Structural Reforms in Southeastern Europe since the Kosovo Conflict

Daniele Cremoni
Sanaya Misra
Recent World Bank Technical Papers


No. 429  Gary McMahon, José Luís Evia, Alberto Pasco-Font, and José Miguel Sánchez, *An Environmental Study of Artisanal, Small, and Medium Mining in Bolivia, Chile, and Peru*

No. 430  Maria Dakolias, *Court Performance around the World: A Comparative Perspective*

No. 431  Severin Kodderitzsch, *Reforms in Albanian Agriculture: Assessing a Sector in Transition*

No. 432  Luiz Gabriel Azevedo, Musa Asad, and Larry D. Simpson, *Management of Water Resources: Bulk Water Pricing in Brazil*

No. 433  Malcolm Rowat and José Astigarraga, *Latin American Insolvency Systems: A Comparative Assessment*


No. 435  Iain Begg, *EU Investment Grants Review*

No. 436  Roy Prosterman and Tim Hansstad, ed., *Legal Impediments to Effective Rural Land Relations in Eastern Europe and Central Asia: A Comparative Perspective*

No. 437  Csaba Csaki, Michel Dabatisse, and Oskar Honisch, *Food and Agriculture in the Czech Republic: From a “Velvet” Transition to the Challenges of EU Accession*


No. 439  Mustapha Nabli, *Financial Integration, Vulnerabilities to Crisis, and EU Accession in Five Central European Countries*

No. 440  Robert Bruce, Ioannis Kessides, and Lothar Kneifel, *Overcoming Obstacles to Liberalization of the Telecom Sector in Estonia, Poland, the Czech Republic, Slovenia, and Hungary: An Overview of Key Policy Concerns and Potential Initiatives to Facilitate the Transition Process*

No. 441  Bartlomiej Kaminski, *Hungary: Foreign Trade Issues in the Context of Accession to the EU*

No. 442  Bartlomiej Kaminski, *The Role of Foreign Direct Investment and Trade Policy in Poland’s Accession to the European Union*

No. 443  Luc Lecuit, John Elder, Christian Hurtado, François Rantra, Kamal Siblini, and Maurizia Tovo, *Demystifying MIS: Guidelines for Management Information Systems in Social Funds*

No. 444  Robert F. Townsend, *Agricultural Incentives in Sub-Saharan Africa: Policy Challenges*

No. 445  Ian Hill, *Agricultural Incentives in Sub-Saharan Africa: Policy Challenges*

No. 446  Gordon Hughes and Magda Loevi, *Economic Reform and Environmental Performance in Transition Economies*

No. 447  R. Maria Saleth and Ariel Dinar, *Evaluating Water Institutions and Water Sector Performance*

No. 448  Keith Obitas and J. Raymond Peter in association with Gautam Pingle, Halla M. Qaddumi, and Jayantha Perera, *Transferring Irrigation Management to Farmers in Andhra Pradesh, India*


No. 450  World Bank, *Privatization of the Power and Natural Gas Industries in Hungary and Kazakhstan*

No. 451  Lev Freinkman, Daniel Treisman, and Stephen Titow, *Subnational Budgeting in Russia: Preempting a Potential Crisis*

No. 452  Robert F. Townsend, *Agricultural Incentives in Sub-Saharan Africa: Policy Challenges*

No. 453  Gordon Hughes and Julia Bucknall, *Poland: Complying with EU Environmental Legislation*

No. 454  Dale F. Gray, *Assessment of Corporate Sector Value and Vulnerability: Links to Exchange Rate and Financial Crises*


No. 456  Mary Canning, Peter Moock, and Timothy Heleniak, *Reforming Education in the Regions of Russia*

No. 457  John Gray, *Kazakhstan: A Review of Farm Restructuring*

No. 458  Zvi Lerman and Csaba Csaki, *Ukraine: Review of Farm Restructuring Experiences*

No. 459  Gloria La Cava and Rafaela Y. Nanetti, *Albania: Filling the Vulnerability Gap*

No. 460  Ayse Kudat, Stan Peabody, and Caglar Keyder, eds., *Social Assessment and Agricultural Reform in Central Asia and Turkey*

No. 461  T. Rand, J. Haukohl, and U. Marxen, *Municipal Solid Waste Incineration: Requirements for a Successful Project*

(List continues on the inside back cover)
Structural Reforms in Southeastern Europe since the Kosovo Conflict

Daniela Gressani
Saumya Mitra

The World Bank
Washington, D.C.
Daniela Gressani and Saumya Mitra are lead economists in the Europe and Central Asia Region of the World Bank.

