INSTITUTIONAL REFORM FOR
INVESTMENT AND GROWTH
IN SOUTH EASTERN EUROPE

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OVERVIEW

I. Introduction

A successful transition process and the restoration and consolidation of peace and stability in South Eastern Europe (SEE) hinges upon well-working market institutions that engender investment and growth by facilitating business transactions, enhancing job creation and poverty reduction, and integrating the region’s domestic markets with the world economy. Throughout much of the mid-1990s low levels of domestic and foreign investment have constrained economic development in SEE and during this period abundant evidence emerged—from anecdotal sources to more systematic diagnostic studies and surveys—that the cost of doing business in the SEE appeared to be excessively high and was discouraging private investment. The countries of South Eastern Europe and their development partners recognized explicitly the importance of improving the investment framework in the region. All beneficiary members of the Stability Pact have undertaken to implement the Investment Compact, which includes important legislative and administrative commitments supported by numerous donors.

Improvement of the investment framework in SEE is not only important, but also urgent. The European Union (EU) has greatly expanded trade access to the Single European market not only for the accession countries (Bulgaria and Romania), but also for the Western Balkans and Moldova. Simultaneously, intra-regional trade liberalization has found new momentum as the eight SEE countries (SEE8)—Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Serbia and Montenegro and Romania, which are the focus of this study—signed the Memorandum of Understanding on Trade Liberalization and Facilitation. Seizing the opportunities created by these developments will be possible only if investment increases substantially.

At the same time, high unemployment and insufficient job creation throughout the region are closely associated with high and stubborn poverty. This endangers social stability and could undermine the prospects for SEE growth.

This study analyses the institutional impediments to investment and growth in SEE and suggests "second generation" policy reforms to ease these constraints. Chapter 1 reviews the recent trends in the economies of the eight countries that comprise the region (SEE8) and their prospects for international and intra-regional integration. It conveys the message that a favorable institutional framework for domestic and foreign investment is essential to achieve sustainable growth in SEE. The chapter presents the scope, methodology, and the approach the study undertakes for assessing the role of key market institutions in SEE business development. The analysis utilizes not only traditional, official data from the eight countries to assess the characteristics, trends and relationships between these institutions, but also employs data from a set of 40 original enterprise-level business case studies carried out in each of the eight countries and the two rounds of the Business Environment and Enterprise Performance Survey (BEEPS) conducted in 1999 and 2002.

The study focuses on four institutions that relate fundamentally to the efficient operation of market incentives in an economy: (i) inter-enterprise competition and economic barriers to entry/exit, (ii) access to (regulated) utilities and infrastructure services, (iii) corporate governance,
financial transparency and access to finance, and (iv) commercial dispute resolution. The methodological tools employed in the analysis investigate these institutions systematically across the eight SEE countries to allow for cross-country and cross-sectoral comparisons, and to develop a regional as well as a country-specific perspective on corresponding policy challenges.

To assess the progress of structural reforms carried out and highlight the remaining policy challenges, Chapter 2 presents an overview assessment of each of the four core issues of this study. It reviews in the aggregate the business environment in the eight countries, based on BEEPS1&2 and the EBRD transition indicators. The data suggest a general improvement in the business environment in 2002 in comparison to 1999 according to local businesses, although progress with reforms across the SEE8 has varied. Government policies seem to have appropriately targeted to resolve some of the underlying institutional problems in each of the countries, but major institutional challenges remain. To this end, the chapter presents a more disaggregated analysis of the institutional impediments, and documents the progress of reform to date.

Chapter 2 concludes that in general despite the progress already achieved, reform efforts come up short in two important dimensions: (i) the development of key market institutions has been partial and slow, and (ii) effective implementation and enforcement of institutional reforms already undertaken are weak.

The main messages of Chapter 2 highlight the deficiencies in the development of the four market institutions that are explored in the subsequent chapters. First, most countries have adopted policies directed to remove administrative barriers, such as streamlining business licensing and registration procedures. In many of them, however, failure to operationalize the improved registration or licensing requirements in a predictable manner, and inconsistent interpretation of laws and regulations, leads to discrimination between different types of investors, and thus, deficiencies and corruption. More importantly, few of the countries have strengthened the fundamental market institutions that protect firms from anti-competitive structures and conduct: although some of the countries have sound competition laws, there is almost universal neglect of the use of these instruments to reduce economic barriers to entry. On the exit side, the restructuring or liquidation of large loss-making enterprises has not been facilitated sufficiently, in part because key legislation has not been implemented.

