- 3 1991-94.

⁸ While equipment can sometimes be refitted (e.g. gas-guzzling engines in cars or aeroplanes, environmentally damaging power-generating technology), rededicated (e.g. military-industrial plants), or relocated (computers, transport equipment), this will tend to involve substantial new investment. These issues are taken up again in Section 4.3.

⁹ See Box 4.1 on capital valuation. Note that a simple one-to-one relationship between cash flow and the market value of physical capital exists only under strict assumptions which include perfect foresight of investors, the absence of intangible capital, and others.

¹⁰ “Capital services” is employed here for simplicity; in fact, equivalence between cash flow and capital services is only given in the absence of taxes and market power.

Table 4.3**Relative industrial producer prices, selected industries and countries**

Industrial sector	Belarus ¹	Bulgaria ²	Poland ³	Russia ⁴
(Industrial Producer Price Index = 100)				
Energy	127	142	219	222
Fuel	185	148	179	188
Ferrous metals	86	230	109	130
Chemical	123	148	94	118
Machine-building	36	73	61	83
Electrical/electronic	—	65	61	—
Building materials	98	115	86	97
Glass	30	114	92	—
Textiles	53	78	57	30
Food	62	109	103	81

SourcesNational Statistical Yearbooks, *Russian Economic Trends*.**Note**

Change in price over the period relative to the average industrial producer price index

¹ Dec. 1991-Mar. 1995² 1989-93³ 1985-93⁴ Dec. 1991-Dec. 1994**Changes in the structure of demand**

Trade liberalisation, the new power of consumer preferences and the cutback in defence spending in many transition economies have shifted sectoral and geographical patterns of demand. Table 4.4 illustrates that there have been dramatic shifts, over a period of only four years, even at a broad sectoral level of disaggregation. The service sector has gained substantially in most countries in terms of shares at the expense of industry and, to a lesser extent, of agriculture. More detailed data show wide differences in the performance of individual industries within these aggregates.¹¹ This has brought opportunities to some industries and severe adjustment problems to others. To the extent that prices were not flexible enough to accommodate demand (or that products would not find a buyer whatever the price) the result has been “structural unemployment” of the capital stock in the now neglected sectors – reduced capacity utilisation that will not be overcome by a cyclical upturn in aggregate demand. In accounting terms, the excess capacity should be written off. There will also be gainers from these demand shifts, with capital in the “favoured” sectors enjoying temporary scarcity rents. The same propositions developed here for “physical” capital apply to human capital, to the extent that it is application-specific (i.e. they apply to certain forms of on-the-job training but not to general education which is “fungible”).

Table 4.4**Changes of sector shares in GDP at current prices, 1989-1993**

	Industry	Agriculture	Services ¹
Change in share (% of GDP)			
Albania	-26.4	6.7	19.7
Armenia	-22.5	47.9	-25.4
Azerbaijan ²	7.7	0.7	-8.4
Belarus	5.2	-5.5	0.3
Bulgaria	-23.5	1.3	22.2
Croatia ³	-3.6	2	1.6
Czech Republic	-10	-0.4	10.4
Estonia	-8.4	-9.9	18.3
FYR Macedonia ²	-7.3	2.6	4.7
Georgia	-21.3	34	-12.7
Hungary	-8	-8	16
Kazakhstan	9.2	-15.1	5.9
Kyrgyzstan	-6.7	4.1	2.6
Latvia	-13.1	-4.3	17.4
Lithuania	-3.3	-6.7	10
Moldova	1.8	-11.9	10.1
Poland	-19.4	-5.9	25.3
Romania	-19.3	6.7	12.6
Russia	-11.1	-5.6	16.7
Slovak Republic	-14.9	-2.7	17.6
Slovenia	-8.9	0.2	8.7
Tajikistan	1.3	6.1	-7.4
Turkmenistan ⁴	1.7	-4.3	2.6
Ukraine	-3.5	13.5	-10
Uzbekistan	2.7	-7.8	5.1

SourcesComputed from data from national statistical offices, *World Tables* (World Bank), *Trends in Developing Economies* (World Bank), UNECE.¹ Calculated as a residual for some countries.² Change over 1989-92.³ Change over 1990-93.⁴ Change over 1989-91.**Changes in regulations**

In various countries of the region, particularly the east European candidates for accession to the EU, environmental and health and safety regulations have begun to be adapted to Western standards. Existing installations, for instance in the power-generating and chemical industries, will have to comply with these standards over time, often by deadlines that are likely to lie well within their economic lifetimes. Consequently, refitting or premature scrapping will be required, reducing the discounted value of capital services and thus the market value of equipment and perhaps structures. Investment needed to achieve environmental “parity” with the EU has been estimated at ECU 91 billion for the six large central and south-east European candidates for accession,¹² implying substantial annual spending if measured as a share of 1990 GDP (Table 4.5). While some of the investment will take

¹¹ Chart 4.3 illustrates the variation of output and investment shares in Romanian industry.¹² These are Bulgaria, the Czech Republic, Hungary, Poland, Romania and the Slovak Republic.

place as part of the normal replacement cycle of capital goods and structures,¹³ it will place impossible burdens if any attempt is made to compress it into a period of five years or so. The environment is an area where international partners have both an incentive to collaborate and expertise to impart. It is likely to be of special importance in the activities of the international financial institutions in the coming years.

Technology shock

The liberalisation of external transactions has made technologies and products available to economic agents in eastern Europe, the Baltics and the CIS that are sometimes far superior to domestic ones, especially given the new set of input prices. This is equivalent to an innovation shock – “creative destruction”, in Schumpeter’s terminology.¹⁴ The impact on existing capital in this case derives not from changes in the product markets but directly from competition in the markets for capital goods. The capital stock in the affected sectors is relegated to an obsolete “vintage”, and its market value can decline sharply independently of any changes in product and input prices or demand. For instance, if the profit rate on gross revenues generated by “old” machinery is 10 per cent, new equipment that helps to save input costs representing another 10 per cent of sales value can double profits and thus – assuming everything else remains constant – the user value of the machinery. As illustrated by Table 4.1 in the previous section, the efficiency differential, for instance regarding the use of energy, can be very large.

Measures of the decline in the market value of capital

The “shocks” described in the previous section can be synthesised in a drop in the value of inherited capital that combines conventional measures of physical decay with a structural and technological rate of obsolescence.¹⁵ Many of the changes do not

take place once and for all, but over various years. If they are initially underestimated – and there is some evidence of that – this increased depreciation can also be a drawn-out process. An exception to this is East Germany, which adopted Western prices, regulations and demand structures virtually “overnight”, on 1 July 1990. According to estimates, at reunification between 50 per cent and two-thirds of the capital stock became subject to write-off under West German accounting rules.¹⁶

However, accounting rules do not generally reflect market values. Unfortunately, in the absence of well-functioning stock markets (pre- and post-reform) it is very difficult to estimate changes in the value of installed capital. The closest that Western market economies have come to such an experience in recent history was the oil price shock of the 1970s. Between 1973 and 1974, the industrial share price index dropped by 23 per cent in the United States and 41 per cent in the UK.¹⁷ While many other factors influence stock prices, it is likely that this crash was heavily influenced by the instant loss in value of company assets that were either energy-intensive or dedicated to the production of energy-intensive goods (such as certain models of motor car).

A different approach to measuring the effective size of the inherited capital stock under market conditions is to approximate it by that which would generate the same value of output in comparable market economies. Taking account of measures of human capital and labour endowments in the transition economies, Borensztein and Montiel, for instance, estimated that between 50 and 75 per cent of the pre-transition capital stock in the former Czechoslovakia, Hungary and Poland should be written off.¹⁸ This methodology values capital in proportion to value added at market prices, and the implied write-off thus reflects primarily the high technical input coefficients of the existing capital stock. Some of these may show

Table 4.5

Investment needs to achieve regulatory and emission standard parity with the EU

	Czech Republic, Slovak Republic	Poland	Hungary	Bulgaria	Romania	Total
Investment needs (ECU billion)	17.7	30.4	12.3	11.5	19.1	91.0
Investment need per capita (ECU)	1,128	796	1,160	1,304	837	947
Annual investment need as % of 1990 GDP ¹	2.8%	4.0%	3.3%	4.5%	3.9%	3.7%

Source

Environmental Resources Management (1993), based on estimates by IFO Institut für Wirtschaftsforschung, Munich.

¹ Assuming costs are spread over 15 years.

¹³ Hence, one should not ascribe the full amount of the investment to stricter environmental regulation. Note that much of the investment will have to be done by municipalities, not the enterprise sector. The detailed estimates were prepared in 1993 as part of EBRD/EU-Phare-sponsored research into the implications of harmonisation of regulations in the environmental field. The estimates are derived from case studies covering the fields of air (Poland), water pollution (Hungary) and treatment of waste (Czech Republic), and represent a high-case scenario, i.e. they imply meeting high western European environmental and technological standards, and not necessarily those that would represent the appropriate balance between cost and priorities of the transition economies. See Environmental Resources Management (1993).

¹⁴ The industrial history of Western market economies abounds with examples. Among the more prominent ones is the “sudden” obsolescence of existing computers every time a new, more powerful generation of these machines is introduced, with corresponding falls in their market value.

¹⁵ Baily (1981) develops such an approach.

¹⁶ Estimates by the Institut für Angewandte Wirtschaftsforschung and the Deutsches Institut für Wirtschaftsforschung, according to Sinn and Sinn (1992), p. 44.

¹⁷ Industrial share price indices reported in the *International Financial Statistics*, IMF.

¹⁸ Borensztein and Montiel (1991).

some flexibility, for instance, allowing for substitution of labour for energy services in agriculture. The estimates would therefore overstate the value depreciation of the capital stock. However, neglect of the structural and regulatory changes and “technology shock” elaborated in the previous section in turn suggests a downward bias.

4.3 Returns to investment

What does the value-contraction of the capital stock imply for investment? In Chapter 3 we elaborated on the potentially high growth-contribution of investment in a transition setting. In essence, new capital can make a significant contribution to economy-wide productivity growth because: (i) new physical capital can complement valuable existing assets such as human capital which are now in excess supply; and (ii) it should differ from the inherited capital stock in quality and sectoral allocation and could thus initially enjoy scarcity rents.

Equivalently, the returns to new capital, *if well invested*, can be expected to be high. Investment in the transition is “special” in that we should not assume that the growth in the capital stock is more or less balanced across sectors – as may be a reasonable approximation in more mature market economies. Its composition is crucial and is the subject of this section. The focus is on enterprise investment; public investment is briefly discussed in Section 4.5. It should be noted that the following discussion perhaps provides perhaps a somewhat optimistic assessment of the investment process in the transition economies. In fact, investment is subject to a variety of constraints which are taken up in Section 4.4.

Broad trends in the sectoral allocation of investment

It is instructive to view some evidence of sectoral investment patterns in the transition economies. Data on sectoral changes in investment that allow cross-country comparisons over various years are not easy to obtain. Table 4.6 provides our aggregation to the “smallest common denominator” – agriculture, two industrial sectors, four service sectors – for 13 countries. The figures represent the variation in the share of the respective sector in total investment, between 1989 and 1993. We have created three loose country groupings based on the country-specific progress in transition that had been made by mid-1994.

A clear pattern that emerges is the loss in the share of agriculture and, to a lesser extent, of industry, in favour of the service sectors. This pattern is valid for all subgroups, though differences emerge regarding gainers and losers within the service sectors. The trade sector has most consistently posted gains, while there is surprising variation in housing investments across countries, perhaps partly explained by institutional differences in this sector. The presence of uncertainty over investment outcomes, which tends to constrain investment in capital-intensive sectors, may explain part of the early improvements in the relative position of (less capital-intensive) services (this is discussed in Section 4.4). Some of the contraction in certain sectors reflects particularly severe state and municipal budget cuts (low infrastructure investment in the bottom group) and geographical specificities (high infrastructure investment in the Baltics), and one should be careful not to interpret all movements as a function of the economic transition alone.

Table 4.6

Changes in sectoral investment shares (1989-93)¹

	Agriculture	Industry	Construction	Transport & communication	Trade	Housing	Other services
<i>In per cent of total investment</i>							
Czech Republic	-7.5	-0.9	-0.7	-0.2	0.1	-5.2	14.2
Slovak Republic	-7.6	-7.5	0.3	7.6	1.6	0.3	5.3
Hungary	-6.8	1.0	0.2	6.6	0.7	-2.9	1.2
Slovenia	1.2	-9.9	-0.9	5.9	2.1	5.3	-3.7
Poland	-5.0	-3.1	0.8	-1.5	3.3	-7.7	13.0
<i>Sub-average</i>	<i>-5.1</i>	<i>-4.1</i>	<i>0.0</i>	<i>3.7</i>	<i>1.6</i>	<i>-2.0</i>	<i>6.0</i>
Latvia	-19.6	-0.6	-1.0	19.3	1.7	7.4	-7.2
Lithuania	-10.3	-5.4	-3.0	12.4	0.8	1.6	4.1
Kyrgyzstan	-13.5	-1.0	-1.4	9.3	-0.1	7.2	-0.4
<i>Sub-average</i>	<i>-14.5</i>	<i>-2.3</i>	<i>-1.8</i>	<i>13.7</i>	<i>0.8</i>	<i>5.4</i>	<i>-1.2</i>
Russia	-1.8	-7.5	-8.2	-3.9	8.2	10.3	2.9
Bulgaria	-5.7	-3.9	-0.4	0.8	9.3	-3.5	3.4
Romania	-11.1	3.7	-0.6	2.6	6.6	-5.0	3.8
Kazakhstan	0.6	8.2	-4.4	-7.4	0.6	3.5	-1.0
Ukraine	-7.4	-1.7	-0.9	-4.0	1.1	8.4	4.5
<i>Sub-average</i>	<i>-5.1</i>	<i>-0.2</i>	<i>-2.9</i>	<i>-2.4</i>	<i>5.2</i>	<i>2.7</i>	<i>2.7</i>
Overall average	-7.3	-2.2	-1.5	3.7	2.8	1.5	3.1

Source

Elaborated on the basis of data provided by national statistical offices.

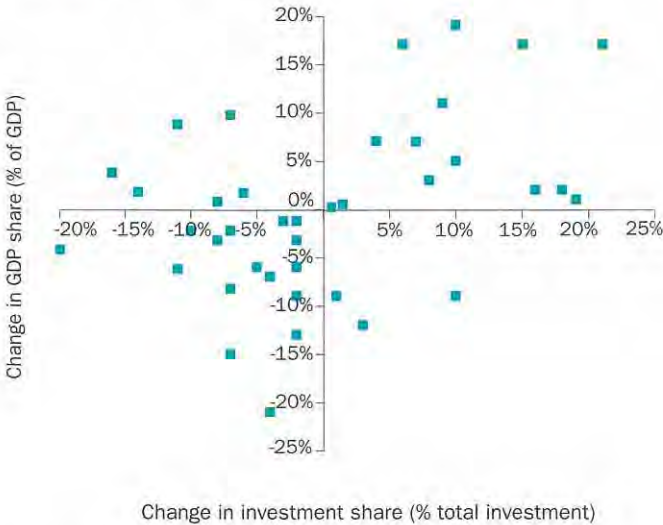
¹ Example: The share of agriculture in total investment in Lithuania fell from 14.6 to 4.3 per cent between 1989 and 1993, hence by 10.3 per cent of total investment.

Net cash-flow, technology and the structure of investment

The broad investment trends suggest that an adjustment process is in motion whereby the “central planning biases” in the production structure of the transition economies are gradually being overcome. Services were consistently underrated under central planning. Shifts in demand and prices caused by the switch from planners’ to consumers’ choices might thus provide a simple explanation for the investment trends.¹⁹

As discussed, it is plausible to assume that capital specific to the sectors favoured by price and demand shifts (more generally cash flow) should rise in value, drawing in new investment to increase production capacities, whereas that in the declining sectors should fall, with correspondingly sluggish investment activity. Over time, with capital stocks adjusting to their new equilibrium sectoral structure, scarcity rents should end and returns to investment activity in all sectors should return to “normal”. When all this takes place within a framework of declining aggregate GDP and investment, we should nevertheless expect investment of the sectors favoured by the new relative prices to expand as a *share* of the total.²⁰

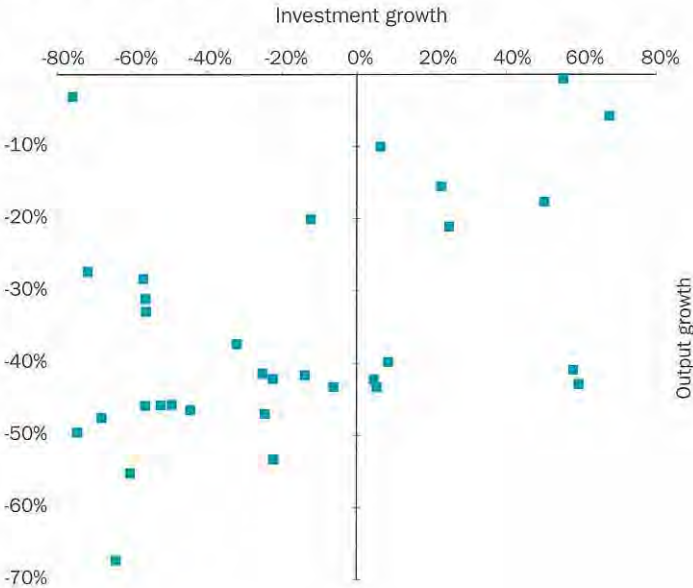
Chart 4.2
Change in GDP and investment shares of agriculture, industry and services (13 countries, 1989-93)



Sources
Tables 4.4 and 4.6.

Note
Each point represents the change in investment and GDP shares of either agriculture, industry or services in one of the 13 transition countries for which consistent data are available.

Chart 4.3
Sectoral output and investment growth in Romanian industry, 32 sectors (1990-93)



Source
Romanian Statistical Yearbook, various issues.

Employing output shares as a proxy for demand, this proposition turns out to hold reasonably well at the broad level of sectoral aggregation chosen here. Chart 4.2 plots variations in the sectoral shares in GDP and investment of agriculture, industry and services in 13 countries in transition, over the period 1990-93.²¹ Three-quarters of points in the scatter-plot lie within either the first or third quadrants, indicating that the relative importance of sectoral investment and GDP changed in the same direction.

There is little evidence, however, of changes in investment having generally been more drastic than output changes, as one might have expected. Strong movements in investment shares coincide with only moderate ones in output shares and vice versa, with numerous points in the second and fourth quadrants.

Some of this could of course be explained by differences in the depth of the transition process among the countries in the sample. Nevertheless, a more disaggregated look at the performance of industrial sectors, as displayed in Chart 4.3 for Romania, suggests that other factors must also have been at work. Examining levels rather than shares, output in all sectors declined. Nevertheless, investment growth, in some cases substantial, was measured in 13 of the 34 sectors of Romania’s industrial classification system.²² A positive correlation between investment and output growth exists but is weak (the correlation

¹⁹ The direction of structural change can be “predicted” by employing the Chenery- method of identifying “stylised” patterns for market economies of the same income level, size and natural resource endowment as the economies in transition (Chenery, 1960). Results from such studies confirm the likelihood of structural change away from agriculture and industry and towards the service sectors in transition economies. For example, Döhrn and Heilemann (1995) perform estimates for four central European countries.
²⁰ This ignores the role of subsidies. The phasing out of subsidies can lead to higher prices and lower profitability at the same time. Cash flow would be a better measure of resource pull.
²¹ That is, each point in the scatter-plot refers to one of the three sectors in one of the 13 countries.
²² Two further sectors, both with positive investment and negative output growth, are not shown. They displayed extreme values.

coefficient is 0.24). Altogether, industrial investment fell by only 7.6 per cent, while output collapsed by 39 per cent.²³

It is likely that a relationship between investment and demand is hard to pick up at a disaggregated level partly since differences in technological obsolescence are obscuring it. The technological gap that separated productive assets from those in now competing market economies varied widely among sectors. There is no reason *a priori* to suspect that it was greater or lesser in sectors that benefited from liberalisation.

How does this affect the calculation of the individual investor? As a general rule, investment will tend to flow into those sectors in which capital is particularly scarce, to take advantage of scarcity rents. Simplifying somewhat, scarcity is a function of the “gap” between the stock of capital in a sector (with new technologies) that could be sustained by demand, and that which currently obtains. It is then clear that, if output price changes are favourable to a sector, while its capital stock is heavily depreciated due to obsolescence, returns to investment in this sector will be potentially high and vice versa. When favourable output prices together with a valuable capital stock or unfavourable conditions on both counts prevail, the effect on returns is harder to predict, since it will depend on aggregate demand conditions.

While empirical information to illustrate these propositions is hard to obtain, they may explain some of the variance observed in Charts 4.2 and 4.3. A further hypothesis based on complementarities between different assets is elaborated in the following subsection.

Complementarities between different assets

Once we take into account that firms employ various forms of capital, the possibility arises that they depreciate at different rates. However, as long as they are closely bound together, such as usage-specific machinery and the structures to house it, the potential value of assets that are only weakly affected by relative price changes can often not be realised without new investment. This is true for individual firms as well as for sectors or the economy as a whole. An example of the latter is the presence of a surplus of engineers and scientists who, though perhaps “mobile”, may not find productive applications once complementary physical capital has declined in value because of obsolescence, or because the market demands somewhat different abilities. The market value of such capital can decline sharply as a result, although its potential productivity, given some new investment, is great. In view of the high levels of human capital indicators in the transition economies (see Chapter 2), this is a highly relevant issue.

To illustrate the implications for investment, we analyse two cases of complementarity. First consider a factory in, say, Poland, that

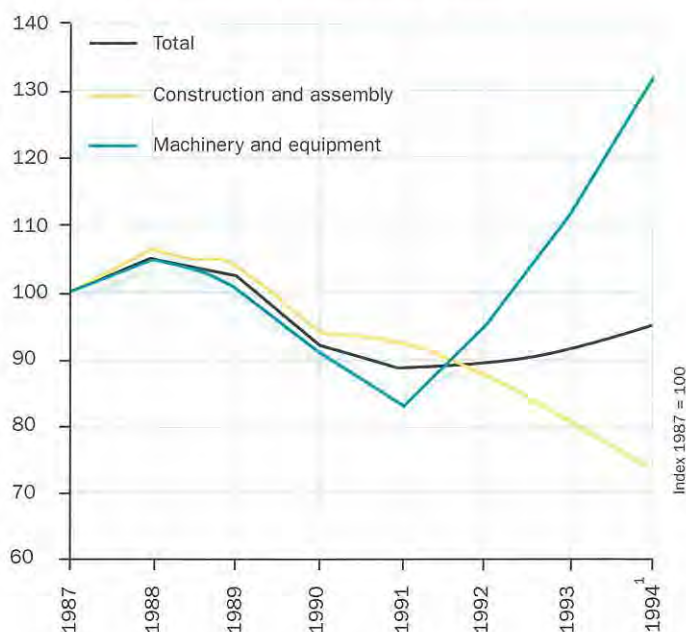
runs an obsolete assembly line in good-quality buildings. Replacing a share, maybe a small share, of the company’s capital – namely all or part of the equipment – together perhaps with managerial and organisational changes, can bring it up to the standard of its (foreign) competitors. Since the buildings and other usable assets represent sunk costs, the returns to this investment would be higher than, say, that of competitors abroad in expanding their production capacity.²⁴ This effect is magnified when, as has happened in various transition economies and sectors, the unit labour cost falls as a result of declines in wages disproportionate to the decline in potential labour productivity.

The development of investment outlays by the enterprise sector in equipment and buildings, during the Polish transition, provides a vivid illustration of the point made here (Chart 4.4). After first declining jointly until 1990, investment in equipment rose rapidly while building investment continued to fall. Table 4.7 shows that Poland’s experience is shared by other east European countries that are recovering from recession (except Hungary), while equipment investment had not yet picked up in the countries of the former Soviet Union.

A second example should illustrate that the same considerations apply for human capital, perhaps still more strongly. Consider an accountant, say, in a Ukrainian firm, with skills that are quite

Chart 4.4

Poland 1987-94: investment in construction and machinery



Source

GUS (National Statistical Office), *Monthly Statistical Bulletin*, various issues.

1. First three quarters only.

²³ An alternative approach is to view growth in investment as a function of relative prices instead of output. Again, except for Poland, changes in investment show little correlation with relative industrial sales prices at a detailed industry level: the correlation coefficient for the period 1990-93 is -0.3 for the Czech Republic, 0.46 for Poland and 0.08 for Romania. Computed from data in the *Statistical Yearbooks*

(Statistical Offices) of the Czech Republic (17 industrial sectors), Poland (23 sectors) and Romania (24 sectors).