Library of Congress Cataloging-in-Publication Data
Gressani, Daniela, 1956-
Structural reforms in South-Eastern Europe since the Kosovo conflict / Daniela Gressani, Saumya Mitra.
   p. cm.— (World bank technical paper ; no. 526)
   Includes bibliographical references.
   ISBN 0-8213-5197-4

HC40 .G777 2002
338.9496"009"049—dc 21

2002027203
CONTENTS

FOREWORD ........................................................................................................ IV
ABSTRACT ........................................................................................................... V
ACKNOWLEDGMENTS ......................................................................................... VI
EXECUTIVE SUMMARY ....................................................................................... 1

CHAPTER 1: STRENGTHENING PUBLIC FINANCES AND FIGHTING CORRUPTION ........................................................................................................... 7
  Strengthening of Public Finance Management ...................................................... 7
  Institutions Are Still Weak .................................................................................. 7
  Large Unfinished Agenda Lies Ahead .................................................................. 8
  Anti-corruption Efforts Receive Greater Priority .................................................. 9
  The Nature of Corruption .................................................................................... 9
  Struggle Against Anti-corruption Continues ....................................................... 10
  Reforms in Governance ..................................................................................... 10
  Reforms of the Business Environment ................................................................ 11

CHAPTER 2: CREATING A LIBERAL TRADE ENVIRONMENT ................................... 13
  Background ....................................................................................................... 13
  The EU Liberalizes Access for Southeast Europe Countries .............................. 14
  The Southeast Europe Region Takes Steps toward Deeper Integration .............. 15
  Recent Patterns in Trade Flows .......................................................................... 17
  Greater Efforts at Integration over the Medium Term Are Necessary ............... 18

CHAPTER 3: ENCOURAGING FOREIGN INVESTMENT ................................................ 20
  Donor Efforts .................................................................................................... 20
  Reform Efforts in the Region ............................................................................. 20
  Patterns of FDI Inflows .................................................................................... 22

CHAPTER 4: FOSTERING THE GROWTH OF PRIVATE MARKETS .......................... 24
  The Commercial and Competition Environment ............................................... 25
  Enterprises, Privatization, and Private Participation in Infrastructure ............... 26
  Fostering the Growth of Small and Medium Enterprises ................................... 29
  Reforms in Banking and Finance ...................................................................... 30

Tables

1: Progress in Transition in Southeastern Europe ................................................. 4
2.1: Trade Openness, 1998-2000 ........................................................................ 17
2.2: Direction of Trade Flows of the Southeast Europe Countries by Major Partner, 1998-2000 18
3.1: Foreign Direct Investment ......................................................................... 22

Graphs

1: Reform Progress after Four Years of Transition Versus Initial Conditions Ranking .... 6
2: Reform Progress after Four Years of Transition Versus Ranking after Eight Years ........ 6
3.1: FDI and Privatization Revenues Per Capita .................................................. 23
FOREWORD

This study was undertaken by the Poverty Reduction and Economic Management Department in the Europe and Central Asia Region of the World Bank in order to examine the progress of the countries of south-east Europe in implementing structural economic reforms in the three years following the end of the Kosovo conflict. This period has seen a re-invigorated effort by countries in this part of Europe to consolidate macroeconomic stability, achieve structural reforms in trade and private markets, develop a private banking system, attract foreign investment, and strengthen standards in public governance. This effort has been matched by unprecedented donor commitments of financial and technical assistance to these countries. This study looks at successes from this engagement and unfinished tasks that lie ahead. The analysis covers developments up to April 2002.

The technical paper series was launched to promote wide dissemination of analytical work being carried out in the Bank with the objective of generating further discussion. The findings and conclusions contained in this work are those of the authors, and should not be attributed to the World Bank, its Board of Executive Directors or any of its member countries.

Cheryl Gray
Director
Poverty Reduction and Economic Management Department
ABSTRACT

Since the Kosovo conflict, the countries of Southeastern Europe have made encouraging progress in advancing structural reforms and preparing their economies for greater integration with Europe and the rest of the world with the aim of raising the rate of sustainable economic growth. But progress has been uneven across sectors and across countries. The gap in economic performance with respect to central Europe remains large and can be bridged only with determined reforms in creating the conditions for the formation and growth of private enterprises. Attention must also shift towards strengthening governance and fighting corruption.
ACKNOWLEDGMENTS

This paper has benefited greatly from the contributions of World Bank country teams on Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania and the Federal Republic of Yugoslavia; and also by extensive comments from the European Commission, the European Bank for Reconstruction and Development, the Organization for Economic Cooperation and Development and the Stability Pact. Special thanks are owed to Dimitri Demekas, Johannes Herderschee, and James McHugh of the IMF, to Christiaan J. Poortman, Andrew Vorkink, Jacqueline Coolidge, Bartek K. Kaminski, Constantine Michalopoulos, Rory O’Sullivan, Kyle Peters, and Margret Thalwitz (World Bank). The authors acknowledge with particular gratitude the insights provided by the authorities of the countries covered by this paper. Research assistance was provided by Zhicheng Li Swift, editorial assistance by Helder Ferreira do Vale, and processing for publication by Armanda Çarçani. The views expressed in this paper do not necessarily correspond to those of the members of the World Bank Executive Board.
EXECUTIVE SUMMARY

This paper attempts to describe and assess the achievements of the countries of South Eastern Europe – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania and the Federal Republic of Yugoslavia – in pursuing structural economic reforms in the period since the end of the Kosovo conflict. It also provides an indication of the unfinished task that lies ahead for the region across the range of reforms that they have decided to implement. Finally, the paper outlines the efforts undertaken by the principal donors to the region in providing support for the design as well as the implementation of reforms.