Second, countries are in the process of overcoming the severe infrastructure bottlenecks caused by conflict and inadequate maintenance that have characterized the region—although to a different extent depending on country and sector context. The development of predictable and transparent regulatory frameworks that would ensure users’ access to competitively priced, high quality services and engender investment in the utility sectors—and in general in infrastructure—is however lagging in all countries. Indeed, the inefficient pricing and cross-subsidies embedded in many of these sectors stifle incentives for attracting investors and privatizing utilities.

Third, the governments of SEE8 have shifted away from insider techniques of state ownership divestiture and increasingly have relied on more transparent methods of privatization. However, although some countries have adopted international accounting standards and introduced independent financial audits for enterprises, most are still in the process of doing so. In addition, adoption of these instruments needs to be supplemented with training of managers who can properly interpret and use the improved financial information to engender improved enterprise performance. At the same time, in most countries enforcement of commercial legislation is still ineffective in protecting minority shareholders and in imposing the needed
discipline of financial disclosure and transactional transparency. As a result, there are weak checks and balances on managerial performance.

Fourth, the legal frameworks help ensure the protection of property rights and the enforcement of contracts in all countries. But the functioning of the associated institutions is limited by lengthy procedures, lack of qualified and independent judges, and weak enforcement mechanisms. Alternative out-of-court administrative channels for dispute resolution—such as the use of arbitration—are underdeveloped in all eight SEE countries. In addition, inefficient land and property right registration systems present another source of disputes and barriers to investment in most of SEE.

The remaining sections of this Overview present a summary of the main findings of each of the four core chapters of the study: competition, regulated infrastructure utilities, corporate governance and finance, and commercial dispute resolution.

II. Competition

The thesis of Chapter 3 is that along with the other key institutional reforms addressed in this study, a more competitive business environment will help capitalize on the economic reform progress made to date in the region that has promoted consolidation of peace and stability. The chapter investigates the incentives and constraints on competition in the eight SEE countries and recommends policies for reform, focusing on the fundamental determinants of competition. Deeper economic diagnosis of how basic market institutions affect inter-enterprise competition in SEE is essential for the design of enduring policy reforms.

The chapter assesses the structural conditions for competition in SEE along two dimensions -- horizontal and vertical, and argues that after a decade of privatization attempts and the establishment of new private firms, the changes in SEE enterprise ownership may not be sufficient to generally induce competitively structured markets and the competitive conduct of business operations. Weak incentives in the SEE countries’ market institutions and policy frameworks have produced little restructuring of large SOEs and engendered insufficient restructuring of privatized firms by allowing firms with dominant sectoral positions to operate unchecked by a competitive market structure. SEE firms that achieve sufficient dominance in a market, as a result of facing relatively few competitors and attaining appreciable market share, should (all other things equal) have greater discretion over the setting of prices. Using the BEEPS survey data the analysis suggests that there is a statistically significant negative relationship between a firm’s market share and (i) the extent to which the firm is de novo private (relative to being a privatized or still a state-owned business), (ii) the firm’s indicated number of competitors, and (iii) whether the firm is in the services (versus the manufacturing) sector. There is a statistically significant positive relationship between market share and (i) firm size, (ii) extent of vertical integration, (iii) horizontal integration, (iv) subsidies received as a percent of sales, and (v) technological prowess, as measured by spending on R&D as a percentage of sales. Also, an inverse relationship exists between size of market share and the degree to which an SEE firm’s conduct in the face of a (hypothetical) 10 percent increase in market prices would result in a loss of sales.
The findings of the chapter indicate that the degree of vertical upstream and downstream integration by SEE firms varies significantly across sectors, ownership, and countries. In terms of downstream integration, the BEEPS data show that for the SEE region, on average about 11 percent of firms’ output “transactions” are conducted internally or made to related parties. This is generally a much lower level of vertical integration than the case studies indicate for upstream integration. About two-thirds of the surveyed SEE8 firms indicate that they have at least 4 suppliers for their “main material inputs.” Based on the BEEPS data and the enterprise-level case studies the chapter finds that there is a clear pattern that proportionately more de novo firms than privatized or state owned firms buy their inputs in markets populated with more suppliers, suggesting that new businesses are most able to benefit from upstream competition. Overall, the evidence suggests that while privatized/private firms “shop around” for distributors/customers more than SOEs, the converse is the case for input purchases.

In assessing the extent of entry and exit barriers to private sector development in SEE the analysis distinguishes between different types of barriers: those that are (i) economic in nature, principally determined by technology, and those that are (ii) institutionally-determined, policy-driven or administratively-induced. The need for policy intervention to deal with economic barriers generally arises when such barriers are chronically high and in markets where there is already significant horizontal or vertical dominance, and is best determined on a case-by-case basis. Evidence from the business case studies and the BEEPS survey data suggests that generic economic policy uncertainty—understood to be unanticipated or unilateral “changes in the rules of the game”—and macroeconomic instability are seen as the most pernicious obstacles to new business formation in SEE, suggesting that governments in fact can proactively carry out policy reforms to reduce barriers to entry in the region. The other perceived key entry barriers are: high tax rates; substantial cost of credit; corruption; and anticompetitive practices of other businesses. Interestingly, the data give less support to what has become the conventional wisdom that “administrative barriers” are the major impediments to business development in transition economies: for example, access to land, titling or leasing of land, business licensing and permits, and tax administration are not perceived by SEE businesses as major impediments.