²⁴ This phenomenon should be viewed as in fact combining two types of investment, rededication and “new” (i.e. replacement), of which only the latter is measured in investment statistics.

specific to the Soviet system of recording financial and physical flows. Such skills cannot generate the kind of information that would allow the firm to take appropriate decisions in a market environment, receive access to bank loans, etc. As can be observed in many transition economies, skilled workers may end up engaging in petty trading activities or others that do not make use of much of their human capital. Effectively, this capital “depreciates”. However, it consists of various components, including years of primary and secondary schooling, post-secondary training that raised the ability to think conceptually, and only a relatively small component that was specific to the now obsolete accounting skills. A similarly small investment in training in market-based accounting methods could re-establish a high level of productivity, with the difference between the “new” value to the firm and the value of an unskilled activity representing the returns to this investment. Again, as in the case of the equipment investment previously discussed, the sunk cost of this accountant’s general education can cause these returns to be very high.

The two examples can be combined and extended to other cases where complementarities between different forms of capital characterise the investment process.²⁵ The effect, as in the previous considerations regarding scarcity, is that marginal returns to capital in individual sectors and activities can be very high.

4.4 Investment-constraining factors

The previous sections have pointed out the potential for investment in the transition economies. However, the scale and pervasiveness of the adjustments during the economic transition within a framework of nascent and weak institutions can severely strain the ability of investors to respond to these opportunities. As a consequence, potentially useful capital may gradually decay, and knowledge wither away. Perhaps the most important constraint is uncertainty, but others include coordination problems in the presence of market linkages, problems in financing investment, continuing government intervention, deficient governance and high transaction costs. While the discussion in Section 4.3 emphasised “fundamentals” and did not stress cross-country differences in the investment process that we should observe – except for the requirement of substantial liberalisation – the constraining factors differ widely between countries. It is the existence of these constraining factors, the high potential and the cost of delay, that provide a strong justification of the participation of a financial institution such as the EBRD acting on the frontier of the investment process.

Uncertainty and investment

Uncertainty, the waiting option and the structure of investment

Uncertainty – over market developments, prices, legal problems and changes in government regulations – is a central feature of transition. Once we recognise the inevitable uncertainty about the evolution of these parameters, we see that waiting can enhance the value of an investor’s opportunity by reducing the chances of the resources committed to it proving inappropriate in quantity, form

Table 4.7

Share of machinery and equipment investment in total fixed investment (per cent)

	1990	1991	1992	1993	1994
Bulgaria	45	47	46	46	–
Czech Republic	46	46	46	52	57
Estonia	–	–	–	58	–
Hungary	46	46	48	48	45
Latvia	42	33	34	37	–
Lithuania	–	25	23	37	–
Poland	35	35	39	42	47
Romania	41	39	37	45	45
Slovak Republic	46	51	–	–	–
Slovenia	45	54	51	60	62
CIS	54	–	48	41	43

Source

UNECE Economic Survey of Europe in 1994-95, Table 3.2.15.

or embodied technology. Prospective investors may delay their projects in the hope that uncertainty will be dissipated. When the investor has some notion of the distribution of returns, the value of the “wait and see option” can be calculated and set against the net present value of the investment. It is easy to show that even a small amount of uncertainty can result in a high “option value” as long as relatively safe alternatives for “parking” funds exist and there is little difference in principle between investing now or later – the cost of waiting for a year is then only the difference between the expected yield of the investment and that of the alternative, while the potential “cost” of investing, should events take an unfavourable turn, could be a significant capital loss.

Uncertainty affects different types of investment differently, since the exposure of the investor is a function of the degree of irreversibility of the commitment and its duration, and the opportunity cost of delay varies. Because of a smaller exposure, the presence of uncertainty tends to discourage investments in sectors with low capital requirements and a high turnover to a lesser degree, such as labour-intensive industrial sectors (e.g. clothing), trade and a variety of other services. Services are also less penalised because of the often greater reversibility of their capital investments. Computers, offices and warehouses, to pick some examples, are not as inherently dedicated to a particular use as an assembly line tends to be. The opportunity cost of delay, in turn, depends on characteristics such as the competitive situation in a market and the ability to pre-empt competitors. The chance of acquiring a strategic asset such as a brand name in a new market, or natural resource exploration and extraction rights, can be a strong incentive to invest before the competition does, even in the presence of uncertainty.

There is no reason to assume, *a priori*, that the sectors that are least discouraged by uncertainty are also those in which the potential productivity of investment is highest. As a result, prolonged uncertainty not only limits overall amounts invested, it can also introduce

²⁵ Note that putty-clay technology for all capital investments is not a necessary condition for these conclusions to hold. In the accountant’s case, only the specialised Soviet accounting skills represented such a technology.

Box 4.2

Evidence on the relationship between inflation, investment and growth

Evidence of a harmful effect of inflation on both growth and investment is presented in Table 4.8. This result is corroborated by three econometric studies which use data covering the last three decades. The first two studies, using data for over 100 countries, found that a permanent increase in inflation by 10 percentage points per year reduces the growth of real GDP per capita by 0.2 to 0.3 percentage points per year and lowers the ratio of investment to GDP by 0.4 to 0.6 percentage points every year.¹ Beyond a point (say, for inflation rates above 100 per cent a year), however, further increases in the inflation rate have a declining incremental (negative) effect on real GDP and investment. The third study arrives at the result that the volatility of the return on capital has a depressing effect on investment and that this effect is greater for developing countries than for industrial economies.² Further, it finds that – after trying a range of indices of political and economic instability as explanatory variables – only inflation seems to be clearly and robustly correlated with the volatility of the return on investments.

On the other hand, at lower rates of inflation (say 20 per cent a year or lower) there is less evidence of any clear pattern of covariation between inflation and growth or between inflation and other observable indices of efficiency, such as total factor productivity. Thus, in speaking of the damaging effects of inflation on performance, one must be clear that it is the high rates of inflation that are at issue.

¹ Fischer (1993).

² Pindyck and Solimano (1993).

Table 4.8

Some economic characteristics of fast-growing and slow-growing countries

Averages of:	Fast growers	Slow growers	t-statistic *
Inflation rate	12%	31%	1.7
Black market exchange rate premium	14%	57%	3.8
Investment/GDP	23%	17%	5.2
Export/GDP	32%	23%	2.3

Source

Levine and Renelt (1990, Table 2). Sample of 109 countries; fast growers are the 56 countries whose growth rate of per-capita income exceeds the mean; slow growers are the remaining 53 countries.

* The rule of thumb is that t-statistics close to 2 or higher signal that the averages are significantly different in statistical terms with a high (95 per cent) probability.

distortions in the pattern of capital accumulation, with potentially long-term consequences. A country may be led far down a low-tech, low-capital path while valuable human capital decays.

Reform path and uncertainty

While transition tends to engender uncertainty, there have been marked differences between countries regarding its extent and duration. Government policy tends to be the principal source of these differences. Decisiveness and swiftness in implementing reforms are important in mitigating uncertainty. As long as a “backlog” of reforms remains, relative prices and other investment conditions are subject to change, enhancing the value of the waiting option. One of the key sources of uncertainty is inflation, which, in addition to its direct detrimental effects, often reflects deeper political and social causes of uncertainty. Evidence on a negative relationship between inflation and growth and investment in large country samples is presented in Box 4.2.

An illustration for the countries in transition is provided by an analysis of foreign direct investment (FDI) patterns in the region, based on a recent survey of investors carried out by the EBRD.^{26,27} In December 1994 the EBRD sent a questionnaire to more than 11,000 companies worldwide, representing approximately 80 per cent of world enterprise capitalisation. Companies were asked to provide a short profile of their investment intentions in the EBRD’s countries of operations.²⁸

Some of the results are shown in Charts 4.5 and 4.6. In each case, the vertical axis measures the existing number of investment projects of the firms in the survey, per capita, in each of the EBRD’s countries of operations. On the horizontal axis, Chart 4.5 uses the transition indicators developed in the 1994 *Transition Report* to measure progress in transition, while the logarithm of inflation in 1993 is reported in Chart 4.6.²⁹ The results indicate that countries that are comparatively advanced in market-oriented transition and price stabilisation have attracted significantly more foreign investment than other countries.³⁰ The evidence from the survey sample is confirmed by the distribution of balance of payments data on FDI presented in Table 4.9.

In Chart 4.7 an attempt is made to capture the extent to which investors are “waiting” and to relate it to price stability as an indicator of uncertainty. It uses information from the survey to construct a ratio between “considered but deferred” investments³¹ and the number of those already undertaken. The positive correlation between this “waiting ratio” and inflation (a correlation

²⁶ This study is part of the Programme of Policy Studies to Promote Private Sector Development being conducted by the Office of the Chief Economist of the EBRD.

²⁷ Foreign investment is particularly sensitive with regard to uncertainty, since alternative investment opportunities tend to exist in other locations. This reduces the opportunity cost of not investing in a particular country and thus enhances the waiting option.

²⁸ This assessment was made based on information from the Worldscope Database. 1,450 companies completed the questionnaire. The response rate was high when measured against the number of large companies likely to consider investing in eastern Europe and the former Soviet Union. Addressees included, for instance, a large number of heavily capitalised municipal enterprises and other companies that would be unlikely to consider investing in the EBRD’s countries of operations. As expected, the response rate among these companies was low.

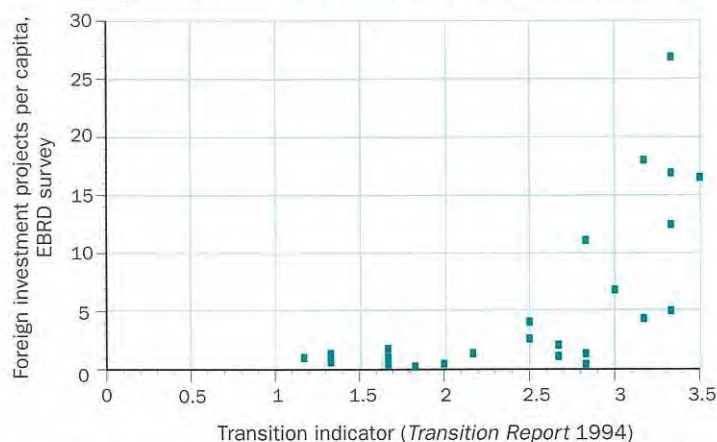
²⁹ The transition “scores” are taken from Table 2.1 of the EBRD *Transition Report* 1994 rather than from the corresponding table of the present Report, given the timing of the survey. In Chart 4.6 inflation for 1993 is used since there tends to be a lag in the effect of inflation on investment decisions.

³⁰ Note that both the transition indicators and inflation show a significant exponential relationship with the level of per-capita investments. That is, the cost of greater macroeconomic instability or the lack of reform can be very high at the margin.

³¹ The survey instrument included questions concerning future investment plans, including a “concrete plans” and a “wait and see” category.

Chart 4.5

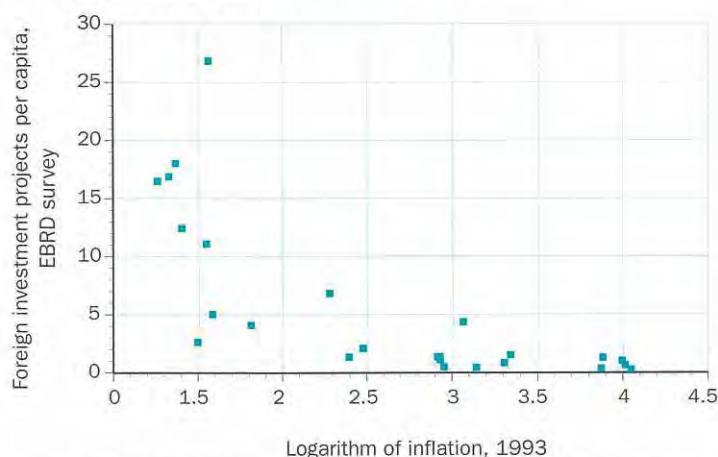
Foreign direct investment and transition level – 25 countries in transition



Note Each point reflects the number of investments in a country that had been undertaken by the companies in the survey, divided by population size (in millions), and the average of six scores that a country received in different areas of reform, in Table 2.1.

Chart 4.6

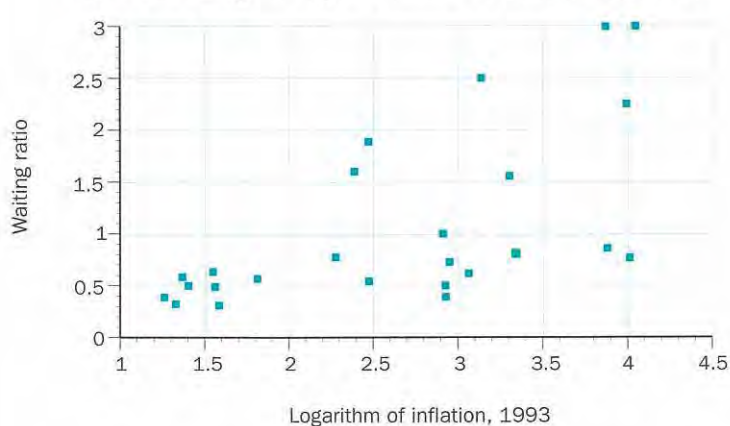
Relation between inflation and foreign direct investment – 25 countries in transition



Note Each point reflects the number of investments in a country that had been undertaken by the companies in the survey, divided by population size (in millions), and the logarithm of the rate of inflation in 1993.

Chart 4.7

Plot of the “waiting ratio” against inflation – 25 countries in transition



Note The “waiting ratio” is defined as the ratio of the number of investments that companies in the EBRD survey indicated they were considering to undertake (if conditions improved), and the number of investments that they had already undertaken.

Box 4.3

Foreign investment: increasing geographical diversification

As described in last year’s *Transition Report*, most foreign investment in the region is concentrated in a small number of countries. However, the dominance of the top five countries is gradually eroding, from 83 per cent of the total in 1992, to 78 per cent in 1993 and 68 per cent in 1994 (Table 4.9). The share of the top two countries in cumulative terms, Hungary and the Czech Republic, has fallen even more significantly, from 59 per cent in 1992 to 35 per cent in 1994. This tendency towards a greater geographical diversification is also evident in the per-capita data, which show an increasingly strong performance of small countries in eastern Europe and the Baltics. It is likely that these developments are explained primarily by the continuing progress in reform in a wide range of countries.

coefficient of 0.61) can be interpreted as a measure of the potential for investments once uncertainty subsides.

Other constraints on investment

Various other factors can prevent investment from responding to the opportunities set out in Section 4.3. They are discussed briefly here for reference. Some of these factors are taken up again in subsequent chapters of this Report.

Coordination failures

Production processes are not self-contained. Any economic activity has to rely on access to necessary inputs and clients, the services of utilities, distribution systems, business services such as advertising and legal advice, and so on. When change is incremental, such as in most market economies most of the time, individual investments can be generally inserted into existing networks of such linkages. When change is as drastic as during the economic transition, the presence of vital linkages can no longer be taken for granted, in particular when some of the necessary goods or services are not tradable. An investment may then have great potential, but only if other investments with which it interacts are undertaken at the same time – investment in a car factory and in parts suppliers, or an agribusiness investment together with the creation of wholesale markets and other infrastructure. Each of these investments may then be postponed because of the danger of being left isolated. The potential for this problem to arise is particularly large in more sophisticated processes – those required to catch up with Western technology. Conversely, however, positive interaction can generate bursts of investment feeding on each other.³² The problem is that, while these linkages can provide benefits to the economy as a whole, they are not seen as returns realisable by the investor who generates them. Linkages are further discussed in Chapter 6.

³² There is a parallel in the economic development debate of the 1940s and 1950s, when these considerations led to proposals of a “big push”, in which the government should take an active role in catalysing investment across broad fronts to overcome such coordination failures. These ideas have recently been taken up by the new literature on growth; see, for instance, Murphy, Shleifer and Vishny (1989). Some of the East Asian development successes have been partly ascribed to a coordinating role of government. Even if correct, this is highly demanding of the skills and credibility of governments and public administrations, qualities that are not easily replicable in other circumstances.

Table 4.9

Foreign direct investment in the economies in transition (US\$ million)¹

	1989	1990	1991	1992	1993	1994	Cumulative 1989-94	Per capita Cumulative	Per capita 1994
Albania	–	–	–	32	45	53	130	38	16
Armenia	–	–	0	0	0	3*	3	1	1
Azerbaijan	–	–	0	0	20	50*	70	10	7
Belarus	–	–	50	7	18	10*	85	8	1
Bulgaria	–	–	–	42	55	105	202	22	12
Croatia	–	–	–	13	72	98	183	38	20
Czech Republic	–	120	511	983	517	850	2,981	289	83
Estonia	–	–	–	58	160	253	471	295	158
FYR Macedonia	–	–	–	–	–	5	5	2	2
Hungary	187	311	1,459	1,471	2,339	1,146	6,913	671	111
Kazakhstan	–	–	–	–	473	330*	803	47	19
Kyrgyzstan	–	–	–	–	10	25	35	8	6
Latvia	–	–	–	43	51	155*	249	92	57
Lithuania	–	–	25	27	61	60	173	46	16
Moldova	–	–	–	–	14	23*	37	9	5
Poland	–	–	117	284	580	542	1,523	40	14
Romania	–	–	–	77	94	428	599	26	19
Russia	–	-400	-100	700	400	1,000*	1,600	11	7
Slovak Republic	–	–	–	100	156	187	443	84	35
Slovenia	–	1	41	113	112	88	355	178	44
Tajikistan	–	–	–	8	9	12	29	5	2
Turkmenistan ²	–	–	–	11	104	100*	215	55	26
Ukraine	–	–	–	170	200	91	461	9	2
Uzbekistan	–	–	–	9	48	87	144	7	4
Total	187	32	2,103	4,148	5,538	5,701	17,709	45	14

Source

Central bank annual reports, IMF, EBRD estimates.

¹ Data for Georgia were not available.² FDI data for Turkmenistan are subject to more than the usual degree of uncertainty.

* 1994 estimated.

Financing

When financial systems are weak and underdeveloped and capital markets shallow, potentially high rates of return do not translate into investments in a straightforward way. As Chapter 4 demonstrates for various transition economies, in such circumstances most investment has to rely on internal financing by enterprises. The need for cash flow makes investment decisions hostage to prior (rather than future) favourable relative price developments (or the presence of market power) and prevents the reallocation of investible funds across sectors to their highest-yielding uses. As Section 4.3 has argued, good investment opportunities in the transition economies – in particular for replacement investment – may often be found in sectors adversely affected by the relative price changes. This assigns a strategic role to financial sector development in the investment process, perhaps more acutely so than in settled market economies.

Transaction costs and government interventions

Efficient investment processes in the transition economies are, lastly, impeded by a host of factors that can be subsumed under the notion of transaction costs. Some of these lie in the nature of the adjustment process – efficient coordination mechanisms to substitute for central planning do not spring up overnight – and time and continuing reform will serve to overcome them. Others have their root in government interventions or administrative systems that are badly adapted to the challenges of a market economy. One such source of difficulties for investors results from the interplay between the tax system and inflation, and is illustrated in Box 4.4. As shown, effective rates of profit taxation can be highly sensitive to inflation under certain conditions, such as accounting rules that do not take account of rising replacement values of assets.

Box 4.4

The influence of inflation on the enterprise tax burden

The company tax burden under inflation depends on the details of a country's tax system as much as on statutory rates. If tax codes are badly adapted to the effects of inflation on the valuation of assets and revenue and cost flows, they can become a serious deterrent to investment. In some cases, companies may benefit from high inflation, at the expense of the tax authorities. This is particularly true if the companies are allowed to pay taxes on a particular flow of income long after the income is earned. The longer they are permitted by tax regulations to wait (or the lower the penalty for non-compliance), the greater will be the extent to which inflation will erode the real value of their tax liability. At the same time, however, the tax legislation may include stipulations that lead to particularly harsh profit taxation when inflation is high. One example would be a stipulation that forces companies to use historical costs to assess depreciation allowances. Another (which has been applied in many countries in eastern Europe and had a great impact, for

example, in Poland in 1990) is a requirement that companies pay tax on the nominal appreciation of their inventories.

The sensitivity of profit taxation to inflation is illustrated in Table 4.10. The data in the table reflects the results of simulations, rooted in a data-set that pertains to a concrete private investment project in which the EBRD participates. A first round of simulations tested specifically within the framework of detailed tax codes for Hungary and Russia the impact on the company tax bill of changes in the rate of inflation and in the tax collection lag.

Table 4.10 measures the tax burden with reference to the "effective rate of taxation", which is defined for a particular investment project as the percentage gap between the internal rate of return before and after taxation.¹ The simulations take into account country-specific taxes levied on profits, dividends, assets, capital gains, sales and certain cost items. They also make adjustments for country-specific rules governing indexation, interest-deductibility, carry-forward of losses, investment incentives, depreciation rules and other features of the tax code.² None the less, it is important to be aware that such simulations cannot capture

the full complexity of the tax treatment in individual cases. For instance, the Russian tax system is often perceived as unpredictable and insufficiently transparent, factors that cannot well be reflected in our figures.

The simulations that were based on Russia's tax code illustrate the potential importance of collection lags at high rates of inflation. Should inflation return from the current comparatively modest levels to the 2,000 per cent seen in 1992, then the effective rate of profit taxation (ERT) could wind up as high as 77 per cent if – as is currently the case – interest payments were only partly deductible and there were no lag between the time at which income was earned and the time at which taxes on this income were paid. On the other hand, the ERT could be as low as 6 per cent if there were a six-month collection lag at this high level of inflation and the company managed to contract considerable debt. Using the 1994 inflation rate in Russia of 203 per cent, the ERT could wind up anywhere between 15 per cent and 53 per cent, depending on collection lags and debt/equity ratios. In practice, the Russian tax authorities introduced as early as in 1992 a system of monthly advance payments for both the VAT and the profit tax. Thus the high tax

1 The calculations were made with the help of the Marginal Effective Tax Rate (METR) software developed at the World Bank, which we modified to suit the context of our simulations. For the METR model, see Dunn and Pellechio (1990).

2 The simulations take account of the following provisions of the tax codes:
Corporate income tax in Russia is charged at a standard rate of 35 per cent. Taxable income is gross income less operating costs and deductions. Dividends are excluded from the tax base for profit tax purposes but are subject to a final withholding tax. The proceeds of share issues and bank loan repayments used for capital investment can be written off against taxable profit. However, there are

some limitations on interest deductibility. The simulations assume that half of interest payments are deductible. There is no specific provision for inventory valuation and capital gains are subject to profit tax. Depreciation allowances follow the straight-line method. Wages are deductible to up to four times the minimum wage, which is set by the government and is usually much lower than the average wage. Losses may be carried forward for five years. Dividends paid to resident and non-resident companies are subject to a final withholding tax of 15 per cent. Dividends paid to resident individuals are subject to income tax (deducted at source), but final withholding tax at a flat 20 per cent rate applies to dividends paid to non-resident individuals. Business property tax at a maximum rate of 2 per cent is levied

by local governments. There are a number of investment incentives for small enterprises. Tax incentives may not decrease the amount of taxable profit by more than 50 per cent. Most companies are required to make monthly advance payments for income tax.

The tax system in Hungary has been radically changed in 1995. Corporate income tax is currently levied at 18 per cent, but an additional 23 per cent tax is due on income distributed to shareholders. Capital gains are included in taxable income and charged at a rate of 18 per cent. The Hungarian tax law permits a number of deductions from the tax base for depreciation allowances. Interest paid by the company is treated as an ordinary business expense but there are some limitations on shareholder

Table 4.10
Sensitivity of the effective profit tax rate to inflation

Country	End-year inflation (per cent)	No collection lags Debt-to-equity ratio			Collection lag: 6 months Debt-to-equity ratio		
		0	0.5	1.5	0	0.5	1.5
		Effective tax rate (per cent)					
Russia	0	32.4	32.0	32.3	32.4	32.0	32.3
	2,318 (1992 actual)	76.9	50.5	31.6	14.3	9.9	6.3
	203 (1994 actual)	52.6	34.4	26.4	29.0	19.2	14.9
	145 (1995 forecast)	49.4	33.3	26.4	30.5	20.8	16.6
Hungary	0	37.9	36.2	33.6	37.9	36.2	33.6
	21.2 (1994 actual)	42.9	37.7	31.1	38.9	34.1	28.2
	28 (1995 forecast)	44.0	37.7	30.5	38.7	33.2	26.9

Note
The same rate of inflation was assumed to apply over the entire life of the project (30 years).

rates quoted in Table 4.10 for the “no collection lag” simulations may reflect reality for those companies that fully comply with the tax code.

If inflation in Russia falls to the more modest levels experienced in Hungary in 1990-94, then the effective rate of taxation will be much less sensitive to changes in collection lags and to additional reductions in the rate of inflation. The data for Hungary in Table 4.10 illustrate this. The difference in the effective rate of taxation between the 28 per cent forecast for 1995 and a no-inflation situation represents at most 6 percentage points, whereas for any given financing structure shifts in collection lags from zero to six months would reduce the rate by at most 5 percentage points (still substantial but small compared with the effect at much higher rates of inflation).