This paper was prepared as a contribution to a joint World Bank-International Monetary Fund document devoted to macro-economic and structural reforms presented at the Regional Conference for South Eastern Europe in Bucharest on October 25-26, 2001. It has subsequently been updated to take account of developments and policy measures up to end-March 2002.

This paper concentrates on four key areas of structural reforms that the countries of the region have committed themselves to pursuing: (i) public management and anti-corruption; (ii) creating a liberal environment for trade in goods and services; (iii) attracting foreign investment; and (iv) encouraging the growth of a private market based economy. It finds that structural reforms have advanced in the aftermath of the Kosovo crisis – despite the disruptions occasioned by the crisis and albeit at an uneven pace. The region has made impressive gains in several areas of the reform agenda, and reforms efforts are under way or in a late stage of design in some other areas, whereas in a number of difficult issues, progress remains to be seen. Progress across the region has also been uneven, and a number of countries now need to make strong efforts at catching-up, whilst the more advanced parts of the region need to maintain the reform thrust in order to meet the goals that have been established.

Donors have devoted considerable attention and resources to the region since the end of the Kosovo conflict – this can be seen as a reinforcement of donor activities in the region that began to take root in the mid-1990s, with the end of the various wars of Yugoslav succession. Besides financing the reconstruction and recovery programs in the region (which lie outside the scope of this paper), donors have provided a great deal of technical assistance in the design and implementation of reforms, and they have developed structures for the coordination of assistance, interactions between countries of the region in undertaking reforms, and, broadly, played a highly pro-active part in creating incentives for reform in the region. The creation of the Stability Pact for South Eastern Europe and the establishment of a clear path for integration in the European Union with the Stabilization and Association process have been particularly important in mobilizing domestic and international support for reform, as has been the establishment of the High Level Steering Group of the G-8 for coordination of financial assistance.

1 This paper makes reference to these seven countries of the SEE region as well as, where relevant, to the two republics of the Federal Republic of Yugoslavia – Montenegro and Serbia – and to the province of Kosovo. For reasons of brevity and style, these are referred to as Montenegro, Serbia and Kosovo, respectively.

2 “Building Peace in South-East Europe” (www.seerecon.org)
The principal findings of the paper can be summarized as:

- **The region has seen a substantial strengthening of public finance management, but institutions are still weak, and good practices are still to be ingrained.** In many countries budgets have been or are being unified, stricter expenditure controls have been put in place, and fiduciary requirements and practices have been enhanced. But administrative structures, implementation, and enforcement and adjudication, generally, are still weak. Addressing these lacunae remains an important part of the unfinished agenda. Reform gains have been much less in certain parts of the region (notably, Bosnia and Herzegovina and the Federal Republic of Yugoslavia - FRY).

- **Anti-corruption initiatives have been accorded higher priority by the region, but the fight is only just beginning.** The region is characterized by high degrees of corruption and organized crime. Public finance management reforms, reduction of discretionary powers of public agents, and simplification/de-regulation measures have reduced the scope for corruption. But matters are at an early stage: countries are just formulating strategies or are beginning to implement programs, some legislative changes have taken place, but, for the most part, they are not complete. Institutional development is rudimentary, capabilities are weak, civil service reforms are at an early stage, and civil society is still to be adequately engaged. The region is still to give effect to international conventions against corruption, to raise internal standards on corporate behavior, and to police corporations more effectively.

- **Integration to the rest of the world through trade and integration within the region itself have made significant strides; there is a clear momentum for continued reform.** The EU initiatives for greater market access has proven to be a powerful incentive for trade liberalization and regional cooperation. The region has significantly liberalized its trade regime. It now needs to complete bilateral free trade agreements, without losing energy in engaging in multilateral opening. The increasing openness of the economies (as measured by the share of trade in domestic output) and the beginnings of a growth in regional trade are encouraging.

- **Despite some efforts by the region, the record on attracting foreign investment is poor.** Barriers to foreign investment are being whittled down and improvements in the overall investment climate can be seen in much of the region, but foreign investment has been small, generally linked to privatizations (usually telecom-related); greenfield investment has been negligible. With diminishing political risk and a sustained record of reforms, the region could look more competitive over the medium term.

- **Private sector investment has also lagged behind.** The commercial environment for economic investment in general has a much improved legislative and regulatory framework, but work on competition lags behind. Fair and competent implementation of laws and rules constitutes the major challenge for the future. Reform has largely been of a legislative character. Implementation is proving to be the Achilles’ heel. Professionalism across a range of activities, including civil service at the national and local level, judicial, accounting, and so forth, has to be raised.
After a slow beginning, enterprise restructuring and privatization are now taking place across the region, but the framework to attract private participation in infrastructure is still to be adequately formed. The pattern across the region is uneven, with certain countries still at the stage of small enterprise privatization, but most are planning sales of large enterprises and even some utilities. The lack of clarity on land ownership and use and on treatment of nationalizations are significant barriers. Work remains to be done on creating efficient regulation for utilities. Completing privatizations honestly and efficiently will be a great challenge for the authorities.

Banking intermediation is being revived through the withdrawal of the state from banking, entry of foreign banks, and greater public confidence arising from improved supervision standards and credible deposit insurance schemes. But insolvent banks remain to be closed in some countries, and privatization of solvent ones is not complete. Future challenges lie in achieving tougher supervision in practice and fostering public confidence. The development of capital markets will take time and much external technical assistance.