To make economic space for new entrants and to re-channel productive assets bottled up in inefficient firms to new ventures where employment can be expanded and new products created, exit barriers need to be low. This calls for “hard budget constraints” to engender improved corporate competitiveness from viable firms, and to expose firms that are no longer commercially viable. The case studies suggest that in many of the SEE economies, budget constraints are “soft” and barriers to exit are in some cases appreciable. The BEEPS survey data show that for the region, 11 percent of the firms closed at least one plant since 1998; this is a rather low share by international standards, especially when taking into account that many firms in SEE are not commercially viable. On a net basis, about 9 percent of the firms indicated opening at least one plant. The infrastructure sector had the largest percentage of firms reporting plant closures, and very little net new plant openings. SOEs reported both the greatest proportion of gross plant closures and closures on a net basis. De novo firms had the smallest proportion indicating plant closures, and on a net basis indicated the largest share of plant openings. The average SEE firm indicated it received subsidies from national government entities amounting to 9.5 percent of sales revenues, and received subsidies from regional and local governments amounting to 17.7 percent of sales revenues. SOEs receive the greatest amount of subsidies as a proportion of sales revenues, followed by privatized firms and then by de novo private firms (except for FYR Macedonia and Moldova, where privatized firms receive the largest share of subsidies as a percentage of sales revenues). The largest recipients of subsidies are firms in the services and infrastructure sectors; firms in the trade, mining, and hotel/restaurant sectors are the
The smallest recipients of subsidies. With regard to tax forbearance, the SEE average level of tax arrears is 12 percent of sales revenues, not an insignificant amount.

The chapter also examines the relationship between competition, firm growth, and performance of SEE8 businesses. Changes in sales revenues, exports, employment, investment in fixed assets and profit margins serve as measures of business performance of surveyed SEE firms over the period 1995-1998 and 1998-2001. The analysis indicates that in recent years, there has been considerably less cross-country uniformity in all firm-level performance dimensions except profit margins. Employment growth jumped in Moldova and Albania, while firms in Romania, Albania, and Croatia exhibited sizeable spurts in sales revenues. Albania and Croatia also experienced above-average growth in investment in fixed assets. Compared with 1995-1998, export growth diminished significantly in 1998-2001. On a sectoral basis, in 1995-1998 growth in investment in fixed assets was particularly high in the services, transport, and manufacturing sectors. These generally are the sectors that in the later period firms indicated high growth rates of employment. While firms in the services sectors and to a lesser extent power generation, registered significantly higher profit margins than those in other sectors in 1998, there was more uniformity in profit margins across sectors in 2001. The examination of performance across ownership types yields a striking variance: de novo private firms outperformed privatized and state owned enterprises in all of the aforementioned five dimensions in 1995-1998. In 1998-2001, again, de novo private firms generally outperformed the two other ownership types. But the gap in employment growth rates between these firms and privatized and state-owned firms considerably widened, while performance differences between privatized firms and SOEs narrowed considerably along all dimensions.

Examination of data on the dispersion of firm profitability in 2001 shows that the greatest portion of loss-makers is concentrated in Bosnia and Herzegovina (11 percent), Bulgaria (8 percent), and Croatia (4 percent). Moreover, a substantial share of surveyed firms in all countries (except for Romania and Albania) indicated zero profits. Together with the number of firms who reported losses, this shows that business conditions can be tough for some SEE businesses. Most of the surveyed firms indicated a profit to sales ratio in the 1 to 10 percent range. Across countries, the distribution of firms with profitability rates above 10 percent varies significantly. Across most sectors, there is more uniformity in the distribution of firm profitability (except for the mining and hotel/restaurant sectors). Across ownership types, loss-makers and those earning zero profits are most heavily represented in the SOE category. Privatized firms have the next largest proportion of firms in those two categories.

Multivariate regressions are run on the approximately 1600 surveyed SEE firms and the results suggest that higher firm profitability is associated with increased market share, greater vertical integration, receipt of a lower level of subsidies, an absence of state ownership (either contemporaneously or in the past), and more intensive R&D spending (a measure of a barrier to entry). These findings are consistent with analyses of the determinants of business performance in other regions of the world that show that profit differentials are likely driven by the structural competitiveness of markets. The econometric results also indicate that there are country-specific factors that explain the variance in firm profitability across the SEE region.