The cross-country data for 1994 (in Table 4.11) show not surprisingly that the ERT was most sensitive to the length of collection lags in countries that registered comparatively high levels of inflation. The ERTs spanned (with no collection lag and a debt-to-equity ratio of 0.5) a range from 38 per cent in Hungary to 87 per cent in Ukraine. With a collection lag of six months, ERTs varied from 34 per cent in Hungary to 49 per cent in the Czech Republic.

lending. The law requires straight-line depreciation with a loss carry-forward of up to five years. Tax is paid under a system of corporate self-assessment, where advance payments are required, based on the previous year's liability. Fines are levied for failure to pay the taxes. There is no withholding tax on dividends paid to resident or non-resident recipients. Dividends paid to resident individuals are subject to 20 per cent withholding tax if the paying company has not paid corporate income tax and to a 10 per cent withholding tax if it has. Effective 1 January 1995, no investment incentives are available to new companies.

In addition, a number of local taxes, import-export duties, and minor other taxes exist in both Russia and Hungary. Inflation is not taken into account in the tax codes of either country.

Other impediments shall only be listed here, for brevity. Thus regulatory and administrative complexities still hamstringing flexible investment decisions in many countries, and multiple and rapidly changing taxes tend to confuse it; legal systems erect obstacles to bankruptcies – thus binding resources that could find more productive uses – and prevent the use of assets as collateral for lending; payment and settlement systems, though rapidly developing, still tax what should otherwise be simple transactions; market and economic information is often scarce; the basic infrastructure for business, such as telecommunications, tends to be deficient; and an under-developed housing market restricts the mobility of labour. Together, these factors curtail the responsiveness of investment to the opportunities outlined in Section 4.3. There is some further discussion of these issues in Chapters 6, 7 and 9.

4.5 Concluding remarks: the role of policy

The key message of this chapter is that returns to investment in the transition are potentially high, both socially – to society as a whole – and for the individual investor. Impressive labour productivity growth rates in the more advanced transition economies, well beyond the initial period of rationalisation, illustrate this point (see Chapter 11).³³ While the focus of this chapter has been on decentralised decisions rather than on policy, there are nevertheless a number of broad messages for the role of governments in supporting the investment process.

Perhaps most importantly, what constitutes a high-productivity or even just sensible enterprise investment during the period of transition is a very complex question. Marginal returns to capital are determined by factors that allow few broad conclusions regarding the appropriate sectoral or product composition of investment. A policy of attempting to target “winners” is likely to be a losing proposition. The information problem is better solved in a decentralised process by managers and entrepreneurs. That is what the market is for. Government investment policy should concentrate on facilitating the response to opportunities by helping to overcome the constraints identified in Section 4.4.

This suggests that the principal task for policy is to mitigate uncertainty, by stabilising the macroeconomy, allowing relative prices to adjust rapidly to their long-term, market-determined levels, and establishing predictable and transparent rules. A stable environment for investment is necessary not only to increase its quantity, but even more so to ensure its (sectoral and technological) quality, which should be the principal source of productivity growth during the economic transition. Rapid and decisive reforms have been successful in achieving these objectives in various countries of the region.

The discussion of investment-constraining factors suggests further scope for policies in promoting linkages, spurring the development

Table 4.11

Effective tax rates in selected countries in transition

Country	End-year inflation 1994 (per cent)	No collection lags		Collection lag: 6 months	
		Debt-to-equity ratio		Debt-to-equity ratio	
		0	0.5	0	0.5
Effective tax rates (per cent)					
Bulgaria	122	83	55	54	36
Czech Republic	10	59	51	55	49
Hungary	21	43	38	39	34
Poland	30	63	47	54	41
Romania	62	–	61	–	47
Russia	203	53	34	29	19
Slovak Republic	12	51	42	48	40
Slovenia	18	51	41	46	37
Ukraine	401	86	87	36	37

Note

The same rate of inflation was assumed to apply over the entire life of the project (30 years).

³³ A more thorough analysis of total factor productivity growth would have to substantiate these propositions. However, since recent net additions to the capital stock in the transition economies have not been higher than in Western market economies, an increase in the average capital intensity of production is unlikely to explain much of the growth in labour productivity.

of the financial sector and reducing transaction costs, including those caused by arbitrary or unnecessary government regulations and interventions. As in other contexts, the development and maintenance of infrastructure are crucial for private enterprise and investment during the transition. While this point has been discussed in Chapter 3, it is worth repeating that many areas of infrastructure are no longer "natural monopolies" because of technological developments and more diverse demand. This opens the possibility of private sector involvement in the provision of these services and in the funding of the required investments – an important consideration for cash-starved reforming governments. Even where private funding is excluded because of the size and duration of the required capital exposure, private management of public services is often possible and desirable.

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Financing enterprise investment

The command economy delivered only low growth, despite high investment, because the investment was of low quality. Under central planning investments were misallocated, and with inadequate or bizarre incentives in enterprises they were inappropriately designed, badly utilised and poorly maintained. In the transition toward a market-oriented economy, an autonomous, if not private, financial sector gains a greater role in mobilising savings by allocating them to investments and by exercising financial discipline over enterprises. This chapter examines how the financing of enterprise investment has evolved so far in the transition. Particular consideration is given to the questions of how, and how far, the lack of finance has held back enterprise investment and whether the evolving financial structures are conducive to improving the quality of investment and the financial discipline on enterprises. Several policy measures to strengthen the financing of enterprises are proposed.

Aggregate data on the financing of enterprises in a representative sample of countries provide the analytical base for this chapter. These countries are the Czech Republic, Romania and Russia, which differ not only in terms of their pattern of enterprise finance at the start of the transition, but also in their progress in developing decentralised or market-based sources of finance. The period covered by the sample discussed is 1990-94. The main identified sources of finance are gross savings of the enterprises themselves (profits after taxes and distributions plus depreciation), bank lending and government transfers for investment. There are also some data on the supply of foreign savings to fund enterprise investment.

5.1 Financing of state enterprises under the old regime

Under central planning, the investment of enterprises was among the most strictly controlled aspects of their operations, and the way in which investment funds were allocated reflected how this control was implemented by government.¹ Most fixed investments by state-owned enterprises were largely funded directly through the state budget. The share of fixed investment financed by savings of the individual enterprise or by bank credits was relatively small. Any surpluses accruing to enterprises after the sale of their products and deduction of costs were typically transferred to the state through a variety of taxes and levies. With the partial reforms to central planning in the 1980s, enterprise autonomy increased and self-finance by enterprises and bank credits gained in significance.

A second method of control was through provision of short-term credits to fund inventories through the state banking system, which provided both the information required to monitor their

levels and a means of exercising control if there was an excessive accumulation of stocks relative to planned targets. Interest rates on these bank loans were kept low: in certain countries and periods, below the rate of inflation.

The role of state banks under central planning was largely passive, apart from exercising administrative control over inventory accumulation. The state banking system comprised the central bank and specialised banks controlled by the central bank. The accounts that enterprises held with these banks were designated for particular purposes, such as fixed investment, material inputs and wages. Money deposited or created for one particular purpose could not be converted into money for another purpose without administrative approval. This internal inconvertibility of money through segmentation of enterprise accounts occurred either within the central bank or between it and the specialised banks. For investment funds provided in the form of credits, the interest rates on the loans were low and their repayment was subject to bargaining between the bank and enterprise.

5.2 Financial reform and development

Comprehensive market reforms require a much greater degree of enterprise autonomy than was achieved under the partial reforms to central planning. This increased autonomy has arisen in part from a winding down of direct government outlays and directed credits for enterprise investment, and in part from an overhaul of enterprise taxation to allow the greater accumulation of savings. This autonomy has been reinforced in some countries through enterprise privatisation and transformation of banking.

The transformation of banking has involved splitting up the monolithic banking system controlled by the central bank into a two-tier system with a central bank and autonomous commercial banks, along with the establishment of internal convertibility of money. This initial change, buttressed by strengthening prudential regulation and supervision and by recapitalising and privatising state banks, has helped to increase the autonomy of enterprises by hardening formerly soft credits (see Chapter 10).

The patterns of enterprise finance that emerge from this chapter reveal that, as the state begins to withdraw from direct support for enterprise investment and to transform banking, enterprises become much more dependent on their internal cash flows to finance investment. It also appears that enterprises as a whole accumulated substantial financial assets as the comprehensive market reforms were being implemented. This period of enormous structural change and great uncertainty may well have encouraged enterprises to postpone fixed investment outlays until a more

¹ Kornai (1992) pp. 131-159.

stable economic framework emerged.² While the significance of bank lending has also tended to increase with progress in transition, the heavy dependence on internal finance remains.

5.3 Challenges ahead

One might be tempted to argue that the heavy reliance on enterprise savings to finance investment in transition economies, bearing a remarkable similarity to the pattern of corporate finance in advanced industrialised countries, is desirable. However, in transition economies the ownership structure of enterprises is not conducive to efficient decisions. In some countries, privatisation has been slow, leaving the bulk of enterprises in state ownership. In others, mass privatisation has achieved the rapid transfer of enterprise ownership to the private sector, albeit at the expense of weak enterprise governance by private owners.³ In each case, the controlling owners of enterprises tend to be either the state or the managers and workers on the one hand, or dispersed outside shareholders on the other. None of these ownership structures are likely to be a source of strong financial discipline (Chapter 8). Therefore, from a perspective which emphasises the role of finance in improving allocations and decisions, as opposed to simply the patterns of flows, the funding of enterprise investment predominantly by internal cash flows does not mark a particularly dramatic departure from the previous regime.⁴

For those enterprises with weak governance structures, greater provision of outside finance can provide an important source of financial discipline. Outside finance can also improve the allocative efficiency of investment. If access of enterprises to outside finance were severely restricted, the allocation of investment would be impaired, since only those enterprises with both sufficient gross savings and profitable investment opportunities would undertake investments. In a well-functioning market economy, only the latter should be the key determinant of whether an investment takes place.

To facilitate and to promote recourse to outside finance, there are two complementary areas for policy. Both entail important considerations for outside potential investors. The first is fostering the development of the financial sector to expand the supply and effectiveness of outside finance (see Chapter 10). The second involves measures to promote product market competition, primarily trade liberalisation, enforcement of anti-monopoly laws or regulations and facilitation of market entry, to keep profits in check and to boost the demand for outside finance (see Chapter 2). This line of argument presumes that the basic fiscal reforms of eliminating the direct government financing of enterprise investment and of overhauling enterprise taxation have already been undertaken. Clearly, the measures to expand the demand for and supply of outside finance should move together.

5.4 Measuring the sources of investment finance

Cross-country comparisons of investment finance encounter a range of challenging issues, and the present analysis is no exception. There are basic issues concerning whether to focus on the outstanding stock of financial claims on enterprises or the flow of these claims and, since enterprises not only raise outside finance but also invest in financial assets, whether to analyse financial claims on a gross or a net basis. The comparability across countries of data and their quality are also important considerations.

Two considerations weigh in favour of the flow approach for the purpose at hand. First, since investment is a flow concept, the question of how investment is being financed is thus primarily about the financing of flows. In terms of stocks, the equivalent question would be how the existing physical capital stock of enterprises was financed in terms of their balance sheets. Of course, the two concepts are linked, with the outstanding stocks at a point in time both representing the cumulation of past flows and being key determinants of future flows. Given the dramatic changes in financial arrangements in transition economies, however, cumulating the past financing of investment is much less relevant to the issue of investment finance than are the new flows. Second, given the high inflation in some countries and the wide range of accounting practices with regard to depreciation, comparability across countries of stock data based on enterprise accounts would be limited. Similar concerns arise in the flow data, but some of the bias in the data can be more clearly identified. For these reasons, the approach taken in this chapter focuses on financing of investment rather than that of the existing capital stock.

The second measurement issue concerns whether a particular type of financial flow should be measured on a gross or a net basis. For example, should bank lending to enterprises be scored on a gross basis or reported net of deposit taking? Similarly, should the acquisition of securities by enterprises be netted against the amount of securities that they issue? To the extent that the objective is to examine the financing of physical investment, the netting of financial flows serves to isolate the amount of funds actually available for investment. The reporting of financial flows on a net basis, however, can risk understating the significance of a particular source of financing. For example, since this chapter analyses aggregate data, the role of banks could be understated if some firms are net depositors with banks while others are net borrowers. The net flow figure at the aggregate level could well indicate zero bank financing, even though banks would clearly be financing some firms.

As with the stock versus flow issue, there is no single answer to the question of whether to measure financial flows on a gross or a net basis. The approach taken here largely reflects data considerations that restrict much of the analysis to net financing flows. However,

² This empirical observation calls into question the emphasis on financial constraints as a primary factor in the downturn in investment in the region. For expositions of that view, see Calvo and Coricelli (1992, 1994) and Calvo and Kumar (1994).

³ See also *Transition Report*, EBRD (1994), pp. 49-68.

⁴ Of course, the introduction of domestic and foreign product market competition does impose a significant discipline on enterprise behaviour. The incentives and constraints faced by enterprise managers and workers have also been altered by the reforms.

in transition economies, the scope for the acquisition of financial assets by enterprises is limited primarily to domestic bank deposits and capital flight.

This chapter focuses on three countries in the region: the Czech Republic, Romania and Russia. The extent of country coverage reflects primarily the availability of data on investment, profitability and depreciation, and net bank lending that are consistent in terms of their coverage of enterprises. The time period for the analysis is 1990-94, to the extent available data allow. The enterprise data are typically compiled by each country's central statistical office from tax or other financial reports filed by enterprises. The coverage of these data can be restricted according to enterprise size, with small enterprises in some cases excluded from the database. On bank lending to and deposit taking from enterprises, alternative data are available from the balance sheets of commercial banks, as compiled by a country's central bank. There can be significant discrepancies between the data on bank lending based on enterprise data and that from commercial banks. These discrepancies reflect both the differences in data sources and in the extent of coverage of the enterprise sector.

Apart from enterprise savings and bank lending, a significant source of finance for investment has been the government. The direct support of government to enterprises has taken the form of current subsidies, such as those for producer prices and operating losses, and transfers to enterprises for investment. The former are typically recorded as revenues to enterprises and reflected in their profitability, while the latter are recorded as financing items. This type of investment finance remains significant in the Czech Republic and Russia. Government support for the enterprise sector in Romania was largely channelled through the banking system. Where possible, current subsidies to enterprises are reported along with their gross savings.

Another source of finance for enterprise investment is the foreign sector. In principle, foreign investment can involve either the acquisition of existing assets or the provision of finance for investment. Some data on this source of investment finance are available for the Czech Republic and Russia. In these countries, the emerging domestic securities markets represent another potential source of finance. However, for the period covered by this chapter, primary issuance of securities in the domestic markets was very limited. The Prague Stock Exchange opened in April 1993, while the securities activities of the Russian exchanges only picked up after the completion of the mass privatisation programme in the middle of 1994.

5.5 Composition of investment financing

The data on enterprise investment and its financing are obtained primarily from the central statistical offices of each country and a number of qualifications are necessary. It must be emphasised that the concepts of enterprise and of investment used in Russia differ substantially from those in the Czech Republic and Romania. In the latter two countries, the statistical coverage of enterprises includes state enterprises and private companies with at least 15-20 employees. In Russia, however, the enterprise is the fundamental

unit of the economy as inherited from the previous regime. The concept of an enterprise is very broad and covers all economic organisations, including non-profit organisations and entities that would typically be considered part of the government sphere, such as schools. Moreover, it is common for commercial enterprises to provide public services, such as housing, education and health care, to their employees. The sharp distinction that is drawn between government and enterprises in a market economy thus remains blurred in Russia as a carry-over from central planning.

In addition, the Russian data on investment distinguish between new fixed investment, repairs to existing capital and inventory investment. Available official data on financing of investment applies only to new fixed investment, the equivalent to net fixed investment in a market economy. As under central planning, the bulk of stock building appears to be financed with bank credits.

The analysis of how enterprise investment is financed in transition economies begins with the Czech Republic. The main reforms that have affected the financing of enterprises are in the areas of fiscal policy and banking. As part of the comprehensive reform programme in the former Czechoslovakia launched in January 1991, current subsidies to enterprises and households were cut sharply, while the tax rate on enterprise profits was halved, along with a substantial reduction in the turnover tax. A two-tier banking system was implemented in 1990, with the newly formed Consolidation Bank taking over low-interest and some non-performing loans beginning in 1991. The authorities have moved steadily to strengthen the prudential regulation and supervision of banks.

The share of gross savings of Czech enterprises in their investment has averaged 129 per cent for the period 1990-94 as a whole (Table 5.1). The fact that enterprise savings exceeded physical investment reflects the accumulation of financial assets, in particular during the period 1990-91. In subsequent years, however, Czech enterprises have been net borrowers from banks and other financial institutions, although the ratio of gross savings to investment by enterprises remains high, averaging 81 per cent in 1993-94. Subsidies to enterprises have declined steadily as a share of gross enterprise savings, falling from 34 per cent in 1990 to 18 per cent in 1994.

The net borrowing of Czech enterprises from banks and other financial institutions has fluctuated significantly. In 1990-91, enterprises accumulated net financial assets with banks and other institutions amounting to 118 per cent of physical investment. However, in 1993-94 enterprises obtained net outside finance amounting to 79 per cent of investment. Some caution is warranted in interpreting these figures because of the large "residual" in the data, movements in which tend to offset the fluctuation in outside finance. Data based on the accounts of commercial banks on net lending to enterprises point to less extreme fluctuations. Moreover, these data also reveal a significant increase in the recourse of enterprises to foreign savings as a source of outside finance in 1993-94. Capital transfers for investment by Czech enterprises rose sharply in 1992 to 42 per cent of investment, but then tapered off in subsequent years.

Table 5.1**Composition of the financing of investment in non-financial enterprises, as percentage of total investment**

	1990	1991	1992	1993	1994	Average
Czech Republic						
Gross financial savings	65.8	228.8	189.0	77.1	85.4	129.2
Net borrowing from banks and other financial institutions	-74.0	-161.5	6.9	95.0	62.3	-14.3
Capital transfers from the state	11.6	42.3	30.0	27.9	21.1	26.6
Other	96.6	-9.6	-125.9	-100.0	-68.8	-41.5
Romania						
Gross financial savings	52.4	96.5	89.0	–	–	79.3
Net borrowing from banks	30.2	3.1	4.7	–	–	12.6
Capital transfers from the state	20.3	6.7	6.0	–	–	11.0
Other	-2.9	-6.3	0.3	–	–	-2.9
Russia						
Decentralised resources	63.0	70.0	70.0	63.0	66.0	66.4
Gross financial savings	–	51.0	31.0	19.0	–	33.7
Credit of commercial banks	–	–	10.0	6.0	–	8.0
Other	–	19.0	29.0	38.0	–	28.7
Centralised resources	37.0	30.0	30.0	38.0	34.0	33.8

Sources

Czech Republic: Czech Central Statistical Office.
Romania: *Statistical Yearbook*, various issues.
Russia: Le Houverou (1995), Astapovich (1995).

Note

Investment figures for Russia refer to the whole economy, which approximately coincides with the system of enterprises, and are measured according to the concept of "new fixed investment" (see text).

In Romania, the pattern of investment finance depicts the withdrawal of the state from the direct and indirect financing of enterprise investment. This was achieved as much through high inflation, which raised enterprise profits relative to bank lending, as by changes in fiscal and banking policies. The ratio of enterprise savings to physical investment increased significantly from 1990 to 1991, rising from 52 per cent to 96 per cent. The share of gross savings in enterprise investment has remained broadly stable since then. The increased reliance on internal savings mirrors other developments. The share of net borrowing from the banks dropped sharply, from 30 per cent in 1990 to 3 per cent in 1991, while at the same time the share of capital transfers from the state declined from 20 per cent of investment to 7 per cent. This does not include the substantial write-down of enterprise debts in 1990-91.

The sharp rise in gross enterprise savings as a share of Romanian enterprise investment between 1990 and 1991 reflects in part the interaction of high inflation with the local accounting system. The valuation of inventories at historical cost during the high inflation of 1991-93 resulted in large paper profits. However, the combination of high paper profits and a top 45 per cent marginal tax rate on profits left enterprises with insufficient liquidity to replace inventories at current costs. As a result, enterprises accumulated arrears both on taxes due and on accounts payable to other enterprises. In addition, new banking and central bank laws were passed in April 1991 which established the principle of universal banking and made banks responsible for their lending decisions. However, the repeated recapitalisation of state banks in 1990-92 may have weakened the incentive of banks to impose financial discipline on enterprises. The government's direct financing of enterprise investment through the budget was significantly reduced in the April 1991 macroeconomic stabilisation

programme. At same time, enterprise taxation was overhauled, although the tax burden on enterprises remained relatively heavy.

In Russia, the financing of enterprise investments remains substantially unreformed. The share of government financing in new fixed investment of enterprises has remained broadly unchanged, fluctuating between 30 per cent and 38 per cent from 1990-94. Direct government financing includes budgetary outlays by the federal and local governments and by extra-budgetary funds, as well as direct central bank lending to enterprises. Since the enterprise accounts are on a cash rather than accrual basis, government financing does not include the significant tax arrears that enterprises have built up with the government, leading to the overstatement of after-tax profits and understatement of government financing. The bulk of budgetary outlays for investment are targeted to a few key production sectors, such as agriculture, fuel and energy, communications and defence. Only a fraction of these centralised investment programmes could be considered as involving the provision of public goods. The extra-budgetary funds provide resources for both public investments, such as roads, and for commercial investment in specific industrial sectors. Similar to earmarked funds under central planning, these resources are raised through specific levies and can only be spent on investment projects in particular sectors or activities.

The share of gross enterprise savings in investment has fallen from 51 per cent of new fixed investment in 1991 to 19 per cent in 1992-93. This largely reflects a corresponding fall in depreciation allowances. While there has been a partial reform of enterprise taxation in 1991, the depreciation of fixed assets has not been adequately adjusted for inflation. Bank lending for new fixed investment remains limited, averaging 8 per cent of investment in 1992-93. As under central planning, the bulk of bank lending for

enterprises reported on the basis of data from commercial banks would appear to be for accumulation of inventories. While data on enterprise deposits in domestic banks is not available, the accumulation by enterprises of financial balances outside Russia has been significant. A recent estimate of foreign assets held by Russian enterprises and households amounts to US\$ 43 billion, much of which was accumulated in 1991-94 (Box 5.1). This amount is equivalent to 21 per cent of new capital investment during this period.

While the ability to make cross-country comparisons is limited by the differences in statistical concepts among the three countries, a few broad conclusions emerge from the data. First, in the period of considerable uncertainty surrounding the introduction of far-reaching structural reforms and macroeconomic stabilisation, enterprises in the Czech Republic and Russia accumulated significant financial assets. This opens a question about the extent to which financial constraints contributed to the slump in fixed investment. At least in this period, the causality may well have run from a contraction in the demand for investment goods by enterprises to the decline in outside finance, rather than in the reverse direction. However, as growth and investment demand recover, the inherent weaknesses in the financial sectors are likely to hold back both the supply of outside finance and actual investment. Second, the Czech and Romanian data support the hypothesis that early in the transition enterprises are heavily dependent on their internal savings to finance investment, as the state withdraws from direct outlays on investment and as the nature of bank lending changes. In Russia, this preliminary step in the transformation of enterprise finance had not yet taken place. Third, as the domestic financial system begins to develop, outside finance (particularly bank lending) accounts for an increasing share of enterprise

investment. In the Czech Republic, it is noteworthy that access to bank lending is not confined just to domestic banks but extends to international institutions as well. This reflects in part the low transfer risk in the Czech Republic, limited term lending by Czech banks and financing of multinational enterprises by their international banks.

5.6 Sectoral composition of enterprise savings and investment

The sectoral composition of enterprise savings and investment provides additional information on the role of internal finance in transition economies, allowing a disaggregated analysis of financial flows among enterprises. A potential bias in using aggregate data on enterprise financing is that some of the variation among enterprises becomes concealed. The sectoral data, to some extent, overcome this problem. The sectoral analysis is limited to the Czech Republic, where the distortions to accounting data from inflation are less pronounced than in the other two countries.

The sectoral breakdown of enterprise gross savings (profits before taxes and distribution plus depreciation) and investment for the Czech Republic reveals that in most sectors savings exceeded investment for the period 1990-93 (Table 5.2).

The three sectors in which investment exceeded savings were manufacturing, transport and other services. The latter category includes housing, education and health. Investment in manufacturing exceeded gross savings in that sector by a substantial margin. The sectoral pattern of enterprise savings and investment thus reveals considerable diversity, in which the accumulation of financial assets by a number of sectors is counter-balanced by the financing requirements of the manufacturing, transport and other services sectors. As a result, the financing flows recorded on a net basis understate the significance of outside finance to the enterprise sector. That being said, it must also be noted that the majority of sectors appear to have relied extensively on internal finance for investment. Only in transport did before-tax profits plus depreciation fall below 50 per cent of investment for the period as a whole.