The state of play with respect to structural reforms prior to the Kosovo crisis can, perhaps, be best obtained by looking at the transition indicators compiled by the EBRD. These classify countries across various transition variables in a qualitative manner using policy measures taken, institutional development, and performance. Note that these indicators were based on data of the 1998-99 period, i.e., the pre-Kosovo crisis period and, therefore, do not reflect the progress with reforms made in the region since then. Nevertheless, they are informative. Developments in the post-1999 period are discussed in this report.

Broadly, the leaders in reform as shown by the EBRD indicators are Bulgaria, Croatia and Romania – the indicators show these countries as being extremely close to each other. These countries have made strong advances with liberalization of prices and of international trade, and have done well on banking sector reforms. Corporate governance and enterprise restructuring together with competition policies are areas deserving much greater reform efforts; capital market development is also at an early stage.

This group is followed by Albania and FYR Macedonia – these two countries show weaker performance on privatization and on banking reforms but not much worse performance on commercial and competition policies as compared to the leaders. Bosnia and Herzegovina brings up the rear, with weak performances on all indicators but for price and trade liberalization. FRY (and its components of Montenegro and Kosovo) are not classified by the EBRD, but it would show uniformly the poorest indicators (except for trade liberalization), but Kosovo has a liberal price regime as well and banking reforms are advanced.

---

Table 1: Progress in Transition in Southeastern Europe

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (millions mid-2000)</th>
<th>Large-scale privatization</th>
<th>Small-scale privatization</th>
<th>Governance &amp; enterprise restructuring</th>
<th>Markets and trade liberalization</th>
<th>Financial Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>3</td>
<td>75</td>
<td>2</td>
<td>4</td>
<td>2</td>
<td>2+</td>
</tr>
<tr>
<td>Bosnia &amp; Herzegovina</td>
<td>4</td>
<td>35</td>
<td>2</td>
<td>2+</td>
<td>2-</td>
<td>2+</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>8</td>
<td>70</td>
<td>4-</td>
<td>4-</td>
<td>2-</td>
<td>3</td>
</tr>
<tr>
<td>Croatia</td>
<td>5</td>
<td>60</td>
<td>3</td>
<td>4+</td>
<td>3-</td>
<td>3+</td>
</tr>
<tr>
<td>FYROM Macedonia</td>
<td>2</td>
<td>55</td>
<td>3</td>
<td>4</td>
<td>2+</td>
<td>3-</td>
</tr>
<tr>
<td>Romania</td>
<td>22</td>
<td>60</td>
<td>3</td>
<td>4</td>
<td>2-</td>
<td>3</td>
</tr>
<tr>
<td>FR Yugoslavia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: 1/ The "Private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable.

Source: Transition Report, EBRD (2001)

Classification System for Transition Indicators

Large-scale privatization
1. Little private ownership.
2. Comprehensive scheme almost ready for implementation; some sales completed.
3. More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatized (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possible with major unresolved issues regarding corporate governance.
4. More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress on corporate governance of these enterprises.
4+ Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

Small-scale privatization
1. Little progress.
2. Substantial share privatized.
3. Nearly comprehensive program implemented.
4. Complete privatization of small companies with tradable ownership rights.
4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

Governance and enterprise restructuring
1. Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
2. Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
3. Significant and sustained action to harden budget constraints and to promote corporate governance effectively (e.g. through privatization combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).
4. Substantial improvement in corporate governance, for example, an account of an active corporate control market; significant new investment at the enterprise level.
4+ Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.

Price liberalization
1. Most prices formally controlled by the government.
2. Price controls for several important product categories: state procurement at non-market prices remains substantial.
3. Substantial progress on price liberalization: state procurement at non-market prices largely phased out.
4. Comprehensive price liberalization; utility pricing which reflects economic costs.
4+ Standards and performance typical of advanced industrial economies: comprehensive price liberalization; efficiency-enhancing regulation of utility pricing.

Trade and foreign exchange system
1. Widespread import and/or export controls or very limited legitimate access to foreign exchange.
2. Some liberalization of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
3. Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.
4. Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility.

4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; WTO membership.

Competition policy
1. No competition legislation or institutions.
2. Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant forms.
3. Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
4. Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.

4+ Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

Banking reform and interest rate liberalization
1. Little progress beyond establishment of a two-tier system.
2. Significant liberalization of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.
3. Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalization with little preferential access to cheap refinancing significant lending to private enterprises and significant presence of private banks.
4. Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises substantial financial deepening.

4+ Standards and performance norms of advanced industrial economies; full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.

Security markets and non-bank financial institutions
1. Little progress.
2. Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
3. Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework.
4. Securities laws and regulations approaching IOSCO standards; Substantial market liquidity and capitalization; well-functioning non-bank financial institutions and effective regulation.

4+ Standards and performance norm of advanced industrial economies: full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation.