The chapter concludes with concrete policy recommendations which call for a proactive policy approach—both (i) economy-wide institutional and structural reforms, as well as (ii) better formulation and implementation of competition policy reforms. Such a two-pronged approach is needed in SEE to both facilitate the entry of new businesses and foster the horizontal and vertical restructuring of dominant anti-competitive incumbent firms. Among the specific policy recommendations, the chapter outlines the following:
- Make structurally dominant markets contestable for new entrants. Priority attention and resources should be directed at preventing further horizontal and vertical consolidation through mergers and acquisitions in markets where concentration and structural dominance are already excessive. Explicit, well defined, and transparent-to-the-public merger guidelines should be developed that establish general policy parameters for distinguishing between pro-competitive and anti-competitive mergers.
- Foster proactive competitive restructuring or exit of value-subtracting incumbents through facilitating reorganization and bankruptcy, including where necessary, liquidation, of insolvent firms.
- The SEE8 governments should review the missions of their current competition policy agencies, with a view towards strengthening their rules-based incentive structures and improving their implementation and enforcement capacities.
- Promote market-oriented policies for SME development such as non-governmental support programs (sponsored by commercial banks or international donors) that include (i) providing equity participation in venture capital and investment funds; (ii) funding of local banks providing commercial based credit to SMEs; and (iii) co-financing with local banks of SME projects.
- Establish independent monitoring systems as a check on reform implementation to oversee success, based on widely publicized and anonymous feedback channels for enterprises to report violations.
- Enhance “behind the border” competition to facilitate SEE international trade and foreign direct investment, and continue to bring policy regimes governing FDI in line with international best practice: (i) national treatment for foreign investors; (ii) binding international arbitration for investor-State disputes; (iii) substantial reduction in restricted sectors and limitations on FDI in other sectors; (iv) freedom for profit remittances; (v) expropriation only for a bona fide public purpose and with prompt, adequate compensation; and (vi) an absence of trade-related-investment-measures (TRIMs).
- Establish mechanisms that give individual countries incentives to compete for reform progress in the SEE region. To jump-start such reform competition among SEE countries, governments could play an important role in proposing appropriate metrics to assess progress in reform together with a simple survey methodology.
- Enhance public education efforts to foster a “culture of competition” in SEE by undertaking initiatives aimed at ensuring that consumers at large, as well as all enterprises, especially start-ups, are aware of the importance of the competitive process in practice, and the objectives and content of competition law.

### III. Access to Regulated Infrastructure Utilities

Demonopolization and privatization of the existing infrastructure networks and the introduction of competitive forces where “natural” monopoly conditions no longer exist are pertinent to create the appropriate incentives for innovation both by service providers and business users. The appropriateness of the regulatory rules themselves can matter enormously, removing one significant obstacle to the development and expansion of business, as well as to regional trade and integration. Infrastructure-related barriers are particularly relevant for SEE countries that are in the process of overcoming the severe telecom, transport, and other bottlenecks caused by conflict and the inadequate maintenance of these services that has long characterized the region. The development of predictable and transparent regulatory frameworks
would ensure users’ access to competitively priced high-quality services and would engender investment in the infrastructure sectors.

Based on the BEEPS data and the business case studies, Chapter 4 presents an assessment of the access to, and quality of infrastructure services in SEE8. With the notable exception of FYR Macedonia, where progress appears to be limited, all other countries report a major improvement in infrastructure services. The analysis disaggregates the perceptions of enterprises across each of the infrastructure sectors and presents cross-country and cross-sectoral variations. For the SEE region, the power sector is perceived as the most severe barrier to entry and expansion of “real sector” enterprises, followed by transport and telecommunication. This finding is driven largely by the fact that businesses in Albania (together with those in Bulgaria and Romania) perceive access to electricity as a severe obstacle for entry and expansion. For most other countries -- Bosnia and Herzegovina, Croatia, FYR Macedonia, and Moldova -- transportation is considered as the most relevant infrastructure related barrier to entry, since in most of these countries the road network has been disrupted by war, together with severe under-investment. For Serbia and Montenegro, telecommunication represents the greatest barrier to entry and expansion (likely related to the highly politicized privatization of the Serbian telecom operator under the Milosevic era).

Access to infrastructure is also a source of exit barriers. There is strong evidence that privatized and state-owned enterprises are by far the greatest beneficiaries of soft budget constraints through non-payment of utility services, confirming the presence of an uneven playing field tilted against the private sector. Indeed, respectively 13 percent and 20 percent of privatized and state-owned enterprises are not paying infrastructure providers on time, compared to only 5 percent of de novo enterprises. The uneven playing field across different ownership categories emerges strongly from the case studies and official data as well. Among the utilities, arrears are the most recurrent problems that affect the energy sector. Energy cash collection (in terms of percentage of total collections) averages only 67.5 percent and commercial losses (defined as non-billed consumption) are at 20 percent. Cash collection is particularly low for industrial consumers and consequently incentives for industrial restructuring are blunted.