The sectoral pattern of the balance between enterprise savings and investment, moreover, points to possible divergences following the introduction of market reforms between the return on the existing capital stock in a sector (average return to capital) and the return to investment in that sector (marginal return to capital). In particular, both the shift in relative prices across sectors for inputs and outputs and the extent to which their existing capital stocks became obsolete can vary widely across sectors (see Chapter 3). As a result, some sectors may choose not to invest in new equipment and structures even if the existing capital stock is generating adequate cashflows. This may provide at least a partial explanation for the accumulation of financial balances during this sample period in the agriculture, mining, electricity, gas and water, construction, trade and service, and communications sectors. In contrast, despite low profitability there has been significant fixed investment in the transport sector.

Box 5.1

Russian capital flight

The accumulation of foreign assets has been a major vehicle for saving by Russian enterprises and households. It is estimated that these assets now amount to US\$ 43 billion (see table below). One part of this total is legal capital flight, which consists of enterprises' hard currency deposits in Russian banks plus cash dollars, held mostly by individuals, including those operating in the grey economy. The build-up of hard currency deposits took place in 1992, and that of cash holdings in 1994. The remainder is illegal capital flight, which consists primarily of assets held abroad as cash, securities or real estate. These assets were accumulated most strongly in 1992-93.

(In billions of US dollars)

	1991	1992	1993	1994
Legally held assets	7.6	14.0	16.8	24.9
Deposits	2.6	9.0	9.1	9.4
Cash	5.0	5.0	7.7	15.5
Illegally held assets	3.0	8.4	15.5	18.2
Total	10.6	22.4	32.3	43.1

Sources

Work by A. Lushin and M. Sarafanov, as reported by *Russian Economic Trends*, Monthly Update, April 1995.

Table 5.2

Czech Republic: enterprise savings and investment by sector, in billions of 1989 Czech crowns

Sector	1990	1991	1992	1993	Average	
Agriculture	0.3	9.3	-20.3	0.4	-2.6	Total investment
	18.5	3.4	-1.4	2.4	5.7	Profits+depreciation
	18.2	-5.9	19.0	2.0	8.3	Balance
Mining	3.4	1.1	-0.6	0.1	1.0	Total investment
	0.4	0.2	7.5	5.9	3.5	Profits+depreciation
	-3.0	-0.9	8.0	5.8	2.5	Balance
Manufacturing	188.1	92.4	98.5	97.0	119.0	Total investment
	108.2	104.7	44.2	28.0	71.3	Profits+depreciation
	-80.0	12.3	-54.2	-68.9	-47.7	Balance
Electricity, gas and water	3.6	2.0	10.4	13.6	7.4	Total investment
	0.3	-0.2	21.2	15.5	9.2	Profits+depreciation
	-3.3	-2.3	10.8	1.9	1.8	Balance
Construction	6.4	8.3	-20.4	4.4	-0.3	Total investment
	6.8	4.3	3.4	3.7	4.5	Profits+depreciation
	0.4	-4.0	23.8	-0.7	4.9	Balance
Trade and services	27.3	11.0	-7.9	2.6	8.2	Total investment
	20.3	7.3	5.5	2.3	8.9	Profits+depreciation
	-7.0	-3.7	13.5	-0.3	0.6	Balance
Transport	11.9	11.9	11.3	10.7	11.4	Total investment
	5.1	-1.6	-4.2	-0.1	-0.2	Profits+depreciation
	-6.8	-13.5	-15.5	-10.8	-11.7	Balance
Communications	2.8	3.8	3.6	7.9	4.6	Total investment
	7.3	6.3	7.4	7.9	7.2	Profits+depreciation
	4.5	2.5	3.7	0.0	2.7	Balance
Other services	17.8	12.1	13.3	21.1	16.1	Total investment
	24.2	1.0	6.1	3.9	8.8	Profits+depreciation
	6.4	-11.2	-7.2	-17.2	-7.3	Balance

Source

Statistical Yearbook of the Czech Republic, 1993 and 1994.

Notes

Due to insufficient detail of the primary source, "Other services" includes housing, which should belong to "Construction".

The internal balance does not take tax liabilities into account.

Figures are in real terms, calculated using the 1989 c.p. product deflator index for the relevant industrial sector.

The considerable diversity in profitability and investment opportunities among enterprises will place a heavy demand on the financial sector to reallocate savings to the most efficient investments. This demand for intermediary services will be fuelled by the recovery in growth and investment and the adjustment of enterprises to structural reforms. The level and efficiency of investment will thus depend crucially upon the ability of the domestic banks and other financial institutions to provide these services. While there is some evidence in the Czech Republic that banks are reallocating savings among enterprises, there remains considerable weaknesses in the financial system that could hold back investment and growth as the need for enterprise restructuring deepens.

5.7 Investment finance in developing and industrial countries

While a distinguishing feature of enterprise finance in transition economies is the dominant role of internal savings following the introduction of far-reaching market reforms, any assessment of this financial structure requires a broader perspective. A starting point for this is a comparison with the composition of investment finance in other countries. Several recent empirical studies examine the composition of financing in developing and industrial countries.

Data on the composition of finance for enterprise investment is available for nine developing countries (India, Jordan, Korea, Malaysia, Mexico, Pakistan, Thailand, Turkey and Zimbabwe).⁵ These data are based on the financial accounts of the top 50 manu-

⁵ Singh and Hamid (1992).

facturing companies quoted on the stock markets in each country. The enterprise coverage is thus less comprehensive within each country than that above, but it is estimated that the top companies in these developing countries usually account for at least half of the output of all non-financial enterprises. Bearing in mind the usual caveat about the limited cross-country comparability of the data due to differences in accounting practices, a number of points emerge from these data. First, external equity and debt account for the bulk of investment, about 68 per cent on an unweighted average basis (Table 5.3).

Table 5.3

Composition of financing of non-financial enterprises in selected developing countries (1980-88), in per cent of total investment

	Internal	External	Of which	
	Total	external	Equity	Debt
India	34.9	65.1	14.0	51.1
Jordan	11.6	88.4	46.6	41.8
Korea	21.0	79.0	44.3	34.6
Malaysia	66.8	33.2	14.9	18.3
Mexico	26.3	73.7	69.4	4.3
Pakistan	42.0	58.0	20.4	37.6
Thailand	24.1	75.9	40.9	35.0
Turkey	17.5	82.6	60.9	21.7
Zimbabwe	42.9	57.1	35.2	21.9

Sources

Calvo and Kumar (1994) based on Singh and Hamid (1992).

There is considerable variation among the countries, but the only exception to this general observation is Malaysia, where external finance accounted for just 33 per cent of enterprise investment. Second, equity finance plays a more significant role than debt in the financing of investment. On an unweighted basis, internal savings and outside equity comprised 70 per cent of net investment. Only in India did debt financing exceed the total of internal finance and outside equity, at 51 per cent to 49 per cent.

One contrast between the financing of enterprises in developing countries and those in transition economies is that enterprises in developing countries are much more reliant on outside debt and equity finance than are those in the Czech Republic, Romania and Russia. This largely reflects the withdrawal of government from the direct or indirect provision of finance for enterprise investment and the time required to transform the financial sectors. While developing countries also need extensive financial development, the necessary structural changes to the financial institutions and markets in these countries is less profound. One similarity also emerges from the cross-country comparison of enterprise finance. Enterprises in both developing countries and those in transition rely extensively on equity finance.

It is also possible to make comparisons of enterprise finance with selected industrial countries. Recent data on the composition of investment finance are available for Germany, Japan, the United

Kingdom and the United States of America.⁶ The composition of finance is presented on both a gross and a net basis, since the acquisition of financial assets by enterprises in industrial countries is significant. There are a number of stylised facts regarding the composition of investment finance in industrial countries (Table 5.4).

Table 5.4

Gross and net sources of enterprise finance, percentages (1970-89)

	Internal	External	Of which			Stat. adj.
	Total	external	Equity	Bank loans	Other	
Germany	80.6 (62.4)	19.4 (37.6)	0.9 (2.3)	11.0 (18.0)	7.5 (17.3)	0.0
Japan	69.3 (40.0)	30.7 (60.0)	3.7 (3.9)	30.5 (34.5)	-3.5 (21.6)	0.0
UK	97.3 (60.4)	10.8 (39.7)	-10.4 (7.0)	19.5 (23.3)	1.7 (9.4)	-8.0
US	91.3 (62.7)	17.4 (37.3)	-8.8 (-4.9)	16.6 (14.7)	9.6 (27.5)	-8.7
Average, net	86.0	19.6	-3.7	19.4	3.8	—
Average, gross	56.4	43.6	2.1	22.6	18.9	—

Source

Corbett and Jenkinson (1994), Tables 2 and 3.

Note

The first row for each country refers to net sources of finance, the second to gross.

First, enterprise savings are the most significant source of finance, accounting for 56 per cent of gross finance. On a net basis, the share of enterprise savings rises to 86 per cent, reflecting the use of internal funds to purchase financial assets. The country with the lowest share of internal finance is Japan, where enterprise savings account for 40 per cent of gross financing and 69 per cent of net financing or investment. Second, bank lending is the next most significant source of outside finance, accounting for 23 per cent of gross financing and 19 per cent on a net basis. Japanese enterprises have the largest share of bank financing, 35 per cent and 31 per cent on a gross and net basis, respectively. Third, outside equity plays only a minor role in enterprise financing, comprising 2 per cent of gross financing and -4 per cent of net financing. The negative share of outside equity in net financing in the United Kingdom and the United States reflects primarily the large volume of mergers and acquisitions and of share repurchases, both of which involve the purchase of equities by enterprises funded primarily with internal savings or debt.

At first glance, the share of enterprise savings in the financing of investment in transition economies appears remarkably similar to that in transition economies, in the sense that both rely heavily on internal finance. However, such a straightforward comparison would be quite misleading. Given the weak ownership structures of many enterprises in transition economies, a primary concern is

⁶ Corbett and Jenkinson (1994). For an earlier study, see also Mayer (1990).

the extent to which outside investors are able to impose financial discipline. In industrial countries, the financial sector is highly enmeshed with enterprises, financing not only physical investments but also the acquisition of financial assets. For this reason, the gross financing of enterprises portrays more accurately the significance of outside finance to enterprises in industrial countries. Moreover, in the early periods of industrialisation, outside finance played a much greater role in the financing of investment.⁷

The provision of outside finance to enterprises brings with it greater financial discipline. Outside investors must evaluate carefully the value of investments relative to the alternatives. This caution reflects the real possibility that the inside managers of enterprises, who by virtue of their position are better informed about the value of investments, will opportunistically seek external finance only when outsider investors overvalue the claims.⁸ Outside investors must also constantly monitor their investments to ensure that their interests are being respected. However, the role of outside investors in evaluating and monitoring investments is imperfect and costly, and internal finance is widely viewed by enterprises as the more preferable financing source.⁹ In any event, the financial discipline provided by outside investors arises not so much from their being the dominant source of funding for the existing physical capital and stocks of enterprises, but from providing the finance for new investments.

5.8 Outside investors, financial development and growth

The comparison of investment financing in transition economies with that in developing and industrial countries illustrates the limited role of outside investors as a consequence of transition. This limited role can hamper financial discipline in transition economies where most enterprises are only weakly controlled by their existing owners. Moreover, the lack of access to outside finance can also

constrain the allocation efficiency of investment by limiting investments to those enterprises that have both sufficient gross savings and profitable investment opportunities. This constraint is likely to become more binding since the recovery in growth and investment appears to be occurring more rapidly than the reform and development of financial sectors in the region. Available empirical evidence generally supports the importance of these considerations.

One measure of outside investor involvement in evaluating and monitoring enterprise investments is the overall development of domestic financial institutions and markets. A well-functioning financial system, of course, also provides additional services to savers such as portfolio diversification and liquidity. Due to its impact on both efficiency of investment and services to savers, one would expect a strong link between financial development and investment, productivity and growth.

While there are many possible channels through which development of the financial sector can boost growth, available empirical evidence points to a strong overall impact. A recent study of over 80 countries for the period 1960-89 reveals that measures of banking development are positively and significantly correlated with real per-capita GDP growth, real per-capita capital stock and productivity gains (Box 5.2). In addition, regression analysis revealed that measures of financial development at the beginning of the sample period were significant in predicting future growth rates, which supports the hypothesis that financial development contributes to growth and is not simply a consequence of it. The potential impact of financial development on growth also extends to securities activities. As with banking, a recent study has focused on the link between stock market development and growth for the period 1976-93. Available evidence indicates that measures of stock market development are positively and significantly correlated with growth and its components (Box 5.2). Again, the regression analysis indicates that measures of stock market develop-

Box 5.2

Financial development and economic growth

The significance of financial development in promoting growth has long been the subject of empirical investigation. The contemporaneous expansion of the financial sector with growth of the real economy is a well-documented feature of development and industrialisation. However, the issue remained whether the financial sector was making an active contribution to this growth or simply responding passively to developments in the real economy that were leading growth. Two recent studies provide some additional evidence on the direction of causality between financial development and growth, not only with respect to banking but also to securities activities.¹ The evidence comes from regression analysis which serves

to identify factors that contribute to cross-country variations in growth. A number of factors have been identified as significant in explaining variation in long-run growth rates across countries. The non-financial factors that have been identified as having a significant impact on growth include: real GDP per capita at the start of the sample period, initial secondary school enrolment, number of revolutions and coups, initial ratio of government consumption to GDP, and initial inflation rate.

Measures of the initial conditions in the financial sector have been added to examine their contributions to economic growth. These include the ratio of broad money to GDP, the ratio of stock market turnover to market capitalisation and the ratio of turnover to GDP. The initial values for each of these variables is

significant in explaining variations on long-run growth among countries.

A related issue is whether both the measures of banking and securities activities reveal independent effects on growth or whether these measures are simply proxies for each other. This issue was also taken up in the study on stock market development and growth. When measures of banking and securities activities at the beginning of the sample period were simultaneously included in regression equations for real per capita GDP growth, both types of measures were significant in explaining subsequent growth rates. This result suggests that development of both banking and securities activities make valuable contributions to growth.

1 King and Levine (1993) and Levine and Zevros (1995).

⁷ Taggart (1985).

⁸ Myers and Majluf (1984).

⁹ The taxation of dividend income at both the enterprise and household levels typically reinforces the preference for internal finance. However, the tax deductibility of interest payments can swing this preference toward debt, particularly in a period of high inflation (Chapter 4).

ment at the beginning of the sample period, especially those of liquidity, are strongly correlated with future growth rates.

The available empirical evidence thus points to a strong link between financial development and investment, productivity and growth. These studies do not allow identification of the specific channels through which the financial sector influences developments in the real economy, be it the evaluation and monitoring of enterprise investments, diversification or liquidity. Nevertheless, financial development necessarily involves an increased role for outside investors in enterprise finance.

5.9 Concluding remarks

This chapter has examined how enterprise investment has been financed in a representative cross-section of countries in transition, the Czech Republic, Romania and Russia, for the period 1990-94. In each country, the sample period begins before the introduction of comprehensive market reforms. The initial observations thus provide some indication of how enterprises were financed under the previous regime. The observations over time also reveal how the transition to a market economy influenced the financing of enterprises in each country. In the Czech Republic and Romania, the withdrawal of the state from financing enterprise investment has largely involved the cutting back of government transfers for investment, reform of enterprise taxation and transformation of banking. These reforms have led to a significant increase in enterprises' reliance on internal finance. In Russia, however, the government has yet to engineer its withdrawal from the financing of enterprise investment to anything like the same extent. This will involve not only the reform of enterprise taxation, but also the clear separation of commercial investments by enterprises from investments in social goods and services. This will require the divestiture of social assets by enterprises and the comprehensive reform of the government's capital budgeting process. As these structural reforms are implemented, it can be anticipated that enterprises would initially become much more reliant on internal savings to finance investment.

The nature of the structural reforms required for the transition will almost inevitably lead to a period of extensive reliance on internal finance by enterprises to fund their investments. It might be tempting to draw quick comparisons with the extensive reliance on internal finance in industrial countries and to conclude that extensive reliance on internal finance was desirable in transition economies. However, such comparisons and conclusions would be very misleading. The high reliance on internal finance by state enterprises or those that have been privatised to dispersed outside shareholders or to insiders resembles the pattern of enterprise finance from the previous regime, in terms of management and decision-making process and the aggregate flow of funds. The mechanisms for the efficient allocation of capital in the operating and investment decisions of enterprises remain weak. Under these

conditions, the efficiency of investment may well continue to languish near the low levels realised in the previous regimes.

One way to promote the increased use of outside finance by enterprises is to foster market competition through trade liberalisation and anti-monopoly policies. Many countries in the region liberalised trade significantly early in the transition; however, as adverse impacts on enterprise profitability in certain sectors and on the balance of payments materialised, there was a reversion to increased protectionism. Once again, trade protection in the region is declining, in part due to the effects of EU Association Agreements reached with certain countries in eastern Europe and with the Baltics. Also, for these countries, accession to the EU would require a more effective implementation of competition policy. For those countries that are not associated with the EU, it is important to maintain progress in these areas, both in their own right and to promote the increased recourse to outside finance for enterprise investment. The support of the EBRD and other IFIs for the entry of private enterprises into new markets can also help to spur competition.

The development of the financial sector itself must, of course, remain a priority. There has been considerable focus on the development of banking in the region, and rightly so. Banks provide basic transaction services not only for industry and commerce, but also for securities activities. As such, banks are fundamental to a market economy. However, the capacity of banks to intermediate domestic savings into enterprise investments may be limited, at least for while. While securities markets have emerged quickly in a number of countries, they remain small and largely illiquid. Even those markets that have been spurred on by mass privatisation programmes lack the liquidity necessary to promote primary issues. Moreover, the domestic investment and insurance companies remain relatively small. Thus, taking banking and non-banking sub-sectors together, it will be a long time before the financial sector shows the strength (typical of advanced industrialised countries) necessary to generate and allocate savings effectively. It will remain a key area for IFIs to involve themselves in institution building, both through direct investment in particular institutions and in developing sector-wide structures. While this institution building is taking place, the activities of the IFIs, and the EBRD in particular, will remain strongly "additional".

Lastly, while securities markets and non-bank financial institutions clearly offer a potential substitute to bank intermediation of savings, it is important to recognise the potential complementarities between these alternative forms of financing. For example, by listing its shares on a stock exchange, a company can improve the availability of information about its financial performance, both through the monitoring of share price developments and the public disclosure of financial accounts. Similar complementarities can also exist between development of the domestic financial sector and access to foreign savings. A well-functioning domestic financial system that can exercise effective control over enterprises can facilitate the inflow of foreign portfolio investments.

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The contribution of law to fostering investment



Law provides both rules for investment and a vital part of the environment in which investments succeed or fail. For investment to flourish, the right legal rules must be in place. As important as what the rules say, however, is what they mean in practice. A pristine statute on investment that is unknown, unadministered and unenforced is ineffective.

This chapter looks at how conducive the laws of the region are to fostering investment, including foreign investment. First, it considers the extent to which those laws approximate the generally accepted view internationally of which laws best foster investment. Second, it evaluates *effectiveness* of investment laws, that is the extent to which such laws are clear, accessible, and adequately supported administratively and judicially.

A country-by-country assessment of these issues is presented in Annex 6.1, from which some conclusions are drawn. The assessments are based on the results of a survey involving ministries of justice, selected private law firms, and academic and other experts familiar with the laws of the countries of the region. Box 6.2 explains the nature of the survey and caveats required in using the material. Table 6.1 also provides a score for each country.

6.1 Investment rules of the region in relation to generally accepted standards

Legal rules that best foster investment do not proceed from first principles. It is possible, however, to evaluate investment laws in the countries of the region against the benchmark of legal rules that are generally accepted internationally as fostering investment. This evaluation reveals whether existing rules are likely to win the approval of the investing community, including foreign investors.

Box 6.1 identifies the source and content of those legal rules. These include laws that recognise private property rights, enable profits to be taken out of the country and protect against uncompensated expropriation. Also important are laws that enable the registration of security interests, provide a legal framework for investment vehicles, and prohibit discrimination between domestic and foreign investment, whether through licensing regimes, discriminatory taxation systems or other means. A country-by-country assessment of how investment laws of the countries of the region compare with investment rules that are generally accepted internationally is provided in the first column of Annex 6.1.

6.2 The effectiveness of laws affecting investment

The remainder of this chapter, including the last three of the four columns in Annex 6.1, examines the effectiveness of legal rules affecting investment. Three questions are asked: how clear and accessible is the law affecting investment?; how well supported is it administratively?; how well supported is it judicially?¹

How clear and accessible is the law affecting investment?

The second column of Annex 6.1 measures the clarity and accessibility of investment laws against three main benchmarks. The first is the textual clarity of laws, including regulations and administrative rulings. From a textual perspective, laws designed to foster investment may achieve the opposite effect if they are unclear, confusing or contradictory. Where executive decrees and legislative acts are contradictory, the paramount document must be made explicit. The second is the extent to which law has been disseminated. Laws that have not been published widely or promptly are of limited use and may even be counterproductive. Draft laws should be made public in order to elicit comments from various stakeholders (e.g., investors, administrative agencies, courts) which can then be considered for the final texts of laws. Important court judgements on issues of principle should also be widely disseminated to show how the law is interpreted and applied. The third is the availability of comprehensive, independent and adequately supported legal advice to help investors to understand the detailed nature and practical implications of investment laws.

How well supported administratively is investment law?

Besides being clear and accessible, laws fostering investment must be adequately funded and administered if they are to be useful. The third column of Annex 6.1 identifies whether some of the elements of an effective administration are in place in the countries of the region. These elements include a clear demarcation of responsibilities between the various arms of government, but with effective coordination between them. The tax administration office, police and courts need to be properly funded, regarding both personnel and infrastructure. If a particular law requires specific action to be undertaken by investors, the administrative mechanisms necessary must be provided. For example, if a special licence is necessary for the opening of a foreign bank account, the licensing body must issue such licences promptly and in accordance with transparent and consistently applied guidelines. Certain legal rights need to be supported by administrative bodies, such as clear and reliable real property rights which depend on an effective land cadastre.² Similarly, secured transactions depend on shares and other security interests (such as mortgages and liens) being noted on public registers.

¹ These questions are consistent with the philosophy underlying the three considerations discussed in Box 6.1, namely what the rule of law demands, what recognition of economic rights requires, and what are the prescriptive attempts at the international level to promote a legal environment conducive to investment.

² An official public register of property rights and boundaries.

Box 6.1**Generally accepted legal rules on investment**

The generally accepted view internationally of which laws best foster investment can be discerned by drawing on the rule of law, the recognition of economic rights as human rights, and prescriptive attempts at the international level to promote a legal environment conducive to investment.

Rule of law

Investment laws have the greatest credibility within a legal system founded on the rule of law, where the application of laws bears a degree of predictability and consistency, and their enforcement is reviewed by independent parties, usually courts. An important function of the rule of law is that the exercise of the power of the state should be limited to recognised and accepted circumstances. A consequence of the rule of law is that resultant legal rules are better valued by citizens because they are more predictable and embody generally accepted rights and obligations.

Economic rights as human rights

International human rights texts – most prominently the Universal Declaration of Human Rights – enshrine the right to property and, by extension, permit contractual freedom generally. In addition, the Preamble to the Agreement Establishing the EBRD welcomes “the intent of Central and Eastern European countries to further the practical implementation of multiparty democracy, strengthening democratic institutions, the rule of law and respect for human rights and their willingness to implement reforms in order to evolve towards market-oriented economies”.

The sources of investment rules at the international level

Numerous sources contribute to the evolving definition of a legal environment best suited to investment. (None the less, it should be noted that universal agreement on such a definition remains an elusive goal, particularly among certain developing countries, hence

the references in this discussion to prescriptive rules that are generally accepted internationally.) The writings of jurists, arbitral awards and a small number of decisions of public international tribunals, most notably the International Court of Justice, may be understood as establishing best practices from the perspective of the international investor. A number of bilateral investment treaties, national investment codes and a few multilateral instruments (such as the UNCTC *Draft Code of Conduct on Transnational Corporations* and the OECD *Guidelines for Multinational Enterprises*) further contribute to what may be viewed as internationally accepted legal rules on investment. A useful distillation of such views, which also contains a prescriptive or best practice element, is the recent World Bank *Guidelines on the Treatment of Foreign Investment*. (Although concerned principally with direct foreign investment, much of the rationale of the *Guidelines* is equally relevant to domestic and indirect foreign investment.)

Regional standards sometimes both reflect and influence the content of international standards. The commercial laws of the European Union are particularly relevant, because for most countries aspiring to EU membership, harmonising their commercial laws with those of the EU is a legislative priority.