1 The classification system is simplified and builds on the judgment of the EBRD's Office of the Chief Economist. More detailed descriptions of country-specific progress in transition are provided in the transition indicators at the back of this Report. The classification system presented here builds on the Transition Report 1994. To refine further the classification system, pluses and minuses have been added to the 1-4 scale since 1997 to indicated countries on the borderline between two categories.
As informative as the state of play is the dynamics of reform performance, also revealed by EBRD transition indicators. They show that structural reform efforts were disappointingly slow to get off the ground (see Chart 1 in the initial phase of transition for the SEE region until the late 1990s. The region enjoyed initial conditions for transition (generally the early 1990s period) that were favorable in comparison to the former Soviet Union (including the Baltics), as measured by distortions in the economy, the effectiveness of the physical and human capital stock, the flexibility of institutions and the like. Despite this relatively propitious starting point, reforms were slow to take hold, with implementation being fitful. The successor states of FRY were war-torn and Albania was affected by internal strife — this clearly affected performance. But Bulgaria, FYR Macedonia and Romania performed worse than Croatia, even though they were not affected or little affected by conflict prior to the Kosovo crisis. The region was out performed by all of central Europe and also by several countries of the former Soviet Union.

But a clear transformation in performance took place in the late 1990s (see Chart 2), and, in particular, in the post-Kosovo conflict period. A substantial strengthening in the reform effort took place in Bulgaria, Croatia, and Romania and to some extend in FYR Macedonia — this group can be characterized as the “most improved” countries. Albania failed to a significant degree to maintain its reform momentum. A meaningful comparison for Bosnia and Herzegovina cannot be made as it was under war during the first period of transition. Though the EBRD offers no indicator for FRY as yet, it is clear that FRY performed dismally not only relative to its starting position, but also failed to improve in the second half period of transition. However, it should be noted that reform efforts have picked up greatly in FRY over the past eighteen months.

---

CHAPTER 1: STRENGTHENING PUBLIC FINANCES AND FIGHTING CORRUPTION

The re-establishment of macro-economic balances was accorded a high priority by the region over the past two years. Following the shocks emanating from the Kosovo crisis of 1999, Fund-supported adjustment programs played an important role in this area. In parallel, the region has carried out a systemic strengthening of public finances and taken initial measures to fight the high degree of corruption that pervades all countries of the region. This chapter discusses the policy steps taken so far, the major tasks of institutional development that lie ahead, and the efforts being made at the regional level, with the heavy assistance of donors, to transform the norms and the culture of doing business in the public sector to raise standards to contemporary European levels.

Strengthening of Public Finance Management

The major efforts – and achievements – of the past three years have lain in strengthening the system of public finance management. Measures included the unification of public budgets under a single Treasury account that is held in or managed by ministries of finance; stricter fiduciary controls over public expenditure; improvements in tax and customs administrations so as to safeguard revenues and create a neutral field for businesses and individuals; the institution of modern accounting and audit functions; and, importantly, attempts to link such measures to anti-corruption strategies. In addition, the region has seen a strengthening of the overall budget process, from the formulation stage – where measures have been tied more closely to policy objectives and development strategies – to execution and monitoring – where the unification of the recurrent and capital budgets have played an important part in raising the efficiency of public spending, especially investment spending. Moreover, stricter coordination with and among donor agencies has led to a sharpening of the effectiveness of overall external assistance provided to the region.

Institutions Are Still Weak

Progress on such an ambitious front has not been uniform across the region. Most countries, nearly all, have enacted legislative reforms to tax and customs codes and to the supporting administrative structures, but deeper institutional transformations, particularly in ways of working (e.g., professionalization of the civil service), of implementation, of enforcement and adjudication, are still to take place. The tax system has been modernized in most countries on the principles of widening the tax base and associated lowering of tax rates, by the introduction of a VAT, by according close attention to limiting the overall tax burden in the interests of growth and by attempting to attain EU standards in tax administration. Similarly, most of the region has seen a significant liberalization in trade (see Chapter 2 for details) with tariff reductions and rationalizations, and strengthened customs administration – again with the aim of approaching EU standards. The fiscal revenue losses associated with trade tariff liberalization have generally been recouped through changes in the rate and coverage of indirect taxes, chiefly VAT. Considerable donor assistance has contributed to supporting policy and institutional reforms in these areas.
Albania has gone far in the adoption of VAT and tax and customs structures of the kind discussed above and is now creating a system of incentives within the tax and customs administration (e.g., merit-based pay) to raise standards of behavior and, thereby, reduce corruption and increase revenues. Tax reforms are incomplete, though, as income and agriculture taxes and their enforcement are still to be addressed, and the tax system at the local authority level is still to be defined. A fiscal package passed at end-2001 will assist in fighting tax evasion and make the tax system more transparent, but a major challenge remains, that of building capacity throughout tax and customs administrations so that lasting improvements in public finances can be made.

Bulgaria has successfully reduced its excessive tax burden (through lowering income tax rates), introduced a VAT, and restructured tax and customs administration in the context of the EU accession process, and is, generally, far along the path of reform. The UN interim administration in Kosovo has introduced a VAT (which, because of the high threshold, is not broad-based; this threshold will be lowered progressively) and a wage tax will be instituted from April 2002.

FYR Macedonia has just introduced a VAT and carried out an amendment of income and profit taxes; the implementation of VAT has made an encouraging beginning. Romania has carried out a revision of the tax system reforming the basis of income taxation, agriculture taxation and that of local government revenues. Administrative improvements in the implementation of VAT and other indirect taxes is planned.