At the same time, the quality of infrastructure service is poor. Across the SEE8, power outages stand out as the major problem area, with outages totaling over 11 days per year, followed by water (9 days) and telecom (5 days). Telecom services are characterized by higher waiting times, but they are on average more reliable. The opposite holds for electricity.

The chapter addresses these challenges in access and quality of infrastructure services by exploring the relevance of broader regulatory reforms, including greater private sector involvement and enhanced independence of rule-making. There are powerful reasons for accelerating private sector involvement -- especially through foreign investment -- with such low payments discipline in SEE. A private firm owned or managed by a foreign strategic investor will have strong incentives to enforce payments discipline. It will also have the technical knowledge and finance required for essential re-metering programs, computerization of billing and other measures that can help improve payments performance. Experience to date suggests that in cases where the private sector has entered power distribution, payments collection has gone up. Yet the chapter cautions that to be successful in enhancing efficiency, privatization requires a number of complementary institutional changes, including restructuring to create scope for competition and/or to enhance the commercial viability of the privatized utility.

In turn, the regulatory regime that is adopted for privatized network utilities is likely to encompass several dimensions. The establishment of an independent regulator is a key challenge
vital for the settling of market disputes and dealing with policy and other regulatory issues. Two main decisions for a newly established agency are the development of pricing rules and the choice of appropriate rate regulation. In the SEE8 countries where an independent regulator in the electricity sector has been established waiting times of 7 days are about ¼ of the waiting times for countries with no independent regulator. A similar pattern characterizes the telecom sector, where countries with an independent regulator have very low waiting times (lower than 2 days) versus more than 7 days in other countries. But even with an independent regulator the difficult challenge facing the national government is to endow it with technically competent people and give them the authority and budget needed to implement its mandate effectively.

Chapter 4 also analyzes the role of infrastructure development in fostering investment in the real sector and regional integration by exploring the linkages between the provision of infrastructure services at more competitive terms and the greater competitiveness of the real sector. The provision of better infrastructure services could offer tremendous opportunities to reduce costs and/or to increase revenues in the real sector. Downstream innovation has been severely constrained by inadequate infrastructure at the upstream level (as a result of inappropriate regulation). The analysis focuses on two infrastructure sectors (telecommunication and transport) and examines the linkages with intensive infrastructure users (software companies and export/import oriented enterprises, respectively). The choice of these sectors is motivated by the crucial role of telecommunication and transport as facilitators for local, inter-regional and international trade. An adequate transport infrastructure is almost always key for developing regional trade. But this is particularly true for the SEE-8 region, where all countries (except Romania) are small in size and some of them are landlocked. The police and customs agencies are often mentioned as main constraints to enterprise growth and expansion both through their unpredictable application of rules and corruption.

The chapter concludes with policy recommendations for the infrastructure utilities sector:

- Establish an appropriate sequencing of infrastructure reforms by setting in place sound regulatory frameworks before privatizing utilities.
- Promote further private sector involvement, including steps towards commercialization, restructuring and ultimately privatization of key utility sectors. Wherever possible, involve strategic investors in order to maximize privatization revenues, to secure finance for necessary investments and to strengthen incentives for improved efficiency.
- Establish an independent, transparent and publicly accountable regulatory oversight process and institutions. This includes strengthening the independence of the newly created sectoral regulatory agencies (also financially, to ensure that they have the necessary resources to operate). At the same time independence needs to be balanced against accountability and requirements for monitoring and assessment of regulatory impact.
- Strengthen and ensure appropriate coordination of regulatory institutions. With the creation of independent sector regulatory agencies, competition authorities would no longer be responsible for tariff-setting processes and supervision, leaving technical and pricing regulation to specialized agencies. On the other hand, competition authorities could play a more forceful role in the determination of the appropriate scope of regulatory authority, of the appropriate market structure, and on controlling anti-competitive conduct by dominant enterprises.
- Create a more competitive environment for delivery of infrastructure services by establishing fair, transparent and non-discriminatory terms of access to regulated utilities.
- Develop alternative institutional frameworks for improving performance of infrastructure services, including regional and/or cross-sectoral approaches to regulation.
IV. Corporate Governance, Financial Transparency, and Access to Finance

The private ownership of productive assets that characterizes systems in the West relies on an institutional foundation non-existent in the immediate post-communist systems. In particular, capitalist systems provide for legal protections that allow the pooling of capital with controlled risk for investors and a potentially important new source of financing for the productive entity. Investor confidence requires corporate transparency and accountability. In this vein, Chapter 5 focuses on the themes of corporate governance, financial transparency, and access to finance in SEE8 in the context of the detailed business case studies and the BEEPS 2 data.