The content of generally accepted legal rules on investment

The generally accepted view internationally of which legal rules best foster investment can be distilled from the above. Central to this view is the proposition that states should not discriminate between foreign and local investors without due cause. This implies that there should be an open admission policy for all investors, which would obviate the need for special screening procedures for foreign investments, except in rare circumstances such as where an investment proposal has compelling national security implications. Furthermore, the non-discrimination tenet

extends to all aspects of the treatment of such investments and would thereby prohibit laws that establish a taxation regime designed especially for foreigners (whether more or less favourable) or that require foreign investors or foreign-owned local companies to obtain special administrative approvals or licences. Legal rules that impose special restrictions on the repatriation of wages and profits of foreign investors would also be proscribed.

A model legal regime regulating investment, apart from treating foreign and local investors equally, would include property laws that recognise private property rights and protect against uncompensated expropriation, particularly by the state, and laws enabling investments to be secured, particularly through the registration of security interests. Investment vehicles, especially in the form of companies, must also be recognised to allow participants to enter the investment market. Equally, their exit must be allowed by bankruptcy laws.

On a more sophisticated level, laws relating to investment funds and other special investment vehicles, together with adequate securities legislation, will allow more diverse participants in the investment market. Taxation, currency convertibility and capital flows, labour, custody and settlement, and intellectual property rights are other issues affecting investment which need to be addressed in ways that meet the commercial needs of investors generally. The existence of criminal laws to underpin the security of investments is also an important element of a model legal framework.

Comparing the laws of the countries of the region with generally accepted legal rules on investment

The first column of Table 6.1 illustrates the extent to which the laws of the countries of the region approximate the generally accepted legal rules on investment discussed above.

How well supported judicially is investment law?

To be effective, laws fostering investment must not only be clear, accessible and well-administered but also enforceable before courts comprising independent and trained judges. The fourth column of Annex 6.1 evaluates judicial enforcement of investment laws on the basis of judicial impartiality and independence (from both government interference and financial vulnerability), the readiness of the courts to enforce foreign judgements and arbitral awards without re-examining the merits of the case, the availability of procedural due process, and the actual record of enforcement of laws to date, including criminal laws affecting investment.

6.3 The extent and effectiveness of investment laws

Table 6.1 provides a numerical assessment of how conducive the laws of the countries of the region are to fostering investment. Laws have been scored, in respect of each country, against two indicators: the extent to which legal rules affecting investment approximate investment rules that are generally accepted internationally; and the effectiveness of legal rules affecting investment, that is, the extent to which such legal rules are clear and accessible and adequately supported administratively and judicially. The classification system is explained in text accompanying Table 6.1 and further information on the methodology is provided in Box 6.2.

Progress in investment-related law reform

(See classification system for transition indicators opposite.)

Table 6.1

Laws fostering investment

Country	Extensiveness of legal rules	Effectiveness of legal rules	Overall score
Czech Republic	4	4	4
Hungary	4*	3	4
Poland	4*	3	4
Bulgaria	4	3	3
Croatia	3	4	3
Estonia	3	4	3
Slovak Republic	4	3	3
Slovenia	3	4	3
Albania	2	2	2
Armenia	3	2	2
Belarus	3	1	2
FYR Macedonia	3	2	2
Georgia	3	1	2
Kazakhstan	3	1	2
Kyrgyzstan	3	2	2
Latvia	3	2	2
Lithuania	3	2	2
Moldova	3	2	2
Russian Federation	4	1	2
Romania	3	2	2
Ukraine	3	2	2
Uzbekistan	3	1	2
Azerbaijan	2	1	1
Tajikistan	2	1	1
Turkmenistan	2	1	1

Classification system for transition indicators

Transition element	Category	Description of the category
The extensiveness of legal rules on investment	1	Legal rules are very limited in scope, and impose substantial constraints on creating investment vehicles, security over assets or to the repatriation of profits. Indirect investment is not specifically regulated.
	2	Legal rules are limited in scope and impose significant constraints on creating investment vehicles, adequate security over assets, or the repatriation of profits.
	3	Legal rules do not impose major obstacles to creating investment vehicles and security or to repatriating profits. However, they are in need of considerable improvements.
	4	Legal rules do not discriminate between foreign and domestic investors and impose few constraints on creating a range of investment vehicles and security instruments. Indirect investment is specifically regulated.
	4*	Legal rules closely approximate generally accepted standards internationally and impose few restrictions, including on the creation of sophisticated investment vehicles or security. Indirect investment law is well developed.
The effectiveness of legal rules on investment	1	Legal rules are usually very unclear and often contradictory and the availability of independent legal advice is very limited. The administration of the law is substantially deficient (e.g. little confidence in the abilities and independence of the courts, no or poorly organised security and land registers).
	2	Legal rules are usually unclear and sometimes contradictory. Legal advice is often difficult to obtain. The administration and judicial support of the law is rudimentary.
	3	While legal rules are reasonably clear and ascertainable through legal advice, administrative or judicial support is often inadequate (e.g. substantial discretion in the administration of laws, few up-to-date registers).
	4	The law is usually clear and legal advice is readily available. Investment laws are reasonably well administered and supported judicially, although that support is sometimes patchy.
	4*	The law is clear and readily ascertainable. Sophisticated legal advice is readily available. Investment law is well supported administratively and judicially, particularly regarding the efficient functioning of courts and the orderly and timely registration of proprietary or security interests.
Overall score		The overall score allocated in the third column of the table is based on the assessment made in respect of the two indicators; it also draws on other survey information. These overall scores are reproduced in Table 2.1, together with a description of the overall criteria for each category.

6.4 Commentary on Annex 6.1

The commentary is organised largely by looking across countries on particular issues, at the extent of laws fostering investment, at the clarity and accessibility of the law, effective administration and judicial enforcement. Where appropriate some regional groupings are highlighted.

Several points should be borne in mind when reading the commentary. First, it should be remembered that legal reform proceeds from different stages of development within each country. In the countries of eastern Europe and the Baltics a relatively well developed legal framework for a market economy, including civil and commercial codes and a business culture, had existed before the Second World War. The effects and memory of these were not completely eroded and in some cases former practices and laws could be reinstated or revived. This is in contrast to the CIS countries which, for the most part, embarked on the task of constructing a market-oriented legal framework without having any recent history or tradition of market-oriented legal systems. Second, while the commentary and table examines whether countries meet certain legal standards this should not be taken to imply that there is a single optimal legal structure covering investment to which all countries should move.

Extent of laws fostering investment

In general, the countries of eastern Europe have the most favourable rules for investment in the region. Almost all such countries permit foreigners to own property through locally held companies and some now permit land to be owned directly. Additional restrictions sometimes apply to agricultural land. Most countries are in the process of liberalising or have recently liberalised foreign ownership. East European countries generally do not require governmental approval for investment proposals, with the exception of Romania, and in many cases exchange control regulations are minimal. Most of the countries of eastern Europe have adopted international standards regarding expropriation which permit taking of property only for public purposes and with compensation. Such countries have laws regulating, to varying degrees, indirect investment vehicles (apart from Bulgaria, which is in the course of enacting such laws). Most countries in eastern Europe have passed legislation for the creation of stock exchanges.

In the Baltics, the legal rules fostering investment appear to be approaching the level of development of some of the east European countries. At present, indirect investment in domestic securities and investment funds is specifically regulated in Estonia but not in Latvia or Lithuania.

In the CIS countries investment rules are generally less extensive than in the east European countries, with the exception of Russia where, despite a lack of clarity in many areas, the rules fostering investment are among the most developed in the region. Progress in the rest of the CIS has been slower. Land ownership by foreigners or by foreign-owned local companies is more restricted,

although leasing is possible. As in eastern Europe many countries are actively engaged in further land law reform. Laws concerning the regulation of indirect investment vehicles are limited in scope, and stock exchanges are generally poorly developed. Although profits may be repatriated, transfers of foreign currency usually require central bank approval.

Clarity and accessibility of the law

Drafting of laws

The legislative process greatly influences the clarity and predictability of the law. Uncertainty may arise where wide discretion is granted to the executive to modify investment rules, without prior consultation, and by way of executive decree. Incoherent rules may result where different ministries have responsibility for drafting laws and fail to coordinate their efforts. Across the CIS countries, the executive plays a larger role in this respect; in most countries of eastern Europe and, to varying degrees, those of the Baltics, the making of legal rules lies primarily with the legislature.

In eastern Europe the standards of drafting are generally high, with laws prepared by legally trained personnel. However, even such laws are often conflicting, as in a number of countries where some new laws were inspired by a variety of foreign models and often embody conflicting policies or legal concepts. Sometimes there exists, in Lithuania, for example, no clear codification of the basic principles of commercial and civil law.

Where the technical drafters of the law are not legally trained, unclear laws often result. For example, in some Central Asian countries laws are rarely prepared by legally trained personnel and are often based on old Soviet models. Where laws are drafted by Western consultants, concepts unfamiliar to the host country are sometimes crudely transported.

Public dissemination of laws

While most countries in the region publish their parliamentary laws, albeit with varying degrees of timeliness and quantity, not all executive decrees are published and few judgements can be obtained from public registers. It is common practice in Russia, for example, for legal opinions issued in the context of investment transactions to contain qualifications which exclude all laws that have not been made public.

In most of the countries of eastern Europe, new laws are usually published within a month whereas draft laws are not always published. In certain CIS countries, it is not unusual for laws to be first published more than six months after being enacted. In many countries, official reporting of judicial decisions remains rudimentary. Annotated statutes showing relevant cases, common in countries having a longer established legal reporting tradition, are largely unheard of. Even in many law libraries basic investment laws are hard to find.

The availability of legal advice

Foreign investors and a significant number of local investors routinely seek advice to learn what the legal rules are, how they apply to them, how their interests can best be organised and protected within the existing legal rules, and how their rights can be enforced.

International investments are being increasingly entrusted more fully to local lawyers in countries (such as the Czech Republic, Hungary, Poland and Slovenia) where an independent profession is well established, and capable of delivering legal services in an international working language and to international standards. A good measure of the quality of local practitioners is the extent to which foreign investors are willing to have them appointed as arbitrators to resolve investment disputes (in countries such as Bulgaria, the Czech Republic, Hungary and Poland).

In a number of the countries of the region, particularly the Caucasus republics, there are few private sector lawyers working independently of the government and capable of providing comprehensive advice. Throughout the CIS, legal advice is generally available, although it can be expensive or inadequate to meet demand. In many more countries in the region, local lawyers are not technologically equipped to compete with their international counterparts operating locally. The legal work on a large investment in Armenia or Kyrgyzstan, for example, will probably be undertaken almost entirely from abroad, with local lawyers providing services only in respect of such issues as security under local law.

Effective administration

The role of the state

Poorly administered laws result in delays or uncertainty, thereby increasing transaction costs for the investor and undermining the positive impact of an otherwise favourable legal regime. Company registration and the granting of special licences by governmental bodies are areas where administrative delays may affect the effectiveness of investment laws.

Registers exist in many east European countries for company shares and property where the accuracy of the records in the registry and the average time needed to create a limited liability or joint-stock company is generally less than two months. Although almost all countries of eastern Europe do have systems enabling the establishment of registers for land and security interests, the register files in many countries are inaccurate.

Generally, across the CIS, there is no adequate system for registers, or they are incomplete or outdated. Another impediment is the requirement to pay fees on the notarisation or registration of the security instrument. These fees often bear no relationship to the administrative costs incurred in providing the service but are more akin to a tax, sometimes levied at excessive rates, and especially against foreigners.

Box 6.2

Survey on investment laws

The material provided in Annex 6.1 and for most of this chapter is drawn from the results of a survey conducted among ministers of justice, selected private law firms, and academic and other experts familiar with investment laws in the countries of the region. An important part of the survey involved the use of questionnaires¹ completed to a good standard by private sector lawyers (usually two or three law firms for each country). These lawyers were selected on the basis of their expertise in advising on local law issues, often in respect of the EBRD's own investments.

The content of the first column of Annex 6.1 has been reviewed for accuracy by other lawyers, including the EBRD's own legal staff. Nonetheless, it is not a comprehensive survey of all investment-related rules. For example, it does not evaluate tax rules, although these will be relevant to investment decisions. The material in the second, third and fourth columns of the table, much of which is not readily verifiable independently and reflects subjective assessments by survey respondents, has not been reviewed. Similarly, the information and views provided by respondents were not always consistent, and the EBRD has been selective in using material provided by the survey. While the purpose is to give an impression (as of July 1995) of how conducive the laws in the region are to fostering investment, care must be taken in reading and interpreting Annex 6.1.

Responses were organised into the four categories discussed in sections 6.1 and 6.2: (i) the extent to which legal rules affecting investment approximate those that are generally accepted internationally; (ii) the clarity and accessibility of the law; (iii) the extent to which the law is well supported administratively; and (iv) the extent to which the law is well supported judicially. The categories were then weighted, with 50 per cent being allocated to category (i) and 50 per cent being allocated to categories (ii), (iii) and (iv) combined (with equal weighting). The scoring was audited for reasonable assurance of overall accuracy by referring to the relative completeness of all questionnaire responses and, where possible, obtaining independent opinions on the accuracy of selected items in category (i).

¹ The most comprehensive questionnaire, to law practitioners, asked for responses to 59 questions, broken down into 6 main parts. The first part asked for identification and detailed information on the most important laws which permit and regulate investment, foreign and domestic, direct and indirect, and other basic information on investment-related law, such as whether limited liability companies can be created and owned by foreigners, taxation, the rules on compensation in the event of expropriation and the need for government approvals for investment. The second part asked questions related to the quality of legislative drafting, the regularity with which they are published and their accessibility (along with court decisions on them) to practitioners. The third part asked for information on the judicial process: the qualifications of judges, the availability of written reasons for decisions, the right of judicial review of administrative action and the enforceability of arbitral awards by the courts without a re-examination of the merits of the case, amongst others. A fourth section asked questions relating to the quality of the administration, the appointment, size and quality of the civil service, and the extent to which statutory prescribed registers for land or shares exist and whether they were up to date. A fifth section asked questions relating to the availability of comprehensive and independent legal advice: for example, the degree of legal training, the affordability of legal advice and the existence of a mandatory professional code of ethics. A final section asked respondents to assess the public's belief in the extent to which various facets of the law were respected.

Certain laws provide for the priority registration of security interests of lenders in respect of assets or capital of borrowers. The utility of such laws, however, is sometimes compromised by the absence of registers or by the incompleteness of records resulting from the failure of the government to appoint a registrar or to provide staff and other means to maintain an up-to-date register. In Kyrgyzstan, for example, the law on pledge provides for publicly accessible information to be maintained on registers established

by various municipal and regional authorities. Because of a lack of funds, however, no effective registers have been established. One consequence is that lenders are unable to verify independently whether an asset has already been pledged to a third party.

The quality of the civil service

The civil service does not always have the resources to discharge its obligations fully. To some degree these problems exist throughout the region. They are particularly problematic in some countries of the CIS, where the administrative discretion of the civil service is often wide, vaguely circumscribed and arbitrary in scope. The administration may be further weakened by poor recruitment and promotion systems. In some cases, civil servants or judges are not remunerated in accordance with legally prescribed standards.

Investment-related crime and enforcement of the criminal law

Laws designed to foster investment can also be undermined by the failure to enforce the criminal law adequately, whether it is laws against criminal damage to physical property, against corruption, money-laundering, tax evasion or extortion. In a few countries, the level of corruption seriously erodes investor confidence (see Annex 6.1). The enforcement of criminal laws is also reported in some countries as being sometimes selective and politically motivated.

Judicial enforcement

Effective and independent judiciary

An effective and independent judiciary is essential to ensuring the certainty and predictability of legal rights. This is particularly true where one party to a dispute is the government or derives power from it. For the laws to function fully, the courts must be able and prepared to rule against the government and to review improper government action and, if necessary, rule against the government. For example, if an investor is refused an export licence by a government official exercising a statutory discretion on unreasonable grounds, the investor must be able to rely on the courts to check such abuse. Here judges play a crucial role. They must be independent of the government and not easily removable if they are to discharge their functions impartially. In the countries of eastern Europe, respondents to the survey reported the public's belief that courts would enforce the legal rights of private parties against state parties, while the opposite belief generally prevailed in most of the CIS countries.

Judges must be not only relatively free from political influence but also financially independent. In eastern Europe, judicial support for investment law is hindered by the relatively low salaries of judges, which tend in some cases to be only two or three times those of unskilled factory workers. In some CIS countries, where relative salaries are also low, judges sometimes receive less than the prescribed levels of pay.

Enforcement of foreign adjudicative decisions

An effective judiciary must also be willing to recognise and enforce foreign judgements and foreign arbitral awards rendered in investment disputes without re-examining the merits (in those

circumstances where the law permits such recognition and enforcement). Most of the countries of the region do not recognise foreign judgements, but many are required by their treaty obligations to enforce foreign arbitral awards covered by the 1958 New York Convention.

In eastern Europe, foreign arbitral awards are generally recognised and enforced without a re-examination of the merits. In other countries of the region, even if such awards are recognised, there is often a lack of an effective mechanism to enforce the award.

6.5 Concluding remarks

Law makes a major contribution to the fostering of investment. It provides the rules as well as the conditions and mechanisms capable of ensuring that investment laws achieve their purpose of improving the environment in which investment decisions are made and in which investments succeed or fail. This chapter has provided an overview of the laws on investment operating in the countries of the region and has sought to gauge their effectiveness by providing a view of how clear and accessible investment law is and how adequately it is supported administratively and judicially.

Several themes emerge from the survey.

With few exceptions the countries of eastern Europe have made greater progress than those of the CIS both in adopting legal rules fostering investment and in applying and enforcing them. The Czech Republic, Hungary and Poland are the most advanced, with most of the rest of eastern Europe and Estonia also having made considerable progress.

Despite a great deal of legislative activity, few countries of the region have investment rules that closely approximate international standards. Those countries whose laws come nearest are Bulgaria, the Czech Republic, Hungary, Poland, Russia and the Slovak Republic. The Czech Republic, for example, does not generally distinguish between foreign and local investors, thus meeting the international standard of "national treatment" (although this approach may not preclude discriminatory exceptions applying to foreign investors). Legal rules furthest from international standards on investment are found in Albania, Azerbaijan, Tajikistan and Turkmenistan. There may be many explanations for this regional pattern. History may play a part: the most extensive laws are often found in countries with a long, but until recently dormant, market-oriented legal tradition. More extensive laws are also found in countries with avowed EU membership aspirations. Countries having particularly large, or readily accessible, markets tend also to have better legal rules than small, relatively isolated economies.

Most countries have made more progress in enacting law than ensuring its effectiveness. Only three countries, Croatia, Estonia and Slovenia, appear to have made greater progress with enforcement than legislation.

In many countries, laws that closely approximate international standards on investment are severely compromised by being unclear, inaccessible or poorly supported administratively or judicially. Few countries dedicate the necessary economic resources to ensuring that investment laws are adequately supported administratively. This is reflected, for example, in the lack of the financial and logistical support necessary to implement legal requirements regarding registration of proprietary interests, pledges of assets and company registration. The level of judicial support, although generally better than the administrative support accorded to investment law, is frequently weak. Courts in most countries appear to lack the resources, training and experience, to handle complex investment disputes adequately. The type of institutional change required, as for many other aspects of transition, takes time to achieve.

For law fully to contribute to an environment conducive to investment, both foreign and domestic, adequate processes and institutions must be in place to ensure its clarity, accessibility and enforcement. Only then can laws affecting investment achieve their purpose.

Annex 6.1

Laws of the region: conduciveness to fostering investment

How extensive are the legal rules fostering investment?

Albania Laws exist regulating both domestic and foreign investment. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, are limited. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits, whether in the form of dividends or otherwise, may be expatriated freely, and no licence is necessary to export fully convertible currencies. Albanian entities are required to have a licence to hold foreign bank accounts. No governmental approval is required in respect of most investment proposals. Where private property is expropriated, compensation is not required to be granted on a basis that at least approximates market value.

Armenia Laws regulating both domestic and foreign investment exist. Land ownership by foreigners is not permitted. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Companies are required to create and maintain share registers. Most foreign investment proposals are not subject to governmental approval, except for security and health reasons, and apply to both national and foreign investment proposals alike. No licence is necessary to export fully convertible currencies. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Azerbaijan Laws regulating both domestic and foreign investment are limited. Ownership of land by foreigners is not permitted. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, are limited. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.

Belarus The ownership of land by foreigners or foreign-owned local companies is not permitted. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, exist, but the activities of all funds were suspended by presidential decree in March 1995. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. No rules exist prohibiting insider trading in securities of publicly listed companies. A licence is necessary to export fully convertible currencies. Most foreign investment proposals require governmental approval. Where private property is expropriated, compensation is not required to be paid at the time of the expropriation being carried out.

Bulgaria No governmental approval is required for most investment proposals in the country. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Although the ownership of land by foreigners is not permitted, foreign-owned local companies may own land, except land intended for agricultural use. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, have recently been enacted. Rules concerning the pledging of assets are principally aimed at protecting debtors over creditors, although Bulgarian banks benefit from a more favourable regime in this respect. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

How clear and accessible is the law affecting investment?

Laws are drafted by legally trained personnel. Laws drafted by foreign consultants are considered usually to be well adapted to the needs of the country. Legal rules regulating investment are prescribed mainly by the legislature. The full texts of laws are published, but with delays of up to six months. Important court decisions and draft laws are not usually published or accessible by practitioners. Comprehensive legal assistance is available on investment matters but mainly from foreign lawyers practising locally. Where available, the cost of legal assistance is generally affordable to local investors.

Laws are drafted by legally trained personnel. Laws drafted by foreign consultants are considered usually to be well adapted to the needs of the country. Laws affecting investment are prescribed mainly by the legislature. The full texts of laws are regularly published and draft laws are usually accessible to practitioners. Reportedly, many laws are also available on a computer database. Comprehensive and independent legal assistance on investment matters is available to private sector clients, but from a very limited number of lawyers. Where available, the cost of legal assistance is generally affordable to local investors.

Laws are drafted by legally trained personnel. Laws drafted by foreign consultants are considered to be usually well adapted to the needs of the country. Laws affecting investment are prescribed both by the legislature and the executive. The full texts of laws are published, although sometimes six months after being passed. Important court decisions and draft laws are not usually published or accessible by practitioners. Little legal assistance is available to private sector clients on investment matters. Where available, the cost of comprehensive legal assistance is often prohibitive for local investors.

Investment laws are usually drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are not considered to be always well adapted to local needs. Laws affecting investment, particularly indirect investment, are often issued by executive decree. The full texts of laws are published, but sometimes six months after being passed. Important court decisions and draft laws are not usually published or accessible by practitioners. Comprehensive legal assistance, at least in Minsk, is available to private sector clients on investment matters. Where available, the cost of legal assistance is generally affordable to local investors.

Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to the needs of the country. The full texts of laws affecting investment are published, usually within one month of being passed. Draft laws are accessible by practitioners. Important court decisions are usually published or accessible by practitioners, but are not usually published within 12 months of being issued. Sophisticated legal assistance on investment matters is available, at least in Sofia, but is not always affordable to local investors.

How well supported administratively is investment law?

While the law provides for the registration of security interests, registers do not always exist. Where they exist, records are usually at least six months out of date. Limited-liability companies or joint-stock companies may be created in less than one month. No organised stock exchange exists. The size and quality of the civil service in Tirana is considered insufficient for the role attributed to it by the law. Criminal laws, in particular those relating to the protection of property and corrupt practices, are viewed as not extensively policed.

While recently enacted law provides for the registration of security and ownership interests in specified tangible property, registers do not always exist. Limited-liability companies and joint-stock companies may be created in about three weeks. Two organised stock exchanges exist. Governmental approval of foreign investment proposals may take up to three months. The size and quality of the civil service in Yerevan is considered insufficient for the role attributed to it by the law. Criminal laws, in particular those relating to the protection of property and corrupt practices, are viewed as not extensively policed.

While the law provides for the registration of security and ownership interests, certain prescribed registers do not exist and others are not current within 12 months. No organised stock exchange exists. The size and quality of the police force in Baku is considered insufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are not considered to be routinely investigated and prosecuted.

While the law provides for the setting up of a system to register pledges of assets granted by way of security and ownership interests, registers do not exist or are outdated. Limited-liability companies and joint-stock companies may be created in less than two months. The issuance of a licence to export fully convertible currencies may take up to three months. An organised stock exchange exists. The size and quality of the state civil service in Minsk is considered insufficient for the role attributed to it by the law. The public reputedly considers that the exercise of administrative and judicial discretion is sometimes arbitrary. Criminal laws, in particular those relating to the protection of property and corrupt practices, are viewed as not extensively policed.

While legally prescribed registers for interests in respect of land or security exist, there is no requirement to maintain registers to record security interests in movable assets. Records contained in land registers are usually current within 1-3 months but are not centralised. Limited-liability companies and joint-stock companies may be created in less than two months. An organised stock exchange exists: legislation regulating it was passed in July 1995. The size of the state civil service in Sofia is considered sufficient for the role attributed to it by the law. Criminal laws, in particular those relating to the protection of property and corrupt practices, are viewed as not extensively policed.