**Large Unfinished Agenda Lies Ahead**

In the rest of the region, progress has been slower. Strengthening of the tax administration capacities of the entities of Bosnia and Herzegovina is still at an early stage, VAT is still to be introduced, and, despite intensive external technical assistance, customs administration is still to function adequately. Croatia continues to shoulder a high tax burden and the reforms lowering tax rates whilst broadening the base is still to be fully felt. Systemic reform to create firm Treasury control over public expenditures by unifying accounts and spending authority are now being implemented.

In FRY, the Serbian authorities are implementing a far-reaching reform of the highly complex and distorted tax system that was inherited by unifying sales taxes and surtaxes into a single rate, final stage consumption tax (to be replaced by VAT in due course), rationalizing the set of excise taxes, and shifting the tax burden towards indirect taxes. The bases for income and social security taxes are being widened and rates reduced, financial transaction taxes have also been unified and property tax simplified and assigned to local governments. Efforts are also in hand to strengthen customs administration and to make excise taxes more effective. Montenegro is preparing for the introduction of VAT and taking steps to bolster tax administration capability.

In the context of the constitutional agreement between Serbia and Montenegro concluded in March 2002, the two republics have agreed to harmonize fiscal and other economic arrangements with those of the EU and will need to work closely together.
Anti-corruption Efforts Receive Greater Priority

Over the past two years, the region has embarked upon a concerted effort, with much donor encouragement and support, to fighting corruption. Besides the need to enhance economic efficiency by minimizing distortions whilst ensuring adequate resources for public services, the dominant motivation behind reforms in public finances in the region has been to promote the fight against mis-governance and corruption. The reduction of discretionary authority by public sector agents that arises from tax simplification, whittling down of permissible exemptions, broadening the base and lowering rates as well as firm control over expenditures leads to reduced scope for corruption. In addition, transparent accounting and honest auditing, higher standards in public procurement, in disposal of public assets, and autonomy of the enforcement authorities are additional factors that will reduce corruption in the public sector. But an anti-corruption strategy has to be broader than just the fiscal agenda.

In February 2000, the countries of the region adopted an Anti-Corruption Initiative under the Stability Pact to give force to anti-corruption efforts in individual countries as well as to assist each other in the regional context to national, regional and international anti-corruption programs and conventions. The measures taken by the region were to encompass legislative initiatives, administrative, judicial and enforcement agencies' reforms, and establish anti-corruption teams or units in countries to coordinate the fight against corruption and help monitor progress. The greater involvement of civil society and civil associations in sensitizing society to corruption, exercising vigilance, and undertaking monitoring, was also envisaged.

The Nature of Corruption

Recent research undertaken at the World Bank shows not only the pervasive nature of corruption in the region, but also variations within the region in the type of corruption that society faces. The vulnerability of the region to corruption arises from the economic and political transition from the early 1990s. These led to the end of the command economy arrangement or the socialist self-management arrangement, with all the attendant social upheavals and breakdowns in institutions. In the successor states of FR Yugoslavia, such factors have been compounded by social unrest and civil war and the legacy of ethnic strife. It is evident that the weakening of the state has had an adverse impact on the capacity to deliver public services and public goods, protection from crime and violence, safeguarding public services and public assets, providing fair and efficient regulation and laws, and ensuring a functioning basic infrastructure system. The region has faced particular difficulties in the ability to deliver such basic services and public goods even in comparison with transition economies in central Europe and the former Soviet Union.

The region also exemplifies two broad forms of corruption. First, state capture, where state laws, regulations and policy decisions become hostage to a significant degree to the influence of groups or enterprises in the public or private sectors to the detriment of the interests of society as a whole. Accountability suffers greatly as a consequence. Second, administrative

---

5 S. Bloemenkamp, N. Manning with S. Lozoya, “Corruption in South East Europe – An Overview” (World Bank, Working Paper, 2001). Data used in the paper was produced by a joint EBRD-World Bank survey conducted in 1999 on business environment and enterprise performance. Thus, the survey results reveal the views of enterprises only; other elements of society may have different perspectives.
corruption is rife with the implementation of laws, regulations and other discretionary acts of the state being subject to bribes and other similar considerations. Weak institutions, supervision arrangements and low capability make such form of corruption feasible.

Firms in the region show a much higher level of unofficial payments to get public goods and services than those in other transition regions and also report smuggled goods as being a great competitive threat – these reveal the weakness of the state to implement its laws and rules. The weakness of the state also inhibits it from interfering in firms’ production and other decisions – against a contrast to other transition regions.

Romania faces both types of corruption problems to a high degree: concentrated economic interests and weak capacity of public institutions. Anti-corruption institutions are weak and such constituencies have limited voice. Bosnia and Herzegovina, Bulgaria and Croatia can be classified as parts of the region where accountability suffers more than capability, i.e., the state is beholden to powerful interests even more than it is weak in service and public goods delivery. Albania and FYR Macedonia show extreme weakness in practically every aspect of institutional capability.