The chapter investigates how the institutions of financial transparency affect investment and growth at the firm level. Using econometric techniques, the analysis of the BEEPS data suggests that both the adoption of international accounting standards (IAS) and external auditing are associated with a higher firm-level investment. Moreover, it is apparent that most of the significant relationship between investment and financial transparency is due to the average relationship across countries. This finding is consistent with the idea that financial transparency has an important external effect—when firms are generally more transparent, the atmosphere of trust that is so essential for arms-length investing is strengthened, and all firms benefit. In addition, regardless of cross-country differences, ease of access to finance is important for explaining investment intensity across firms. Investment intensity among SEE8 firms appears to be conditioned by the number of competitors and firm size: according to the regression results, firms with more competition and larger firms invest less.

To understand the driving forces behind these results, the chapter looks at the various forms of ownership of firms, the degree of transparency and accountability, and firms’ access to financing for transactional and operational purposes. The BEEPS2 sample exhibits variation in forms of ownership. Croatia and Romania have very few firms describing themselves as sole proprietorships, but large numbers that call themselves corporations. Bosnia and Herzegovina and Bulgaria stand out for the large numbers of firms that said their shares were listed on the stock exchanges. Larger firms are, predictably, more likely to report a corporate form of organization and listing on stock exchanges. Overall for the region, most of the surveyed firms are completely owned by either the state, or by domestic or foreign owners exclusively. Mixed ownership, for example, joint ventures, are less common. Among larger firms, however, mixed ownership is much more prevalent. The chapter cautions that the continuation of State involvement in partially privatized firms does not come without costs. Managers may continue to feel pressured to deliver on the programs of politicians, rather than deliver profits to shareholders.

The degree of transparency and accountability evident in the way the firms present their financial statements is also examined. Among medium and large sized firms (firms with at least 50 full-time employees) that took part in BEEPS1&2, the use of IAS is highest in Croatia and Moldova, both of which also reported the most widespread use of IAS in the 1999 survey. For both of these countries, it appears from the survey that data, IAS has become the norm, used by some 90 percent of firms. At the lower end of the scale are FYR Macedonia, Romania, and Serbia and Montenegro, with less than half of the medium and large firms reporting the use of IAS. The low levels of compliance are in part explained by simple adherence to rules placed on firms by authorities. Within the SEE8 there has been little change in the prevalence of IAS between the 1999 survey and the 2002 survey, with the exception of Bulgaria which showed a marked increase.
The BEEPS data suggest that larger firms and foreign-owned firms are more likely than smaller firms and domestically-owned firms to use IAS and external audits. However, most of the variation in the observed use of IAS and external audits in the SEE8 arises from significant cross-country variation. Apparently, it is the push of external factors, such as requirements embodied in laws, that drives firms to adopt IAS rather than the inward-looking managerial incentives of an improved accounting framework. Ownership concentration is important for explaining the use of external audits in both FYR Macedonia and Moldova, and in both cases it is firms with smaller degrees of concentration that are more likely to use external audits, even after controlling for form of ownership. This finding is consistent with the use of external audits as a tool for diffuse ownership to check the performance of management.

Chapter 5 draws attention to the financial modalities used by firms for their sales and purchases, and the means by which they finance their activities. As a whole, the BEEPS data for the SEE8 countries suggest that firms in countries with less developed formal financial systems are less likely to transact in any manner other than spot exchange. Within the region, both prepaid and credit sales are both strongly negatively correlated with the EBRD indicator on Banking Reform and Interest Rate Liberalization. In addition, the BEEPS data show that the use of alternative means, such as barter, bills of exchange, and debt swaps, are common in most countries. Surveyed firms in the former Yugoslav republics were especially likely to indicate they transact by barter; the business case studies conducted present a similar story.

For working capital and investment purposes, firms throughout the region continue to use primarily their own retained earnings. Croatian and FYR Macedonian firms were significantly more likely to bring in new equity as a means of financing operations, and FYR Macedonian firms were also the most likely to make use of informal credit sources. Croatian firms were the most likely to use formal credit arrangements, consistent with the notion of the more developed level of banking in that country. Albania and Serbia and Montenegro demonstrated the highest levels of financing through retained earnings. The BEEPS data suggest also that the use of new equity for financing investment has increased in Bosnia and Herzegovina and FYR Macedonia, while informal credit has expanded in Bulgaria and Romania.