How well supported judicially is investment law?

While private parties generally believe that courts would recognise and enforce their legal rights against other private parties, they do not believe that courts would enforce such rights against state parties. Remuneration of a judge of a court of first instance is twice that of an unskilled factory worker. A commercial case may usually be heard on its merits in less than six months in Tirana. While foreign arbitral awards are required to be recognised, there is a lack of a clear enforcement mechanism.

Albania

Private parties generally believe that courts would not recognise and enforce their legal rights against state parties. Courts are considered to have neither the experience nor the human resources to handle complex investment disputes. Parties usually wait between six months to one year for a commercial case to be heard on its merits in Yerevan. Foreign arbitral awards are not required to be recognised and enforced by the courts without a re-examination of the merits.

Armenia

Private parties generally believe that courts would not recognise and enforce their legal rights against state parties. Courts are considered to have neither the skills nor the human resources to handle investment disputes. Foreign arbitral awards are not required to be recognised and enforced by the courts, at least not without a re-examination of their merits. No locally incorporated company has been declared bankrupt in the past year.

Azerbaijan

Private parties reputedly believe that courts would not always recognise and enforce their legal rights against state parties and are sometimes reluctant to protect their interests judicially. Courts are reported as sometimes falling under the sway of the executive. The average annual salary of a judge of a court of first instance is twice that of an unskilled factory worker and legally prescribed standards relating to the remuneration of judges are not always met. Parties usually wait for less than six months for a commercial case to be heard on its merits in Minsk. Courts are considered to have neither the skills nor the human resources to handle investment disputes. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. No locally incorporated companies are reported to have been declared bankrupt in the past year.

Belarus

The salary of a judge of a court of first instance is twice that of an entry-level primary school teacher and one-tenth the average earnings of private practitioners. Private parties reputedly believe that courts would recognise and enforce their legal rights, including against state parties, although rules restricting or delaying foreclosure procedures limit judicial action aimed at protecting interests of creditors. An appellate court system has been introduced recently. The financial and administrative support of the courts is regarded as inadequate. Parties usually wait for up to two years for a commercial case to be heard on its merits in Sofia. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.

Bulgaria

How extensive are the legal rules fostering investment?

Croatia Laws exist regulating the ownership of land by foreigners or foreign-owned local companies. Draft laws on securities and on investment funds are under preparation. Senior management of investment vehicles can consist wholly of foreign nationals, except with public unlimited companies. Profits may be expatriated freely and are not generally subject to any withholding tax. The transfer abroad of fully convertible currencies is subject to governmental approval. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.

Czech Republic Laws exist regulating the use of both direct and indirect investment vehicles, such as securities or investment funds. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be repatriated freely. Land ownership by foreigners is permitted through locally created companies. There exist rules prohibiting insider trading in securities of publicly listed companies. Usually, no licence is required for the export of fully convertible currencies. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Estonia Laws regulating the use of indirect investment vehicles exist, regulating investment funds activities and the issuance of securities. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be repatriated freely. Land ownership is permitted, including by foreigners or foreign-owned local companies. Usually no licences are required to export fully convertible currencies. Most foreign investment proposals do not require governmental approval. Investment in banks requires central bank approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation.

FYR Macedonia Laws exist regulating both domestic and foreign investment, including the creation of limited-liability companies or joint-stock companies. Laws exist regulating the use of indirect investment vehicles and the issuance of securities. Foreigners may establish and own wholly limited-liability companies and joint-stock companies. Profits may be expatriated freely. There is no operational stock exchange. Private ownership of land by nationals is permitted. Foreigners can own houses and business premises but not urban land. Where land may be leased from the state, leasehold rights may not be assigned to third parties. Rules regulating the pledging of assets are principally aimed at protecting debtors over creditors. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Georgia Laws exist regulating both domestic and foreign investment, including the creation of limited-liability companies or joint-stock companies. Limited-liability companies and joint-stock companies may be wholly owned by foreigners only. Profits may be expatriated freely. Foreigners or foreign-owned local companies may not own land. Shareholders of a company may be required, for reasons other than fraud, to contribute more than their fully paid-in capital at the time of the bankruptcy of a company. Most foreign investment proposals do not require governmental approval, although the transfer abroad of fully convertible currencies is subject to central bank approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

How clear and accessible is the law affecting investment?

Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to the needs of the country. The full texts of laws affecting investment are published, usually within one month of being passed, although draft laws may not always be accessible. Important court decisions are usually published or accessible by practitioners within 12 months of being issued. Sophisticated legal assistance is available, at least in Zagreb, and is generally affordable to local investors.

Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. The full texts of laws affecting investment are published within one month of being passed. Draft laws are not always published. Important court decisions are usually published or accessible by practitioners within 12 months of being issued. Sophisticated legal assistance is available, at least in Prague, and is generally affordable to local investors.

Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to local needs. The full texts of laws affecting investment are published within one month of being passed. Draft laws are not always published. Important court decisions are usually published or accessible by practitioners within 12 months of being issued. Comprehensive legal assistance is available, at least in Tallinn, and is generally affordable to local investors.

Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. The full texts of laws affecting investment are published within one month of being passed. Draft laws are not usually published. While constitutional and supreme court decisions are regularly published or accessible to practitioners within one month of being issued (depending on the frequency of the publication of the Official Gazette), decisions from lower courts are not usually published. Comprehensive legal assistance is available, although from a limited number of lawyers, but is generally affordable to local investors.

Laws are drafted by legally trained personnel. Laws affecting investment are often issued by executive decree. The full texts of laws are published, although with several months' delay. Important court decisions are not regularly published or accessible by practitioners. Comprehensive legal assistance on proposed investments is rare, but, where available, is generally affordable to local investors.

How well supported administratively is investment law?

Legally prescribed registers for the registration of interests are mainly limited to immovable assets. Records contained in land registers are usually current within six months. Limited-liability companies and joint-stock companies may be created in less than one month. Governmental approval for the transfer abroad of full convertible currencies is generally issued in less than one month from the date of application. Investors generally feel that the issuance of governmental approvals is sometimes arbitrary. An organised stock exchange exists. The size of the police force in Zagreb is considered sufficient for the role attributed to it by the law, although criminal laws, particularly those relating to the protection of property and the prohibition of corrupt practices, are viewed as not extensively policed.

Legally prescribed registers for interests in respect of land or security exist, but are mainly limited to real estate and company shares. Records contained in land or share registers are usually current within three months. The registration of limited-liability companies and joint-stock companies may take up to three months. Career civil servants are stated to be appointed or promoted principally on the basis of merit rather than declared political allegiance. An organised stock exchange exists. The size and quality of the state civil service in Prague is considered insufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are considered to be routinely investigated and prosecuted.

Legally prescribed registers of interests in respect of land and security exist. Records contained in land or share registers are usually current within one month. Limited-liability companies and joint-stock companies may be created in less than two months. No organised stock exchange exists. Career civil servants are stated to be appointed or promoted principally on the basis of merit rather than declared political allegiance. The size and quality of the police force in Tallinn is considered insufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are viewed as routinely investigated and prosecuted.

Registers of proprietary or security interests exist, but are mainly limited to land and other immovable assets. Records are reported to be unreliable and outdated. Limited-liability companies and joint-stock companies may be created in less than one month. A backlog in registration of companies is expected to be experienced when a new law on companies comes into force in autumn 1995, requiring existing companies to re-register. The size and quality of the state civil service, including the police force, is considered sufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are not considered to be routinely investigated and prosecuted.

No system exists for the registration of pledges of assets granted by way of security or for the registration of interests in respect of land. Registers, where in existence, are usually at least several months out of date. Limited-liability companies and joint-stock companies may be created in less than one month. Central bank approval for the transfer abroad of fully convertible currencies may take up to one month to be obtained. No organised stock exchange exists. The size and quality of the state civil service, including the police force, is considered insufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are considered not to be routinely investigated and prosecuted.

How well supported judicially is investment law?

Private parties generally believe that courts would recognise and enforce their legal rights, including against state parties. The average annual salary of a judge of a court of first instance is approximately three to four times that of an unskilled factory worker. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Parties usually wait for up to two years for a commercial case to be heard on its merits in Zagreb. Reportedly, the ability of the courts of first instance to handle investment disputes has, over recent years, been undermined by a drain of human resources towards private practice. Locally incorporated companies have been declared bankrupt in the past year.

Croatia

Private parties generally believe that courts will recognise and enforce their legal rights, including against the state. Courts are viewed usually to have the skills to handle investment dispute matters but still lack human and administrative resources to ensure a smooth administration of justice, particularly in respect of company registration requirements. Parties must wait for up to three years for commercial cases to be finally determined by a court of first instance, in major commercial centres such as Prague. The remuneration of a judge of a court of first instance is three times that of an entry-level primary school teacher, although it is the stated intention of the government to increase the remuneration of the judiciary. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Several locally incorporated companies have been declared bankrupt in the past year. Bankruptcy proceedings are often lengthy.

Czech Republic

Private parties generally believe that courts will recognise and enforce their legal rights, including against the state. Courts are viewed usually to lack the human and administrative resources to handle complex commercial disputes. The remuneration of a judge of a court of first instance is three to four times that of an entry-level primary school teacher. Parties must usually wait six months to one year for an investment dispute to be heard on its merits. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.

Estonia

Private parties generally believe that courts would recognise and enforce their legal rights against another private party where the litigation is considered to be minor. However, private parties do not believe that courts would recognise and enforce their legal rights against state parties. Courts are viewed usually to lack the skills or the resources necessary to handle complex investment disputes. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.

FYR Macedonia

Private parties generally believe that courts would not recognise and enforce their legal rights, whether against a state party or another private party. Courts are viewed usually to lack the skills or the resources necessary to handle complex investment disputes. While foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits, such enforcement remains generally untried in practice. No locally incorporated company has been declared bankrupt in the past year.

Georgia

How extensive are the legal rules fostering investment?

Hungary Laws exist regulating both domestic and foreign investment, as well as the use of indirect investment vehicles such as investment funds and securities. Foreigners may establish and wholly own limited-liability companies and joint-stock companies. Profits may be expatriated freely. There exist rules prohibiting insider share dealing of publicly listed companies. Land ownership is permitted, although foreigners may own land only through local companies. Agricultural land may be owned only by Hungarian private nationals. Most foreign investment proposals are not subject to governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Kazakhstan Laws regulating both domestic and foreign investment exist. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, exist. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Private ownership of land is prohibited, whether by foreigners or nationals. Most foreign investment proposals do not require governmental approval, except for large-scale investments, such as natural resources projects. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.

Kyrgyzstan Laws regulating both domestic and foreign investment exist. Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. The management of limited-liability companies or joint-stock companies may not wholly consist of foreign nationals. Profits may be expatriated freely. Private ownership of land is prohibited, whether by foreigners or nationals, although the right to use land for a period of up to 49 years exists. Most foreign investment proposals must be registered with the relevant authorities and may require governmental approval. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.

Latvia Indirect investment, such as securities or investment funds, is not specifically regulated. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. While foreigners or foreign-owned local companies are prohibited from owning land, they are permitted to lease it. Most foreign investment proposals do not require governmental approval. The transfer abroad of fully convertible currencies does not require government approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Lithuania The use of indirect investment vehicles, such as the issuing of securities and investment funds, is not specifically regulated. Rules exist prohibiting insider share dealing of publicly listed companies. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Although foreigners or foreign-owned local companies are prohibited from owning land, they are permitted to lease it for up to 99 years. The export of fully convertible currency is not subject to government approval. Most foreign investment proposals have to be approved by the government. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

How clear and accessible is the law affecting investment?

Investment laws are drafted by legally trained personnel. The full texts of laws affecting investment are usually published within two weeks of being passed. Draft laws affecting investment are not usually published. Reports of important court decisions are usually published or accessible within 12 months of being issued. Legal rules regulating investment are prescribed mainly by the legislature. Sophisticated legal assistance is available on investment matters, at least in Budapest, and is generally affordable to local investors.

Investment laws are drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to local needs. Legal rules regulating investment have been prescribed mainly by the executive since the suspension of the legislature. The full texts of laws and decrees affecting investment are usually published within one month of being signed, although some decrees are not published. Draft laws may be accessible by practitioners. Important court decisions are not always published or accessible by practitioners. Sophisticated legal assistance on proposed investments is available but is not generally affordable to local investors.

Investment laws are drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are considered to be generally adapted to the local needs. Legal rules regulating investment are prescribed both by the legislature and the executive. The full texts of laws passed by the legislature are published, although may not be readily accessible. Presidential decrees affecting investment are not always published. Draft laws are usually accessible to practitioners. While some supreme court decisions are published in newspapers or accessible to practitioners, decisions of lower courts are not regularly published. Legal assistance in respect of investment matters is available and is generally affordable to local investors, although local law firms may not yet have the skills necessary to handle complex investment matters.

Laws are drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to local needs. The full texts of laws affecting investment is generally published within one month of being passed. Draft laws affecting investment and most important court decisions are generally accessible to practitioners. Independent and comprehensive legal assistance is available, at least in Riga, and is generally affordable to local investors.

Laws are not always drafted by legally trained personnel, and they are often unclear, or impose conflicting requirements. Where investment laws are prepared by foreign consultants, they are considered not to be generally well adapted to the local needs. Legal rules regulating investment are prescribed mainly by the executive. The full texts of laws affecting investment are generally published within two weeks of being passed. Draft laws affecting investment and most important court decisions are generally accessible to practitioners. Important court decisions are not always published or accessible to practitioners. Independent and comprehensive legal assistance is available, at least in Vilnius, and is generally affordable to local investors.

How well supported administratively is investment law?

Where a statute provides for the registration of proprietary or security interests, registers do exist, but are often not current within 12 months. The registration process for limited-liability companies or joint-stock companies may take up to three months. An organised stock exchange exists. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.

Registers for ownership interests exist, but are mainly limited to immovable assets. Where registers exist, records accessible by the public are at least six months out of date. Limited-liability partnerships and joint-stock companies may usually be created within two months. A stock exchange was recently established. Civil servants are stated as being appointed or promoted principally on the basis of their declared political allegiance. The size and quality of the state civil service, in particular that of the police force, is considered insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to corrupt practices, are viewed as not extensively policed.

Legally prescribed registers for security interests often do not exist and when they do they are usually six months out of date. Limited-liability companies and joint-stock companies may be created within about six weeks. A stock exchange was created in late 1994. Civil servants are believed by survey respondents to be appointed or promoted principally on the basis of their declared political allegiance. The size and quality of the state civil service, in particular the police force, is considered insufficient for the role attributed to it by the law. Corrupt practices, including bribery of public officials, are viewed to be quite extensively policed.

Where registries in respect of land or security exist, they are usually current within three months. Limited-liability companies and joint-stock companies may be created in less than one month. An organised stock exchange exists. Civil servants are stated to be appointed or promoted principally on the basis of merit, rather than political allegiance. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.

No system exists for registering ownership interests or pledges of assets granted by way of security. Limited-liability companies and joint-stock companies may be created within one month. An organised stock exchange exists. Civil servants are stated as being appointed or promoted principally on the basis of their declared political allegiance. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, have been only recently adopted.

How well supported judicially is investment law?

Private parties generally believe that courts would recognise and enforce their legal rights against another private party or a state party. The average annual salary of a judge of a court of first instance is three to four times that of an entry-level primary school teacher. Courts are viewed as usually possessing the skills necessary to handle investment disputes, but lack the human and administrative support to ensure an efficient administration of justice. Parties usually wait for up to two years for a commercial case to be finally determined by a court of first instance. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year. The Court of Arbitration attached to the Hungarian Chamber of Commerce is held to possess both the human and financial means to handle complex investment disputes to near-international standards.

The average annual salary of a judge of a court of first instance is twice that of an unskilled factory worker. Judges of the higher courts must be law graduates, but not those of the lower courts. Private parties generally believe that courts would not recognise and enforce their legal rights against state parties. Parties must usually wait six months to one year for an investment dispute to be heard on its merits. Neither foreign judgments nor foreign arbitral awards are required to be recognised and enforced by local courts without a re-examination of their merits. Locally incorporated companies are reported to have been declared bankrupt in the past year.

Judges may be removed by the President. The average annual salary of a judge of a court of first instance is twice that of an unskilled factory worker. Private parties generally believe that courts would not recognise and enforce their legal rights against state parties. The public perception of the independence of the courts remains to be further demonstrated. Courts are viewed usually to lack the skills or the resources necessary to handle complex investment disputes and are not regarded to be familiar with certain commercial law concepts embodied in local legislation. Few bankruptcies of locally incorporated companies have been reported. Parties must usually wait up to one year for an investment dispute to be heard on its merits. Foreign arbitral awards are not required to be recognised and enforced without a re-examination of their merits.

Private parties generally believe that courts would recognise and enforce their rights against other parties, including state parties. The annual salary of a judge of a court of first instance is twice that of an entry-level primary school teacher. Courts are viewed to be generally supportive of laws regulating domestic and foreign investment but often lack the financial and human resources, as well as the training, to adequately handle complex investment disputes. Insufficient budgetary or human resources are considered to be provided by the government in supporting the administration of justice. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.

Private parties generally believe that courts would recognise and enforce their rights against other parties, but not against state parties. The annual salary of a judge of a court of first instance is five to six times that of an entry-level primary school teacher. Courts are viewed to be usually supportive of laws regulating domestic and foreign investment but often lack the financial and human resources to handle adequately complex investment disputes. A commercial case may generally be heard on its merits in less than six months in Vilnius. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.

Hungary**Kazakhstan****Kyrgyzstan****Latvia****Lithuania**

How extensive are the legal rules fostering investment?**How clear and accessible is the law affecting investment?****Moldova**

Laws regulating both domestic and foreign investment exist. Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Companies may be wholly owned by foreigners. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. The ownership of land by foreigners is prohibited. Most foreign investment proposals have to be approved by the government where the proposed investment exceeds US\$ 250,000. Where private property is expropriated, compensation is not required to be paid at the time of the expropriation being carried out.

Laws are drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to local needs. Legal rules regulating investment are prescribed mainly by the executive. While the full texts of legal rules affecting investment are published within one month of being passed, they are not always widely disseminated. Important court decisions are not always published or accessible by practitioners. Independent and comprehensive legal assistance on proposed investments is rare and, where available, is not generally affordable to local investors.

Poland

Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Limited responsibility partnerships or joint-stock companies may be wholly owned and managed by foreigners. Most forms of profits, such as dividends, may be expatriated subject to certain conditions (see Annex 2.2). Land ownership is allowed, including by foreigners and foreign-owned local companies, with an appropriate permit. No licence is usually required for the export of fully convertible currencies, except in specific circumstances. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. The full texts of laws affecting investment are published within one month of being passed. Draft laws are not always published. Important court decisions are usually published or accessible to practitioners within 12 months of being issued. Sophisticated legal assistance is available, at least in Warsaw, and is generally affordable to local investors.

Romania

Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Foreigners may own land through local companies having at least one Romanian shareholder. Senior management of limited-liability companies may consist wholly of foreign nationals. The senior management of joint-stock companies must include Romanian nationals. Profits may be expatriated freely. Most foreign investment proposals require governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature, although the executive is constitutionally permitted to legislate when the parliament is in recess. The full texts of laws affecting investment are published usually within one month of being passed. Draft laws are rarely published. Important court decisions are usually published or accessible by practitioners within 12 months of being issued. Independent and comprehensive legal assistance is available from a limited number of lawyers in Bucharest and is not generally affordable to local investors.

Russian Federation

Laws exist regulating both domestic and foreign investment, although parts of the civil code have yet to be adopted and certain aspects of company law remain unclear. Rules exist regulating indirect investment, but are mainly limited to investment funds and privatisation matters. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Foreigners or foreign-owned local companies may not own land. The leasing of land is generally permitted, although the situation is confused. While most foreign investment proposals do not need to be approved by the Government, transfers to or from Russia of foreign currency (in relation to capital transactions, as opposed to current) are subject to central bank control. In most cases, Russian companies are required to sell to the state 50 per cent of their net foreign currency earnings at a market rate. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Laws are generally drafted by legally trained personnel. Many of the laws affecting investment are issued by means of executive decrees and often are considered to be unclear or to impose requirements conflicting with federal laws. Secondary legislation is rarely adopted. The full texts of laws are usually published within one month of being passed. Important court decisions are not usually published or easily accessible by practitioners. While sophisticated legal assistance is usually accessible on investment matters, at least in Moscow, it is not usually affordable to local investors.

Slovak Republic

Indirect investment, such as the issuing of bonds or the activities of private investment funds, is permitted and regulated. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Foreign-owned local companies may own land. Most foreign investment proposals do not require government approval. Profits, whether in the form of dividends or otherwise, can be expatriated freely, although the transfer abroad of fully convertible currencies is subject to central bank approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Laws are drafted by legally trained personnel. The full texts of laws affecting investment are usually available and published within six months of being passed. While important court decisions are normally published or accessible by practitioners within 12 months of being issued, draft laws affecting investment are not usually published. Independent and comprehensive legal assistance is available (although from a small number of firms), at least in Bratislava. The cost of sophisticated legal assistance on investment matters is usually affordable to local investors.

How well supported administratively is investment law?

No generalised system exists for registering ownership interests and pledges of assets granted by way of security. Limited-liability companies and joint-stock companies may be created within two months. An organised stock exchange exists. Civil servants are stated to be appointed or promoted principally on the basis of their declared political allegiance. The size and quality of the state civil service in Chisinau is considered insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.

Legally prescribed registers of interests in respect of land or security exist. No system exists for registration of security interests in respect of movable assets. Records contained in land or share registers are usually current within three months. Limited-liability companies and joint-stock companies may be created; registration may take two to three months. An organised stock exchange exists. Civil servants are stated to be appointed or promoted principally on the basis of merit rather than declared political allegiance. The size and quality of the state civil service in Warsaw is considered insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.

Legally prescribed registers for the registration of interests in respect of land or security exist. Limited-liability companies and joint-stock companies may be created and registration may take up to two months. A stock exchange is being organised and is scheduled to start operating towards the end of 1995. The size and quality of the state civil service in Bucharest is considered insufficient for the role attributed to it by the law. While the size of the police force is large, criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.

The legally prescribed system for registering pledges of assets granted by way of security is incomplete. Where a statute provides for the registration of interests in respect of proprietary or security interests, registers do not always exist. Where such registers are in existence, records in respect of land or shares are usually six months out of date, at least in Moscow. It may take more than three months for a limited-liability or joint-stock company to be created. An organised stock exchange exists. The quality of the civil service is considered, in certain ministries or agencies, as sufficient for the role attributed to it by the law, but the scope of administrative discretion that may be exercised by governmental agencies is regarded as unclear. Enforcement of criminal laws relating to the protection of property or corrupt practices is viewed as uneven.

Legally prescribed registers for interests in respect of land or security exist, but are mainly limited to real estate and company shares. Records contained in land registers are usually current within one month, while share registers are current within three months. Limited-liability companies and joint-stock companies can usually be created in less than three months. Central bank approvals for the transfer abroad of fully convertible currencies may take up to three months. An organised stock exchange exists. While the size of the police force is considered large, criminal laws relating to the protection of property and corrupt practices are viewed as not extensively policed. Career civil servants are stated as being appointed or promoted principally on the basis of their declared political allegiance.

How well supported judicially is investment law?

Private parties generally believe that courts would not recognise and enforce their rights against state parties. The annual salary of a judge of a court of first instance is twice that of an unskilled factory worker. Courts are viewed as often lacking the financial and human resources, as well as the training, to handle adequately complex investment disputes. A commercial case may generally be heard on its merits in less than six months in Chisinau. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.

Private parties generally believe that courts will recognise and enforce their legal rights, including against state parties. Courts are viewed to have the skills to handle investment dispute matters but still to lack human and administrative resources to ensure a smooth administration of justice. Parties must wait for about one year for their commercial case to be heard on its merits by a court of first instance in Warsaw. While the remuneration of a judge of first instance is three times that of an entry-level primary school teacher, it is the reported intention of the state to dedicate further resources to increase the remuneration of the judiciary. The Court of Arbitration attached to the Polish Chamber of Commerce is stated to possess both the human and financial means to handle complex investment disputes approximating to international standards. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.

Private parties generally believe that courts would not recognise and enforce their rights against state parties. The annual salary of a judge of a court of first instance is two to three times that of an unskilled factory worker. Courts are seen as often lacking the financial and human resources, as well as the training, to handle complex investment disputes adequately. Parties must wait for up to six months for a commercial case to be heard on its merits by a court of first instance in Bucharest. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Few, if any, locally incorporated companies have been declared bankrupt in the past year.