Struggle Against Anti-corruption Continues

The anti-corruption program in the region has made significant strides in the past two years. The legislative requirements in many countries are nearing completion; however, there are still notable gaps in legislative coverage in even the advanced countries, and in some countries, the legislation on the range of anti-corruption measures is at an early stage. Practically throughout the region, much secondary legislation or regulation (e.g., to give effect to procurement laws or to ensure stricter standards in public expenditure management) is still to be drafted. Institutional development is uneven across the region, but is generally at a rudimentary stage, some anti-corruption units have been set up, but appropriate capabilities to enforce new standards of audits and accounts, for example, or judicial investigation and policing of allegations are still at a formative stage. The involvement of civil society and public bodies in monitoring and vigilance is also just beginning. Reversing the corrosive legacy of corrupt ways of doing business and managing public services and assets will undoubtedly require a sustained effort over time.

Reforms in Governance

As noted in the first section of this chapter, the strengthening in public finance management is expected to make a significant contribution to the anti-corruption effort. In the successor states of FRY, the abolition of payments bureaus and the transfer of the treasury function to ministries of finance has done much to enhance transparency and make expenditure decisions and outcomes more accountable. This reform has now to be extended to FRY and its constituent republics. In Kosovo, the central fiscal agency established by the interim UN administration has established clarity in budget accounts. However, the newly constituted

6 A highly informative account of anti-corruption measures in the region can be found in “Assessment of Current Anti-Corruption Measures in South East Europe against the Objectives of the Stability Pact Anti-Corruption Initiative,” (Stability Pact, 2001). This section draws heavily on this report.
representative government in Kosovo faces large challenges in all spheres of governance: establishing ethnic peace, developing policies and priorities in economic reforms and essential public services, and following high standards of governance in a very difficult environment.

Progress in financial controls and in auditing can also be seen, e.g., in Albania, Croatia, FYR Macedonia and Romania where the legal basis for internal audit functions and units for implementation have been established. But progress is much less in Bosnia and Herzegovina and in FRY. It is notable that the challenge for effective financial control lies in developing institutions and capabilities throughout the region. External audit systems have been reinforced in the region, with independent state audit institutions existing in all countries, except FRY. But further efforts will be needed to ensure the functional independence of these audit bodies.

The region has seen the passage of legislation to reform recruitment and performance standards in the civil service, with some exceptions. But implementation remains weak and supporting institutions still have to be created for management and control of the service and for proper training. Procurement laws approximating to international standards has been passed in Albania, the federation entity of Bosnia and Herzegovina, Croatia, FYR Macedonia and Romania, but these need modifications to make them consistent with WTO requirements and/or EC directives. In the rest of the region, laws are still to be adopted. Throughout the region, supporting regulation remains to be issued, and far-reaching remedial action to address weaknesses in procurement agencies are awaited.

Specialized units or services to fight corruption have been established in some countries (e.g., Albania, Montenegro, and Romania), whilst anti-corruption task forces have been formed in Bosnia and Herzegovina. Other countries are mostly on the way to establishing such units. The major weaknesses lie in the investigative capabilities in the region as well as in prosecution. Specialized skills have to be developed and inter-agency cooperation enhanced.

Reforms of the Business Environment

Criminal legislation relating to corruption, bribery and money laundering has been overhauled in the region in the recent past and criminal codes and procedure codes for the most part reflect these legislative changes. Bribery of domestic public officials is a crime throughout the region with sanctions that are appropriate in most countries but are too weak in some. But laws and their enforcement should be strengthened with tighter definitions and institution of bribing foreign public officials as a crime. Corporate liability has to be tightened to better include anti-bribery deterrence. Moreover, adequate company accounting and financial control standards remains to be established.

A mixed picture emerges on progress against money laundering, where Croatia and Romania have fairly comprehensive legislation, and Croatia has made laundering of proceeds from serious crimes, including bribery, a criminal offense. The law in Albania is broadly appropriate, but there has been a serious delay in its implementation. The law in Bosnia and Herzegovina needs to be broadened. FRY lags behind in this area, although draft anti-money

---

7 This section should be read in conjunction with Chapter 4 that deals with reforms in the competition, company laws and in banking.
laundering legislation is under preparation in Kosovo. Recent efforts in the fiscal and customs areas are notable both in Serbia and Montenegro. However, even in countries such as Romania, where legislation is on the books, enforcement remains a major problem.

The new company legislation in the region require adherence to accounting and auditing requirements that will prevent fraud and better reveal suspicious payments with criminal sanctions. Laws to level conditions for foreign and local investors will also attack one avenue for corruption. But several important improvements can be made in the region. In Albania, Bosnia and Herzegovina and Montenegro, dual or secret company accounts need to be stamped out by more rigorous penalties and in Croatia, FYR Macedonia and Romania corporate fines are not effectively imposed. Institutional strengthening, such as that of the Court of Accounts of Romania, remains a major unfinished item of the agenda of reforms.
CHAPTER 2: CREATING A LIBERAL TRADE ENVIRONMENT

The creation of a liberal trade environment has been widely recognized as critical to strengthening the long term prospects for sustained economic growth in the South Eastern Europe (SEE) region. To this end, numerous initiatives have been pursued by both donor institutions and the SEE countries themselves. In the past two years, the Investment Compact and the Working Group on Trade Liberalization and Facilitation of the Stability Pact have contributed to the adoption and implementation of policy measures which have resulted in trade liberalization, and they both monitor future progress closely. Over the medium term, it can be expected that the process of integration of the regional economies to those of the European Union (EU) as well as greater integration of the SEE countries themselves as market economies will lead to large gains in efficiency and to the stimulation of growth.