The chapter concludes with a set of recommendations:

- Stay the course on privatization and terminate the lingering involvement of the State in productive enterprises. Privatization methods that are open and transparent stand the best chance of shifting ownership to effective owners, and minimize the opportunities for corruption.
- Develop clear standards on conflicts of interest issues at the time when laws and regulations are being made. This can help avoid the damaging erosion of investor confidence that have been witnessed in developed markets.
- To ensure greater financial transparency and accountability, increase the vigilance of monitoring public disclosure of financial statements by firms that are required to do so. Accelerate accounting and auditing reforms to build the institutions necessary for the implementation of sound financial controls and enforce adherence to IAS and external audits.
- Enhance training and education programs that build the stock of professionals and highly qualified accountants to establish investor faith in firms’ financial documents.
- Exploit synergies between judicial and financial sector reforms to improve firms’ prospects for investment and growth. Remnants of barter are driven by concerns over payment, which in turn are largely a factor of the lack of confidence in the judicial system to defend claims in a fair, efficient and timely manner if payments are not made, as well as weaknesses in the
financial system. Similarly, the high cost and unpredictability of formal finance leads some firms to avoid the financial system altogether and use informal systems of finance.

V. Commercial Dispute Resolution

Firms necessarily undertake risks in dealing with new clients and suppliers, and face potential disputes with them. There is a spectrum of institutions that facilitate contractual compliance and enforcement. These include both formal and informal mechanisms of enforcement, such as social networks, business associations, and public information channels to decide on who to do business with and under what conditions. While contract enforcement can be mediated through a variety of means, including relationships based on trust, self-enforcement through repeat transactions, third-party enforcement based on reputation, private enforcement, administrative (governmental) intervention, and court enforcement (litigation), courts are the main institution enforcing contracts and resolving business disputes. Without efficient courts and the expectation that courts will uphold their contractual rights and obligations, firms will be less willing to deal with new clients and suppliers, and fewer transactions will take place.

Chapter 6 describes how SEE8 firms deal with commercial disputes. It finds that to avoid and resolve disputes, SEE firms follow several strategies. These include refusing to extend credit to existing or new customers, requiring pre-payment before releasing the objects of the contractual exchange, and using business associations, the government, political parties or private protection services. The BEEPS2 data reveal that SEE firms actually do employ bilateral mechanisms to avoid disputes such as pre-payment and non-use of credit, which significantly reduce the probability of running into payment disputes. Business association membership and donations to political parties, however, are not found to reduce the incidence of disputes, and in fact appear to be complementary to payment disputes and seeking their resolution in court. In fact, 84 percent of interviewed firms indicate that the business association to which they belong has provided no value at all, or at best negligible value to their resolving of disputes with the same third parties.

The survey data also show that firms avoid disputes by foregoing trade with third, unknown suppliers, even when such trade would be on more beneficial terms than existing suppliers could offer. Firms attempt to avoid disputes by forging long-lasting relationships with suppliers and customers, even if it implies a higher cost of doing business. This cost reflects lost opportunities to trade with alternative firms on better terms, and to facilitate the entry of new firms into the market.

In focusing on court enforcement of contracts, the analysis describes how formal, fast and costly the court enforcement of commercial debt contracts in each of the SEE countries is, especially in comparison with the other transition economies. On the ease of resolving contractual disputes in court, the number of procedural steps mandated by law or court regulations, the SEE8 countries show considerable differences. Serbia and Montenegro impose the most procedural steps (40), followed by Albania and Moldova (35), and Croatia the least (20) for resolving what is essentially the same case before a first-instance court in the country’s largest city. As per court efficiency, Serbia and Montenegro has the longest duration of the assumed case in a first-instance court (exceeding 1000 calendar days).
There are significant differences in the cost of court proceedings. Albania has the highest costs of legal procedure before the first-instance courts – at 1.5 times the claim amount. Clearly, if fees exceed the claim amount, firms will not take cases to court. Court procedures are also expensive in FYR Macedonia, Bosnia and Herzegovina, and Serbia and Montenegro, with total attorney and court enforcement fees ranging from over 40 to 80 percent of the claim value. The cheapest among the SEE8 jurisdictions are Bulgaria and Croatia, where total costs equal approximately 13 percent of the claim value.

Overall, the chapter emphasizes that firms tend to use the court system when it is less formal, less expensive, and faster in resolving disputes, and that those firms which regularly use the courts to enforce contracts, are the ones which perform better. But what types of firms do go to court to resolve their business disputes? Three findings emerge: (i) small firms use courts the least; (ii) state-owned firms file more cases, and have a higher proportion of payment disputes resolved in court in comparison to private firms; and (iii) new firms file significantly less cases with the courts and report a significantly lower proportion of payment disputes resolved by court proceedings than older firms do.