Judges may not be removed by the executive once elected. While private parties generally believe that courts would recognise and enforce their legal rights against other private parties in certain cases, they do not have such faith in the court's ability to enforce their rights against state parties. The annual salary of a judge of a court of first instance is three to four times that of an unskilled factory worker. The judiciary is considered as being generally supportive of laws regulating investment, but as often lacking the understanding of certain commercial concepts embodied in those laws needed to handle complex investment disputes. A commercial case may generally be heard on its merits in less than six months, at least in Moscow. Locally incorporated companies have been declared bankrupt in the past year. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits.

Judges may not be removed by the executive once appointed. Private parties generally believe that courts will recognise and enforce their legal rights, including against state parties. Parties may wait up to four years for commercial cases to be finally determined by a court of first instance in major commercial centres such as Bratislava. The remuneration of a judge of a court of first instance is five times that of an unskilled factory worker. Courts reportedly lack the financial and human resources necessary to handle complex investment disputes. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits. Very few locally incorporated companies have been declared bankrupt in the past year.

Moldova**Poland****Romania****Russian Federation****Slovak Republic**

How extensive are the legal rules fostering investment?

Slovenia Indirect investment, such as the issuing of bonds or the activities of private investment funds, is permitted and regulated. The senior management of local companies usually may not consist wholly of foreign nationals. Foreign individuals may not own land. Profits, whether in the form of dividends or otherwise, can be expatriated freely. The transfer abroad of fully convertible currencies is not subject to central bank approval. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Tajikistan Laws regulating both foreign and domestic direct investment exist. Laws exist regulating the use of indirect investment vehicles, such as issuing of securities. Limited responsibility partnerships or joint-stock companies may be wholly owned and managed by foreigners. Foreigners are prohibited from owning land. Profits, whether in the form of dividends or otherwise, can be expatriated freely. The transfer abroad of fully convertible currencies is subject to central bank approval. Most foreign investment proposals require government approval, particularly for the exploitation of natural resources. Where private property is expropriated, compensation is required to be paid at the time of the expropriation.

Turkmenistan Laws exist regulating both foreign and domestic direct investment. Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Foreigners may generally not hold more than 49 per cent of the shares issued by a local company and are prohibited from owning land. Nationals (individuals) may own up to 50 hectares of land. Profits may be expatriated freely. The transfer abroad of fully convertible currencies is subject to central bank approval. Most foreign investment proposals require governmental approval.

Ukraine Laws regulating both foreign and domestic direct investment exist. Indirect investment, such as the issuing of bonds or the activities of private investment funds, is not specifically regulated. Limited responsibility partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits, whether in the form of dividends or otherwise, can be expatriated freely. The transfer abroad of fully convertible currencies is usually subject to central bank approval. Foreign investment proposals do not require governmental approval, except where approval is required in joint ventures in which state enterprises participate or in respect of key economic sectors identified in laws on foreign investment. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.

Uzbekistan Laws regulating both domestic and foreign investment exist. Laws exist regulating the use of indirect investment vehicles, such as securities. Limited-liability and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated. Foreigners and foreign-owned local companies are prohibited from owning land. The transfer abroad of fully convertible currencies is subject to central bank approval. Most foreign investment proposals require governmental approval. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.

How clear and accessible is the law affecting investment?

Laws are drafted by legally trained personnel. The full texts of laws affecting investment are usually available and published within one month of being passed. Important court decisions are published or accessible by practitioners. Draft laws affecting investment are accessible to practitioners. Independent and comprehensive legal assistance is available, particularly in Ljubljana. The cost of sophisticated legal assistance on investment matters is generally affordable to local investors.

Laws are drafted by legally trained personnel. Legal rules regulating investment are often issued by way of executive decree. The full texts of laws affecting investment are usually published more than six months after being passed. Draft laws are not usually published and accessible to practitioners. Important court decisions are not regularly published. Legal assistance to private parties in respect of investment matters is very limited and may not always be independent from the government. Where available, legal assistance on investment matters is not generally affordable to local investors.

Laws are not always drafted by legally trained personnel and are often based on Soviet Union or Russian models. Legal rules regulating investment are often issued by means of executive decree. The full texts of laws affecting investment are not always published and ministerial cabinet decrees are not always available. Important court decisions are not usually published or accessible by practitioners. Legal assistance to private parties in respect of investment matters is very limited and may not be independent from the government. Where available, legal assistance on investment matters is not generally affordable to local investors. Local law firms may not yet have the skills necessary to handle complex investment matters adequately.

Laws are not always drafted by legally trained personnel. Legal rules regulating investment may be prescribed primarily by the legislature, although in the absence of specific legislation, the executive may also prescribe rules. The full texts of laws prescribed by the national legislature are usually published, although often up to six months after enactment. Legal rules enacted by regional or local governments are rarely accessible to practitioners. While supreme court decisions are usually published or accessible to practitioners, decisions from lower courts are not always available. Draft laws affecting investment are not always accessible to practitioners. Independent and comprehensive legal assistance is scarce. Where available, legal assistance is generally affordable to local investors but is becoming more expensive.

Investment laws are not always drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the executive. Executive decrees are not always made public. The full texts of laws affecting investment are usually published within six months of being passed. Draft laws are usually accessible by practitioners. Important court decisions are not always published or accessible by practitioners. Comprehensive and independent legal assistance on proposed investments is available in Tashkent, although from a limited number of lawyers. The cost of sophisticated legal assistance is not generally affordable to local investors.

How well supported administratively is investment law?

Legally prescribed registers for interests in respect of land or security exist. Records are usually current within three months. Registration of limited-liability companies and joint-stock companies may take up to six months. An organised stock exchange exists. Career civil servants are stated to be appointed or promoted principally on the basis of merit rather than declared political allegiance. The size and quality of the police force in Ljubljana is considered sufficient for the role attributed to it by the law.

A generalised system for registering ownership interests or pledges of assets granted by way of security does not exist. Where registers exist, they are often 12 months out of date. It may take more than three months for limited-liability companies or joint-stock companies to be created. Career civil servants are stated to be appointed or promoted principally on the basis of their declared political allegiance. The size and quality of the state civil service in Dushanbe is considered insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.

Although there is a law on pledge, registers of ownership interests and pledges of assets granted by way of security rarely exist. Limited-liability companies and joint-stock companies may take up to two months to be registered. No organised stock exchange exists. The size and quality of the state civil service in Ashgabad is considered insufficient for the role attributed to it by the law, although the police force is considered adequate.

Legally prescribed registers for the registration of interests in respect of land or security do not exist or, where they exist, in some cases are at least six months out of date. Limited-liability companies and joint-stock companies can usually be created within two months. An organised stock exchange exists. While civil servants are required to be appointed or promoted on the basis of merit, this rule is stated to be not always observed in practice. The size and quality of the state civil service in Kiev is regarded as insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as insufficiently developed and insufficiently policed.

Legally prescribed registers for interests in respect of land or security do not always exist. Where in existence, registers are usually 12 months out of date. Limited-liability companies and joint-stock companies can usually be created in less than one month. An organised stock exchange exists. The size and quality of the state civil service in Tashkent is regarded as insufficient for the role attributed to it by the law. While criminal laws relating to the protection of property are reported to be adequately policed, laws prohibiting money-laundering and corrupt practices are viewed as insufficiently policed.

How well supported judicially is investment law?

Judges may only be removed by the parliament once appointed. Private parties generally believe that courts will recognise and enforce their legal rights, including against state parties. It is reported that court officials have at times refused to authorise registration of real property interests of foreign-owned Slovenian companies although legally required to do so. Parties must usually wait for one year for a commercial case to be heard on its merits by a court of first instance in Ljubljana. The remuneration of a judge of a court of first instance is twice that of an entry-level school teacher. Courts are viewed as lacking the financial resources necessary to handle complex investment disputes, although practitioners rate Slovene courts highly. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.

Judges sitting on the highest courts are not always required to be graduates in law. Private parties generally believe that courts would not recognise and enforce their rights against state parties. Courts are viewed as often lacking the financial and human resources, as well as the training, to handle complex investment disputes adequately. A commercial case may generally be heard on its merits in about six months in Dushanbe. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits, although this rule remains largely untried in practice. It is unclear whether locally incorporated companies have been declared bankrupt in the past year.

Judges are appointed by the President for a five-year term. Private parties generally believe that courts would not recognise and enforce their rights against state parties. The annual salary of a judge of a court of first instance is comparable to that of an unskilled factory worker. Courts are regarded often to lack the financial and human resources, as well as the training, to handle complex investment disputes adequately. Foreign arbitral awards are not required to be recognised and enforced by the courts without a re-examination of their merits. No law on bankruptcy exists.

Private parties generally believe that courts would not recognise and enforce their rights against state parties. The annual salary of a judge of a court of first instance is five times that of an entry-level primary school teacher. Courts are viewed often to lack the financial and human resources, as well as the training, to handle complex investment disputes adequately. A constitutional court does not exist, but is being formed. A commercial case may generally be heard on its merits in less than one year in Kiev. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits, yet there is a lack of an adequate mechanism for enforcing awards. A limited number of locally incorporated companies have been declared bankrupt in the past year.

Private parties generally believe that courts would not recognise and enforce their rights against state parties. Courts are viewed often to lack the financial and human resources, as well as the training, to handle adequately complex investment disputes. A commercial case may generally be heard on its merits in less than one year in Tashkent. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.

Slovenia**Tajikistan****Turkmenistan****Ukraine****Uzbekistan**

Transition impact of investment projects



Transition from a command to a market economy involves the movement towards a fundamentally new system for the generation and allocation of resources. Investment projects play a crucial role in advancing this process of radical change. They help to replace the economically or technologically obsolete stock of capital inherited from the command systems. They expose human capital to previously unfamiliar forms of institutional and production arrangements that are compatible with market development. Furthermore, investment projects can change market structure and functioning and may thereby promote the restructuring of the economic system. The investment project, therefore, can have a direct impact on the transition process. For the EBRD, which is an institution with the goal of advancing the transition through the means of project finance, the “transition impacts” of projects are central to its activities.

Investment is then a key vehicle for advancing the transition. The weakness of capital markets and lack of familiarity with market processes mean that, for transition economies, investment should be fostered. But it is not simply the overall level of investment that is at issue.

Investment projects that are particularly rich in transition impacts will not necessarily receive special priority from the private sector. Private investors will invest to exploit the opportunities created by the new, market-oriented environment only if they expect sufficient financial returns. They do not incorporate the contribution of the investment project to the advancement of the transition process in their calculation of profitability. The investment projects that promise the highest private returns may not always be those with the most significant transition impact. Additionally, the countries of eastern Europe, the Baltics and the CIS have only recently started to develop capital markets. Privately profitable investment that also has high transition impact may not be undertaken by the private sector due to lack of a sufficient supply of credit. Investment activity may therefore be too low in areas that are particularly relevant to fostering the transition process.

Governments and international investors whose objectives include promoting the transition process play a key role both in encouraging investment and focusing their involvement on projects with high transition impact. The creation of efficient financial markets to help overcome credit constraints for the private sector will be a central measure in promoting investment activity.

A prerequisite for fulfilling this task is to have an understanding of which investment projects influence the transition process most strongly. Standard cost-benefit methods, which are implemented by governments or international financial institutions (IFIs) for project appraisal, do not necessarily provide such an under-

standing. By relying on the assumption of a stable market structure, for the most part, they capture only imperfectly the dynamic aspects of the transition process and therefore do not take account of potentially important transition impacts of investment projects. Furthermore, the specific situation in a country will affect the transition impact of investment. Hence, to assess likely transition impact requires knowledge of both the institutional and economic conditions inherited from the command era and of progress with transition in the different countries in the region.

The focus in this chapter is to examine the contribution of investment projects in advancing transition along two dimensions: the development of competitive market-based interactions, and the advancement of learning and discovery. The first focuses more on the market and the second on the enterprise. Although there is inevitably some overlap, the two categories serve as a useful way of organising the analysis. We shall see that for both dimensions the development of market-based institutions, including markets themselves, are at the heart of transition impact. The discussion of these categories not only serves to contribute to a clearer understanding of the way in which investment projects can support the creation of a market-oriented environment. It also provides the basis for the set of indicators introduced at the end of the chapter, which are a first step towards assessing the transition impact of investment projects in practice.

7.1 Developing competitive market-based interactions

Essential to the transition is the formation of market-based transactions or interactions within and between the enterprise, financial and infrastructure sectors. While in any economy the growth in one firm or sector interacts with growth in other firms or sectors, in well-functioning market economies this process is mediated fairly smoothly through the market system by price signals. Interactions in command economies were for the most part not market-mediated.

In “strategic” sectors (including defence and heavy industry) firms were often highly vertically integrated, with all stages of production located in a single firm (i.e. conglomerate). In other sectors, enterprises were bound together through the planning system. Supply of credit and infrastructure to industrial enterprises was monopolised by state banks and companies and not governed by profitability. These interactions, or linkages, were in general not based on the competitive advantage of alternative suppliers or on broader supply and demand considerations. As a result, most of the linkages inherited from the command economy are incompatible with market orientation.

Sustainable economic growth in the transition economies will require the development of market linkages that are consistent

with private sector development. Failure to establish efficient, competitive linkages, both between enterprises and the financial and infrastructure sectors, and between different enterprises, will block the transition process.

Financial markets play a key role in creating a competitive private sector, enhancing the overall efficiency of the economy and serving as a coordinating mechanism for the market system.¹ The transition impact of financial sector reforms arises both directly, by restructuring bank-enterprise relationships, and indirectly, by facilitating the growth of the new private sector. Enhanced banking skills and investment finance to upgrade and computerise operating systems improve the capacity of banks to monitor loans effectively. In this way access to credit by enterprises operating in the new private sector can be expanded. Credit can be allocated on a market-determined basis, in particular in relation to enterprise performance, which aids expansion of efficient, competitive firms in the economy. However, while the growth of efficient sets of market interactions in the enterprise sector is contingent on the existence of a competitive banking sector, the competitiveness of the banking sector is equally dependent on not having to support large, non-performing state or privatised enterprises. Programmes of bank and enterprise reform are therefore complementary (see Chapter 10).

Since the commercial banking sector was almost completely absent at the beginning of the transition process, the development of financial institutions is a cornerstone in that process. IFIs can play an important role in this area, as exemplified by the Financial Institutions Development Project in Russia (see Box 7.1).

In addition to strengthening the banking sector, there is a need to promote the development of complementary securities markets and non-bank financial institutions in transition countries (see Chapter 10).

Box 7.1

Financial Institutions Development Project, Russia

One of the most far-reaching transformations in the transition process of the Russian economy has taken place in the financial sector. More than 2,000 commercial banks have been created and have taken over many of the commercial banking functions of the former state banks. As these changes predated the enterprise privatisation process, the performance of the new banking sector as effective financial intermediaries became critical for the successful restructuring of newly privatised enterprises and private sector development.

In this context, the World Bank, in cooperation with the EBRD, initiated the Financial Institutions Development Project to contribute to a more efficient mobilisation of financial resources and allocation of bank credit. This project, administered through a Project Implementation Unit established in the Russian Ministry of Finance, focuses on assisting a carefully selected group of 40 Russian commercial banks in the development and arranging of twinning contracts with international banks. These foreign banks provide technical assistance to strengthen banking operations and modernise the bank's computer systems.

The project aims to achieve several goals. Upgrading banking services, modernising accounting practices and enhancing the financial soundness of the core group of commercial banks will lead to intensified competition and demonstration effects, which create a dynamic for improving the quality of banking activities in Russia as a whole. The tighter lending policies of banks will force enterprises to restructure and to establish efficient linkages with trading partners. Lastly, these banks should operate as effective channels for IFI credit lines. The purpose is therefore to restructure interactions within the financial sector, and between the financial and other sectors, so that they operate on a sound market basis.

The transition impact of such projects can be especially strong if they remove major bottlenecks in the institutional infrastructure needed to make such markets function effectively. Private investors are likely to be reluctant to undertake such investments in

Box 7.2

National Registry Company, Russia

In April 1995 the Bank of New York, two Russian companies, the IFC and the EBRD launched a Russian National Registry Company based in Moscow. The Russian shareholders are Nikoil, an investment broker and registrar company for the oil industry, and Uneximbank, one of Russia's largest commercial banks. The main business of the company is to provide an independent share registration and transfer service in Russia that meets the highest professional standards in all areas of registrar operations and administration, and satisfies the requirements of large Russian enterprises. The Bank of New York, in addition to being a shareholder, was awarded the technical services contract to support the development of the company. The company is planned to become fully operational in October 1995.

The project's potential transition impact derives primarily from the role that securities markets are expected to play in the current stage of the Russian reform process and the obstacles that exist to their development. The voucher privatisation generated predominantly insider ownership of privatised enterprises, typically lacking efficient corporate governance, meaningful restructuring strategies and the necessary investment finance. Given the relatively weak and highly vulnerable banking sector, the development of securities markets can be of critical importance for enterprise restructuring and financing. The single most important obstacle to this development has been the inadequate capital market infrastructure, in particular the lack of reliable share registrars. In Russia the only proof of share ownership is an extract from a register which has been typically managed by the enterprise itself. This situation has created fundamental uncertainties regarding shareholders' rights, increased transaction

costs and contributed greatly to the fragmentation of the equity market. This project represents the first decisive step to establish transparent and efficient capital market infrastructure and should significantly promote capital market development and stabilisation. The project has also accelerated reforms to develop the related legislative and regulatory framework by helping the authorities to identify a number of critical gaps in this area.

The likely direct and indirect transition impacts encompass strengthening both the capital market itself and the effectiveness of its participants. Examples of the first include transferring special skills, reducing transaction costs and increasing competition in the securities markets. The second category includes diluting the current degree of insider ownership and providing incentives for enterprises to submit to higher standards of financial disclosure, accounting and auditing.

¹ See Stiglitz (1993).

institutional infrastructure on their own, in part because of the uncertainties surrounding the future level of securities market activity, which itself depends on continued progress in reform. This is thus an area where IFIs can play an important role, as illustrated by the National Registry Company project in Russia (see Box 7.2).

The provision of infrastructure services, primarily water, power, transport and telecommunications, is also a prerequisite for dynamic private sector development. These services are critical inputs for almost any production activity, and removing infrastructure bottlenecks can stimulate enterprise development. For example, firms with inadequate linkages to providers of telephones, roads, electricity and so on may not develop even though they have the potential to do so. The highway project discussed in Box 7.3, for example, is likely to provide significant impetus for the development of the private sector in Belarus.

In transition economies, the inherited infrastructure was configured to meet the needs of the command economy, not market-based transactions. These sectors require restructuring in order to service the growing private sector on an efficient and commercial basis. Major infrastructure investments such as the Hungarian Telecommunications project can also promote more balanced regional development (see Box 7.4). In dynamic and uncertain transition environments, where it is particularly difficult to forecast the direction of economic activity in the long run, flexibility and the

Box 7.3

Belarus Highway Improvement project

The Belarus Highway Improvement project aims to repair and rehabilitate the Belarus portion of the M1/E30 highway connecting Moscow, Minsk, Warsaw and western Europe. This is the country's most important highway and a vital element of the European transport network. The project's transition impact arises both from the institutional advance associated with the commercial orientation of the organisation and running of the project, and from the direct benefits and linkages it provides.

A newly created entity (Belavostrada) is responsible for maintaining, operating and improving the highway. It is planned to transform Belavostrada from a state enterprise into a joint-stock company to allow for private sector participation and to reduce government spending. User tolls will be introduced, which will provide the primary source of revenue to finance maintenance of the highway and loan repayment. The project contributes to private sector development by supporting the demonopolisation and privatisation of state-owned road construction trusts. The allocation of road work contracts by open tendering will increase competition and improve efficiency in the road construction market.

The project reduces vehicle operating costs, increases average transportation speeds, and introduces better safety standards. It helps to provide an effective domestic transport system and allows an essential input for small and medium-sized enterprises (SMEs) operating countrywide. Additionally, by reducing international border crossing delays, it creates forward linkages to companies involved in the growing market for international truck transportation of high-value goods.

Box 7.4

Hungarian Telecommunications project

At the beginning of the 1990s, the Hungarian telecommunications system compared unfavourably with countries in similar economic circumstances. The general inadequacy of telecommunications services constituted a serious impediment to private sector development. The telecommunications system was particularly inadequate in rural areas, where it was still manually operated. In 1991, the Hungarian Telecommunications Company (HTC), the main provider of telecommunications services, decided to improve the accessibility and quality of its services as well as the overall efficiency of the telecommunications system. HTC engaged in a project which comprised two elements: modernisation and expansion of facilities in Budapest, and replacement of the manually operated system by a fully automated expanded rural telecommunications network.

This project has provided substantial benefits to the Hungarian economy. It supports the efficiency of the private sector by upgrading the quality of a key input to almost any business activity. It also assists the trade sector by permitting linkages to foreign business partners. By promoting balanced regional development, it encourages SMEs to locate outside Budapest and so favours wider linkages and decentralised economic activity.

reduction of fixed-cost elements in infrastructure investments may represent important considerations. In this context, for example, radio and cellular technologies may have some advantages over traditional landline systems for telecommunications.

Despite widespread price liberalisation in most transition economies, prices remain highly regulated in key infrastructure sectors, including energy and critical infrastructure such as water, transport and telecommunications. Particularly damaging is the weak collection of payments from these sectors, which perpetuates soft budget constraints and undermines the market basis for interactions. Weak collection and price distortions slow the restructuring process and undermine rational investment decisions in all sectors. In addition, by reducing profitability, these problems discourage private investment (including privatisation) which could expand and upgrade production and distribution facilities in these critical sectors. Investments that rationalise pricing in these areas thus make a vital contribution to the development of a sound private sector. Examples of such investments are project-related covenants on pricing reform or technical assistance to establish or strengthen market-oriented regulatory institutions.

The linkages created by investment projects help to advance the transition process in an economy. Investment projects create demand for products of other firms which are used in the production process. These have been termed "backward linkages".² Higher demand may lead to the establishment of new firms that may not have existed in the absence of the investment project or programme. Investment may therefore act as a stimulus for the creation of a competitive domestic input supply sector. Of course, in a well-functioning market economy it is prices and costs that correctly signal domestic versus foreign sourcing and such sourcing has no special role in project appraisal.

² Where new input suppliers are successful in a competitive setting, their success may act as a signal for other firms to enter the sector thus expanding its size. These demonstration effects are discussed in Section 7.2.

But what is at issue here is the establishment of the market interactions that provide the vehicle for such price signalling.

The transition impact of backward linkages created by investment projects is closely related to the extent to which local inputs are utilised. If projects rely on foreign input supply sources, their direct transition impact can be diluted. However, such “leakage” needs to be weighed against potential benefits associated with learning and demonstration effects that can accrue from foreign links. Foreign investment and agencies responsible for diffusing new technology can be instrumental as they demand or provide the know-how for the production of new types of advanced inputs. International trade can also be critical in expanding the set of inputs available to domestic manufacturers. Foreign trade and investment also signal to domestic suppliers the potential market for inputs and thereby promote competitive entry. The key requirement is that there be an effective potential domestic supply.³ In short, leakages are not necessarily detrimental provided that the project is not “locked in” to foreign input sources, that learning and demonstration effects are substantial, and that the potential domestic supply response is not severely impeded by regulatory or other constraints.

Backward linkages forged by new investment may increase the variety of inputs available to producers. More diverse and advanced inputs in turn allow for the production of more complex goods at competitive costs through “forward linkages”.⁴ Forward linkages refer to the effects of supplying other enterprises with key inputs. These feedback effects can be crucial in stimulating increases in productivity and technical change at all stages of production and are thus central to the growth process. The Cokoládovny confectionery manufacturer in the Czech Republic is an example of an investment project that has generated many of these types of linkages (see Box 7.5).

The decentralisation of financial responsibility to enterprises through privatisation and restructuring can force them to form more competitive backward and forward linkages. In many countries of the region, mass privatisation has been used as a mechanism to promote industrial linkages that are consistent with market development, open competition and free entry. This task is central to advancing the transition process and will typically require investment finance for capital and technological upgrading as well as substantial technical assistance.

Box 7.6 provides the example of the Russian Mass Privatisation Programme. This shows that the shift to private ownership of enterprises does not by itself ensure that restructuring and market reorientation will take place. Apart from the former East Germany, most large-scale privatisation in the transition economies has occurred through vouchers and insider privatisation to workers or managers or both. There is considerable doubt as to whether either

Box 7.5

Privatisation of the Cokoládovny confectionery manufacturer, Czech Republic

The restructuring of the Czech confectionery manufacturer Cokoládovny provides an example of a successful privatisation that has created substantial backward and forward linkages. Multinational sponsors executed a countrywide industrial restructuring programme, and introduced Western-style management in all aspects of the business. Following the restructuring, which included operations, marketing, sales and cash management, the company was listed on the Prague Stock Exchange. The restructuring of this company increased competition in the local market, which in turn will encourage the formation of efficient linkages. New backward linkages, in particular to domestic SMEs providing inputs, have also been forged, leading to growth and competition in the input supply sector. Because of the limited availability of finance for SMEs, the company presently serves as a banker to its distributors. These forward linkages have contributed to the development of an increasingly competitive distribution network. The success of the company, through demonstration effects, has encouraged entry by foreign confectionery and biscuit manufacturers, which intensified competition in domestic markets. Cokoládovny's increasing export orientation has also led to quality upgrading of its product lines.

of these privatisation methods has delivered effective corporate governance of enterprises. Governance issues are discussed elsewhere in this report (see Chapter 8), but the concern here is with the implications for restructuring and the creation of market-based interactions, which are a key outcome of the privatisation process. Unless mass-privatisation measures are combined with financial measures to harden enterprise budget constraints and “unbundle” social services from the enterprise, incentives to reconfigure interactions may remain weak (see Box 7.6).⁵

The growth of the small and medium-sized enterprise (SME) sector can be an important force in the formation of competitive market interactions in the industrial sector. These firms, which are the main source of growth in the private sector in transition economies, compete directly with large state and privatised enterprises, act as alternative providers of inputs and absorb excess labour. They can play a major role in expanding both the number of transactions that are market-based and the competitiveness of market structures. They facilitate the transfer of the factors of production away from the inefficient, planning-oriented state sector and towards the emergent private sector (see Chapter 9).

The development of competitive bank-enterprise linkages is also of central importance to the formation of efficient linkages in the enterprise sector. Hardening the budget constraints of large state and privatised firms forces them to form more efficient linkages both backwards and forwards, since failure to do this will carry financial costs (including possible bankruptcy). Policies that weaken or sever inefficient linkages between state bank and large state or privatised enterprises are critical in this respect, as is

³ The experience of Japan and other East Asian countries in adapting foreign technical standards and designs, especially for complex and specialised inputs, is of particular relevance here.

⁴ See Rodríguez-Clare (1995).

⁵ See Earle and Estrin (1994), and Pistor, Frydman and Rapaczynski (1994).

Box 7.6**Mass Privatisation Programme, Russia**

The Mass Privatisation Programme (MPP), launched in mid-1992, is a central part of the economic reform programme in Russia aiming at a fast transition to a market economy. It was undertaken in part to set the foundation for a countrywide restructuring of the state-owned enterprise sector. As the first programme of its kind, the MPP was a pilot operation which influenced the policies towards privatisation in other economies in the region.

The programme's first purpose was to introduce clear property rights over enterprises and their assets in a short time. The breakdown of the command system had left many enterprises without clear directives from central authorities, so that establishing unambiguous ownership structures was perceived to be essential to prevent economic standstill. The lack of a regulatory framework for privatisation had led increasingly to the transfer of enterprise ownership from state to private hands through an uncontrolled process of "nomenklatura" privatisations.

Mass privatisation was seen as one way to create a system of linkages between enterprises which was based more closely on efficiency considerations than the structure inherited from the command economy. It aimed to implement a comprehensive change in ownership structure and to ensure the irreversibility of this process. The MPP was also driven by the need to harden links between state enterprises and the central bank as a means of countering the threat of hyperinflation.

The programme specified different privatisation procedures according to enterprise size. It stipulated that large-scale enterprises be transformed into joint-stock companies. Following corporatisation, shares in these enterprises were sold in three steps: closed subscription to employees, public voucher auctions and cash auctions. Each enterprise then had to specify the privatisation method according to three options provided by the programme and this choice had to be agreed by at least two-thirds of the work collective. In effect, this led to workers and managers obtaining majority ownership of enterprises in which they were employed (see Chapter 8).

The MPP was highly successful in achieving a rapid change in the ownership structure of the Russian economy. By September 1994, more than 80 per cent of the workforce of the industrial sector was employed in privatised enterprises. Russia has now more shareholders than any other country in the world. However, there may be a trade-off between speed of privatisation and the depth of restructuring (see Blanchard and Aghion (1995); McMillan (1995)). Insider ownership may have contributed to delaying both internal reorganisation and restructuring of production processes (see Chapter 8). There is also a danger that enterprises, after they have been privatised, inherit the monopoly position from the command economy and therefore may have little incentive to form efficient linkages. Work by Pistor, Frydman and Rapaczynski (1994), for example, shows that many privatised firms continue to receive subsidised state credits. These types of problems are likely to be more severe during early stages of transition, when restructuring is not yet supported by market pressures emanating from price and trade liberalisation and the competitive threat of new private enterprises.

illustrated by the example of Wielkopolski Bank Kredytowy (WBK) in Poland (see Box 7.7). Through privatisation and other means, state banks need to break or restructure relationships with non-performing enterprises and to widen access to viable enterprises in the emerging private sector.

The emphasis so far has been on the development of competitive market-based interactions in the industrial sector. Though this is the pressing issue in most of the countries of the region, agriculture still remains a significant source of employment and output. The collapse of collectively organised agriculture has often ended the provision of essential services such as distribution and processing in the sector, damaging productivity. Box 7.8 illustrates how investments in the Kyrgyz Agribusiness Company (KAC) are

designed to promote more efficient commercial interactions in the agricultural sector.

Fragmentation of various countries in the region has made it important to adopt a regional focus in assessing the transition impact of investment. Backward and forward linkages may be regional in scope. This is particularly true for projects that directly promote intraregional trade. Examples include export-oriented investment projects, trade facilitation activities (such as export finance and insurance) and projects involving direct market interactions between enterprises in different countries. There are other types of projects that strengthen interactions across national boundaries in less direct ways, including infrastructure projects (such as coordination of road and rail transport, or power pooling

Box 7.7**Wielkopolski Bank Kredytowy (WBK), Poland**

WBK was one of the nine state-owned regional commercial banks created out of the National Bank of Poland in February 1989. In April 1993 it became the first Polish commercial bank to be privatised. The EBRD purchase of newly issued shares provided essential support for the public offering and strengthened WBK's capital base, since no strategic Western investor could be attracted.

Initial restructuring efforts concentrated successfully on improving internal operations and cleaning up the balance sheet. A matching programme of technical assistance executed with the Allied Irish Banks provided quality

staff training and advisory services for all aspects of commercial banking. WBK has worked actively with its clients to improve the quality of its credit portfolio, and in the process hardened the budget constraints of its enterprise clients. It has also introduced new financial services to its commercial and retail customers. The development of sound operations led to another capital increase for WBK by the Allied Irish Banks, setting the stage for an expansion of the bank's balance sheet and further improvement in the services provided to its customers.

This project has thus supported privatisation and restructuring of a major bank, expanded finance to private enterprises, and encouraged more efficient commercial links between the bank and its enterprise clients. The transition

impact of this investment was magnified by the considerable demonstration effects it generated both within Poland and beyond. Its success encouraged the Polish government to proceed with the privatisation of the other eight regional commercial banks. Increased competition in the banking sector has stimulated the development and implementation of new types of financial instruments. Overall, the project has widened and strengthened the web of market interactions in the Polish economy between the banking and enterprise sectors.

Box 7.8

Kyrgyz Agribusiness Company

In the command era, Kyrgyzstan's agricultural sector was dominated by omnipresent kombinats controlling input supply, extension services, processing and distribution of agricultural products. Trade liberalisation, price reform and the abolition of subsidies led to the dismantling of the kombinat system and left a vacuum in distribution and processing services. The lack of means to sell harvested crops, together with the insufficient supply of funds for working capital, induced a liquidity squeeze among farmers which contributed to a fall in grain yields from a high of 3.5 tonnes per hectare in 1987 to 2 tonnes per hectare in the early 1990s. Lower grain production affected forward-linked industrial processing activities such as the milling, animal feed and livestock industries, and contributed to a worsening in the daily diet. It necessitated grain cultivation of areas with low yield potential and imports of grain, which reinforced the productivity drop and damaged the balance of trade. The crucial role of agriculture in Kyrgyzstan's economy (it accounts for 30-35 per cent of GDP) adds urgency to the need to re-establish input supply, distribution and processing facilities, and provision of working capital finance.

The EBRD, in collaboration with local banks and other foreign sponsors, supports with a loan the restructuring of the Kyrgyz Agribusiness Company (KAC). After successful completion of a pilot, the project will target 25-30 farms of about 50,000 hectares each. The reformed KAC is to offer two key services: crop production support (input supplies to grain farmers, farm equipment, contract harvesting and storage facilities), and a mechanism for final product processing, marketing and distribution. By providing finance for working capital, commercial distribution and food processing facilities, and adequate input supply, this project addresses directly the most pressing post-liberalisation bottlenecks in agriculture. The project will help Kyrgyzstan to exploit its comparative advantage in agriculture and achieve higher levels of productivity. Key transition impacts are transferring technology and management know-how, upgrading agricultural products through improved input applications and cultivation practices, and alleviating the trade imbalance. Furthermore, the creation of the necessary market infrastructure enables both backward-linked activities such as farming and forward-linked operations such as milling and animal husbandry to benefit from agricultural liberalisation.

in electricity supply) and support for domestic banks which finance enterprises involved in intraregional transactions.

7.2 Promoting learning and discovery

Learning and discovery associated with investment are of special importance in transition economies. As with the development of competitive market interactions, investment projects can contribute to these processes by promoting the creation of new market-oriented skills, production techniques and organisation, and institution-building. We may distinguish between learning by doing, where individuals learn by participating in a process, and learning by observing, where individuals extract information from

the content and success or failure of another project. We refer to the latter as *demonstration effects*. Projects with strong demonstration effects will play a key role in leading the transition.

Learning is critical in economies where participants are attempting to adapt to market conditions and to "discover" their competitive advantage. Markets represent new phenomena, and a large fraction of the population needs to learn the skills that allow them to operate effectively in these new environments. Market economies are oriented towards the customer in a way that command economies were not. Producers, distributors and retailers have to learn how to identify, generate and respond to demand. Particularly in the financial sector, the establishment of skills, trust and regulation must involve the combination of new working methods, organisation and other aspects of institutional development. This requires experience and takes time.⁶

It is often unclear to investors, managers and workers which production activities or jobs they should be involved in. Investment projects provide the opportunity for different production processes and organisational arrangements to be tested; their success or failure acts as a signal as to where to invest or enter. These demonstration effects lead to the replication of successful production processes and the expansion of profitable sectors. Learning and demonstration effects are of still greater importance in the transition economies than in established market economies.

Most of the countries of the region are characterised by high levels of literacy, numeracy and technical skills. The stock of human capital, however, is not directly compatible with the market approach or with new capital or technology (see Chapter 3).⁷ For most workers and managers learning on the job is the most important way of reskilling.⁸ For this type of learning to take place on a sustained basis workers and managers have to be constantly acquiring new skills that are compatible with market development. As is illustrated in Box 7.9, IFIs can support this process by, for example, upgrading management skills in medium-sized and large enterprises. Skill and technology acquisition in turn helps firms to produce advanced goods at competitive costs.⁹ The production of these advanced goods provides additional opportunities for workers and managers to learn new skills. This process of sustained learning underpins modern economic growth and has been a critical factor in high growth regions such as East Asia.¹⁰ If new skills and technology are not constantly introduced into the transition economies through investment or other means, then the potential of learning to influence growth will be small or negligible. These processes are likely to be particularly rapid in transition economies because the basic literacy, numeracy and technical skills are

⁶ Much of the transfer of these market-oriented skills will be to those operating, or intending to operate, outside the investment project and in this sense the transition impact extends well beyond the boundary of the project.

⁷ On the human capital side, the transition economies are at an advantage relative to the developing economies in the sense that the basic investments in literacy and numeracy have already been made. Thus with moderate amounts of reskilling the bulk of the working population should be in a position to participate in economic growth opportunities, whereas some developing economies may take several generations to reach this position. See also the discussion of social indicators in Chapter 2.

⁸ Expenditures on education also need to be maintained in order to maintain high levels of literacy and numeracy.

⁹ There are knowledge-based "set-up" costs in beginning new product lines.

¹⁰ See Young (1991) and Rodriguez-Clare (1995). Demonstration effects would magnify this process. Successful advanced production processes would be copied, thus increasing the aggregate amount of learning going on in the economy.

Box 7.9

The TurnAround Management (TAM) Programme

The lack of management skills needed to operate in a more market-oriented environment often represents a serious constraint to transition. This problem is particularly pressing for managers in medium-sized and large enterprises who are used to operating in the conditions of a command economy. However, the acquisition of such investment skills is complicated due to the general lack of expertise. Investment in the skill formation of managers by enterprises themselves may not pay off, as trained managers may move on to other jobs. Government programmes to encourage the improvement of managerial skills are rare. Furthermore, governmental agencies are often unaware of the problems faced by enterprises owing to barriers imposed by the existing regulatory environment.

The TurnAround Management (TAM) Programme, set up jointly by the EBRD, the European Union and the United Nations, and supported by the governments of the region, is designed to help develop these important skills. It focuses on senior managers in companies which, if appropriately restructured and managed, have a good chance to succeed in the new market environment. To gear the assistance directly to the needs of a particular enterprise, a TAM team is created. This consists of retired or semi-retired experienced senior managers of successful Western companies and a selected group of senior specialists, who advise on functional skills such as marketing or corporate planning. This team works as close personal advisers to a selected enterprise for a period of (normally) one year.

On the basis of the TAM teams' experience with enterprise management, the TAM programme also informs governments and agencies of the region of the need to develop a more competitive economic environment and set of infrastructure services which will attract new investment, facilitate economic growth and permit restructuring of enterprises into viable business units. This secondary objective recognises the central role for governments in ensuring a competitive marketplace.

present and there are the additional returns arising from learning about and applying market-oriented approaches.

On-the-job learning is more valuable when it occurs in enterprises that embody new competitive production processes.¹¹ Learning by participating in obsolete production processes has little value either within or outside a firm. Learning effects are therefore strongest when these involve market, organisational and production processes that are relatively new. These considerations underline the potential contribution of foreign direct investment which embodies new methods of work, a market approach and new technological processes, either in the production of inputs or final products. Export orientation in this context can also be valuable because it induces firms to learn about marketing, upgrading quality and cost-efficient production, all of which are essential to allow penetration in foreign markets. It has been one of the central lessons from the growth experience after the Second World War – both in western Europe and East Asia – that the potential for inducing growth through learning is greatest when product markets are heavily export-oriented.

Demonstration effects created by the success or failure of projects help profitable areas of activity to be identified. A central aspect of the transition process is the search for competitive advantage through experimentation, together with the dissemination of the results of this experimentation through demonstration effects. The strength of demonstration effects will be influenced by the competitiveness and stability of the market setting. For these effects to operate effectively, investment projects should not fail for reasons other than competitive disadvantage. Information imparted by the failure of projects will be of little value if potentially profitable investments are unsuccessful due to volatility in market conditions, excessive of unfair regulation or taxation, or the inability to enforce contracts. Enterprises that succeed because they have a monopolistic position in terms of access to credit or inputs are also of little value because their example cannot, or should not, be replicated. Reforms that stabilise prices, remove barriers to entry, rationalise the tax system and establish clear legal guidelines are therefore likely to strengthen demonstration effects by improving the quality of price and profitability signals. It is where conditions are competitive that success (or failure) constitutes a reliable signal of the competitive advantage (or disadvantage) of a given type of project or production process.¹²

Small and medium-sized enterprises stand out as attractive vehicles for testing new production processes. Their small size and low fixed costs facilitate experimentation. They are not hampered by the problems of restructuring obsolete capital or reducing excess employment which characterise the state sector. New entrants are likely to be trying out new production processes and thus can be a potent source of innovation. The type of production activity being demonstrated by SMEs is also usually readily replicable by domestic firms. However, as further discussed in Chapter 9, SMEs can encounter serious problems regarding regulation and licensing, credit access, market access, import and export controls, and taxation. This points to the importance both of assisting SMEs and deregulating the economic environment in which they function.

Replicating investments that embody new organisations, approaches and technology carries much more value than replicating old ideas or processes. Trade in the international market in ideas implies that the set of ideas over which experimentation is taking place is wider and richer than the domestic set. Successful exporting firms provide a powerful signal to other domestic producers about how to compete effectively (for example, how to organise production, maintain quality control and market final output), and about the potential profitability of export activity. Foreign investment and trade can act as a conduit for technology transfer and knowledge spillovers to countries in the region. These types of investment allow domestic firms to benefit from R&D investments and innovation in other parts of the world through replication and imitation.

¹¹ See Stiglitz (1994). Innovation, though important in some sectors of command economies (e.g. defence), was a fundamentally non-competitive process in the old regime and therefore even technologically advanced products are proving to be commercially unviable.

¹² On the other hand, the value of learning from a given new type of investment project will fall as the number of examples of this type of investment project increases with transition. However, the learning process itself remains important throughout transition and beyond.

In market economies, financial institutions have a central role in generating, sharing and disseminating information connected to the operation of the forces of supply and demand.¹³ There are many types of information at issue here, including prices, profits, risks, trading possibilities, market conditions and future economic developments. This leads to a focus on the development of a range of diverse financial institutions, including commercial banks, bond markets, equity markets and insurance markets.

The establishment of these new types of financial intermediaries is essential to allow people to learn the processes and skills that are integral to operating systems of market exchange. Successful introductions of both financial instruments and institutions can then be replicated. However, potential private investors may be discouraged by the inherent riskiness of these types of projects and by the non-appropriability of the returns.¹⁴ Involvement of IFIs in the development of financial markets in transition economies can help to overcome these problems. Box 7.10 shows how the use of an international bond issue by a formerly state-owned bank in Hungary had strong demonstration effects for other banks in the region.

There are complementarities between different aspects of learning in promoting economic growth throughout the region. Investment in reskilling and other forms of human capital formation enables workers to participate in advanced production activities. This increases the value of both on-the-job learning and demonstration effects, which in turn lead to organisational and technological upgrading and the production of even more advanced goods. These dynamic complementarities have been described as “virtuous cycles” and are believed to be behind the high growth rates observed in several East Asian economies.¹⁵ If learning effects are not promoted, for example, if inefficient, obsolete state (or privatised) enterprises dominate industry in the coming years, then a “vicious cycle” could develop. In this case, skills and accumulated human capital erode, leading to production of backward,¹⁶ non-competitive goods which offer little scope for learning, and an economy trapped in a state of limited transition and low growth.

7.3 Concluding remarks

We have argued that the transition impact of investment may be seen largely in terms of promoting competitive market-based interactions, and learning and discovery. Investment projects that influence the long-run structure of the economy through these effects can have profound impacts on transition and growth. These effects have the characteristic that their benefits extend beyond the returns accruing to the individual investment project or programme. Investment projects that create a competitive market environment also benefit many agents in the economy besides the original investor. There is thus likely to be underinvestment by private investors in such projects, suggesting a role for govern-

Box 7.10

Bond issue by the Hungarian Foreign Trade Bank

The Hungarian Foreign Trade Bank (HFTB) is one of the country's largest commercial banks. With the establishment of the two-tier banking system in Hungary, it became a full-service commercial bank in 1987. With its focus on international banking and trade finance, and with the cooperation of Western banks, it was well positioned to be the first east European bank to issue a medium-term Eurobond without the enhancement of a sovereign guarantee. The bond was issued in June 1993, with the EBRD as co-lead manager alongside Bayerische Landesbank, and subsequently listed on the Frankfurt and Munich Stock Exchanges.

The bond issue was instrumental in improving the maturity structure of HFTB's liabilities and contributed to its eventual privatisation by establishing its commercial viability. The bond issue also had significant benefits for the economy as a whole. There were clear demonstration effects both in introducing Hungarian and other non-sovereign borrowers to international bond markets and in expanding a new line of business for commercial banks (term lending). This increased their ability to channel financing to east European enterprises on a commercial basis. Proceeds from the issue were also used to finance medium-term lending, which benefited SMEs. If lending to smaller non-state enterprises on a medium-term basis proves successful, then it is also likely to be replicated with attendant strong linkage effects. Lastly, given the specialisation of HFTB in intermediating international trade, its strengthening is a contribution to resolving trade problems in the region.

ments, development agencies and IFIs in the promotion of these types of investment. These financing institutions can also facilitate private sector activity by relaxing the overall credit and infrastructure constraints in a given economy. Involvement is particularly relevant during the early stages of transition when markets are underdeveloped or absent altogether.

It is therefore important to develop an analytic framework for thinking about the transition impact of investment projects, particularly for the EBRD, which has as its mandate to promote the transition and which is focused on project finance as its instrument.¹⁷ The broad structure of such a framework has been presented in this chapter. We argued in Sections 7.1 and 7.2 that the promotion of competitive market-based transactions and of learning and discovery were two important dimensions for any analysis of the transition impact of investment. These different dimensions were illustrated using various government and IFI investment projects.

The analysis suggests that governments and IFIs should tailor their roles, including investment projects, according to the stage of transition and the institutional environment of a country. To conclude, in Box 7.11, we present some early efforts by the EBRD to develop a practical framework designed to assess the transition impact of investment projects.

¹³ See Stiglitz (1994).

¹⁴ Private investors do not value demonstration effects because they carry no private benefits, and indeed may have an incentive not to invest in projects with strong demonstration effects as these signals tend to encourage direct competition and the erosion of market power.

¹⁵ See Lucas (1993).

¹⁶ Note that production of technologically advanced goods that are non-competitive (e.g. obsolete military technology) would also lead to small learning and low growth effects.

¹⁷ To ensure effective project lending, it is necessary to assess the transition impact of investment operations both through *ex ante* appraisal as well as *ex post* evaluation. The Project Evaluation Department at the EBRD currently carries out economic performance assessments, including transition impact, of all fully disbursed investment and technical cooperation operations.

Box 7.11

Indicators of transition impact of investment

The objective is to develop a set of indicators identifying key dimensions of the transition impact of investment. We recognise that transition impact is only one component of project appraisal – it should be seen as complementary to conventional cost-benefit analysis, credit appraisal and other relevant criteria. In order to become an effective operational tool for analysis of transition impact of investment the indicators should meet certain requirements. First, the criteria encapsulated in the set of indicators should be fairly comprehensive in encompassing the key dimensions of the transition impact of investment. Second, the indicators should be clearly defined in order to minimise overlap in interpretation and avoid double counting of different dimensions of transition impact. It is also important that transition indicators do not overlap with cost-benefit project appraisal criteria. Third, it should be possible to score investments on dimensions of transition impact within a reasonable time frame and on the basis of readily available project-level information.

The discussion in this chapter of transition impact makes it clear that it is complex and multi-dimensional. Theoretical and empirical difficulties imply that it is not possible to provide precise, plausible quantification of the *impact* of external effects on transition. Instead, qualitative proxies of likely transition impact are developed by identifying channels (dimensions) through which these mechanisms operate. For each investment the strength of each of these channels is examined to give a picture of likely transition impact. Table 7.1 presents a list of indicators for transition impact of investment projects. They represent a first step towards assessing the transition impact of investment projects in operational terms at the EBRD. In line with the organisation of this chapter, these indicators have been grouped into two broad categories: interactions and the competitive environment, and learning and discovery. These distinctions should not be exaggerated, however, since many indicators contain elements from more than one category. The multi-dimensionality of transition impact raises the issue of whether and how to aggregate evaluations across different dimensions. From an analytic perspective, this would require specification of a weighting function which embodies a judgement about the relative importance of different dimensions of transition impact. This is a difficult problem, both because of our incomplete understanding of the dynamics of transition and because the implicit weights would presumably depend both on country-specific conditions and the stage of transition.

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Table 7.1

Transition indicators for project appraisal

Competitive interactions and the competitive environment

- 1 To what extent does the project utilise local suppliers/domestic inputs? (backward linkages, e.g. commodity and services)
- 2 To what extent are such inputs supplied at non-distorted prices? (backward linkages)
- 3 To what extent does the project utilise downstream marketing and/or processing activities? (forward linkages)
- 4 To what extent does the project directly contribute to the formation and expansion of SMEs?
- 5 To what extent does the project contribute directly to the private sector provision of facilities or services?
- 6 To what extent does the project contribute to the development of more rational infrastructure pricing, effective collection and/or effective regulation in the sector?
- 7 To what extent does the project directly improve the competitive environment and/or reduce market distortions in the sector?
- 8 To what extent does the project involve privatisation or other means of improving effective corporate governance of enterprises in ways that increase market orientation?

Learning and discovery

- 9 To what extent does the project create or transfer skills relevant to a market economy? (e.g. management, marketing, financial and banking skills, specialised technical skills, etc.)
- 10 To what extent does the project directly support export-oriented activity, including trade facilitation such as export finance and insurance?
- 11 To what extent does the project contribute to the development of new financial instruments by local financial institutions?
- 12 To what extent does the project directly enhance financial intermediation by creating new types of intermediary? (e.g. insurance company, stock market, venture capital company, etc.)
- 13 To what extent does the project create a new and easily replicable line of activity? (demonstration effects, e.g. in manufacturing or finance)

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