In addition, several key observations arise from assessing firms’ perceptions about the performance of the court system: (i) respondents seldom, or at best only sometimes, consider the judicial system of their jurisdiction as performing well; (ii) court delays are seen as a major symptom of court inefficiency; and (iii) despite their generally low assessments of the courts, firms tend to register somewhat higher scores when asked about their confidence in the legal system. The analysis suggest that although old firms have a more favorable perception about the speed of court justice than new firms do, the differences are not statistically significant. However, large firms tend to find the courts faster than small firms do, and similarly, state-owned firms also believe that the courts are faster than private firms do.

The chapter also focuses on judicial corruption. The results suggest that new firms, small firms, and private firms pay bribes to court officials and judges more frequently than old firms, large firms, and state-owned firms. Using regression techniques, it is found that higher frequency of bribe payments raises the costs of “judicial capture” to the firm. Furthermore, small and medium-sized firms have higher costs of judicial capture, and firm age also affects costs of capture positively and significantly. Interestingly, judicial formalism is found to significantly raise the frequency with which firms pay bribes to the courts, controlling for other factors. This finding lends support to the argument that higher procedural formalism and complexity creates opportunities for corruption.

There is significant cross-country variance in judicial complexity. Only FYR Macedonia makes the use of lawyers for legal representation mandatory in debt collection before a first-instance court, although in practice many plaintiffs in the other countries do hire lawyers in this case. Also, all SEE8 jurisdictions impose written requirements for the filing, service of process, judgment, and enforcement stages; just above a third require that defendant’s opposition be in written form; and a quarter insist that all evidence be in written form and that final arguments be submitted in a written form. This presents an additional hurdle for businesses, as they have to seek legal advice before filing a complaint.

The regulation of evidence is perhaps most responsible for causing delays in contract enforcement. While three-quarters of the SEE8 countries have statutory regulations on out-of-court statements and the recording of evidence, none have regulations on the admissibility of irrelevant evidence and require oral interrogation exclusively by the judge. In each of the eight SEE jurisdictions, enforcement is suspended if an appeal is filed and the suspension lasts until the
appeal is resolved. Furthermore, all jurisdictions allow for comprehensive review in appeal and almost all, apart from Croatia and Moldova, allow for appeal during trial. Thus, appeals can be filed by a debtor who wants to delay execution, even if no reasonable chance of a successful appeal outcome is expected.

The chapter concludes with concrete policy recommendations, outlined below:

- Establish information-sharing institutions: create enforcement mechanisms such as credit bureaus, the media, non-governmental organizations and intermediaries (like accountants and auditors). Such institutions perform important functions in ensuring that contracts are enforced and obligations between business partners met.
- Improve judicial statistics to successfully identify bottlenecks in court performance and signal to policymakers the direction of future reforms. Collecting judicial statistics is also seen as a necessary step in improving the court administration and case management systems, which are in need of modernization and reform across the SEE8 countries.
- Remove non-dispute cases from the courts and transfer non-contentious matters such as company or property registration to relevant administrative agencies to improve court efficiency and free resources.
- Make judicial processes less burdensome and simpler for the parties in order to improve the speed and transparency of litigation. This could involve moving away from written to oral procedures to avoid interruptions and delays; limiting the need for legal justification in straightforward commercial cases; changing procedural laws to allow for more discretion on the part of the judge in admitting evidence and making use of it to ease the judicial process; improving the enforceability of the first-instance judgment and limit the scope for appeals without due cause; and improving the system of court notifications of parties and witnesses to reduce the burden of procedural notifications.
- Establish specialized courts such as small claims courts and specialized commercial courts to reduce procedural complexity, speed disposition and reduce legal costs.
- Strengthen existing or introduce alternative dispute resolution mechanisms such as mediation and commercial arbitration, especially in overburdened courts with significant case backlogs.
- Increase court resources to enhance training of judges and judicial support staff; improve the poor state of judicial buildings and office equipment; and improve the case assignment, case filing and case tracking systems.

VI. Conclusion

Overall South Eastern Europe has made appreciable progress in setting up appropriate elements of an environment for the formation and functioning of private enterprises. However there are still substantial challenges to be tackled everywhere in SEE8. This study emphasizes the importance of developing key market institutions to further enhance the growth and development of a vibrant enterprise sector in the region: institutions that enhance competition and reduce economic barriers to entry/exit; institutions that improve real sector firms’ access to regulated utilities and services; Institutions that improve corporate governance, financial transparency and access to finance; and institutions that streamline commercial dispute resolution. Further development and reform of these institutions are critical to increasing domestic and foreign investment in the SEE8 countries, accelerating growth, and reducing poverty. Moreover, improving the institutional framework for investment will help the region integrate into West European structures.