Background

Two years ago, the SEE countries traded considerably below their potential.\(^8\) This attenuated trade performance was the result of restrictive trade policies, weak capacity in trade-related institutions (customs services, ministries and agencies charged with implementation of trade policies, inadequate physical and financial infrastructure to support trade), patchy record in pursuing market-friendly reforms, as well as conflict-driven factors such as ethnic tensions or sanctions. The degree of openness of the economies varied greatly, with Bosnia and Herzegovina, Bulgaria, Croatia and FYR Macedonia having a higher share of foreign trade in GDP than Albania and Romania; while the foreign trade of FR Yugoslavia was highly distorted by the impact of sanctions.\(^9\)

The EU was then and now the biggest trading partner for all SEE countries. Nevertheless, all SEE countries together accounted for a minute share of EU imports. Intra-regional trade was small, but was likely significantly understated because of unrecorded flows. Exports tended to be concentrated in five sectors: agriculture and processed products, textiles and clothing, iron and steel, shoes, and wood products, with exports of textiles being important to all countries.

Two years ago, trade policy was characterized by high effective rates of protection deriving from differentiated tariff structures (less so in the cases of Albania and Bulgaria); in addition, quotas and specific duties for various products existed as did licensing requirements in certain cases. A number of bilateral free trade agreements had been negotiated (e.g., FYR Macedonia with Bulgaria, Croatia, Slovenia and FR Yugoslavia; Croatia with Slovenia); within Bosnia and Herzegovina, the Federation had a \textit{de facto} free trade area with Croatia, and Republika Srpska with FR Yugoslavia.\(^10\) This patchwork of agreements and practices led to complex and distorted trade regimes, with some of the agreements not likely to be consistent with the requirements of the WTO.

---

\(^8\) Details can be found in “The Road to Stability and Prosperity in South Eastern Europe”, World Bank, 2000.
\(^9\) This comparison is much affected by large donor-financed imports into Bosnia and Herzegovina and FYR Macedonia and by then-existing sanctions on FR Yugoslavia.
\(^10\) But commerce between the two entities of Bosnia and Herzegovina was highly limited.
The EU had established a wide variety of bilateral trade relationships with SEE countries: for Bulgaria and Romania, existing pre-accession agreements aimed at a free trade agreement and provided for liberalization of trade restrictions by both parties. Albania, Bosnia and Herzegovina, Croatia, and FYR Macedonia benefited from unilateral trade preferences of different types. These agreements were characterized by a favorable treatment of industrial products relative to agricultural and by uncertainty arising from the managed trade provisions relating to quotas, agriculture and a selected number of industrial products.

It was also clear that the capacity of all SEE countries to design and implement trade policy and related reforms needed substantial strengthening. Customs administrations were especially weak, and export related institutions often absent.

Finally, the easing of regional political tensions that could be expected to result in the disuse of trade as a weapon in ethnic conflict as well as the emergence of FR Yugoslavia in a democratic, liberal setting able to open its trade and transit routes and engage in normal neighborly relations, would greatly help to take the politics out of trade and unleash the benefits of integration for economic growth.

**The EU Liberalizes Access for Southeast Europe Countries**

Within the framework of the Stabilization and Association process, in September 2000 the EU extended autonomous trade preferences (ATPs) providing very liberal access to EU markets for SEE exporters. Under the ATPs, duty-free access to EU markets is granted for all products, with the exception of some fishery products, wines and textiles (which are subject to quotas), and beef (for which quotas are granted only for baby beef). These preferences came into effect in November 2000 for a period of 26 months and applied to Albania, Bosnia and Herzegovina, Croatia and Kosovo. In November 2000, the ATPs were extended to FYR Macedonia, thereby over-riding the somewhat less liberal—though contractual—provisions of the existing Trade and Cooperation Agreement; and to FR Yugoslavia, following the demise of the Milosevic government. Further, the application of the ATPs was extended to up to 5 years, until December 31, 2005.

The liberal market access granted by the EU through the ATPs is expected to be consolidated and expanded in a contractual form in the Stabilization and Association Agreements (SAAs) that have been or are in the process of being negotiated with the SEE countries. The SAAs guide more broadly the economic and political relationship between the EU and the region. These agreements envisage the establishment of free trade areas between the EU and the SEE countries, with an asymmetric process of liberalization and transitional periods favorable to the countries of the region. In addition, these agreements require that all signatory countries conclude bilateral agreements, consistent with GATT/WTO principles, aiming at creating a network of bilateral free trade areas. Finally, the SAAs require commitments to harmonize

---

11 The countries in the Stabilization and Association process include Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia and FR Yugoslavia. The process was launched by the EU in May 1999, and covers political and economic relations, including trade. The relationship between the EU and Bulgaria and Romania is guided by Europe Agreements.


legislation and regulations with those of the EU on a large range of economic activities, and envisage EU assistance to this end.

The ATPs entail unilateral trade concessions on the EU side, and are revocable. In comparison, the value of SAAs arises not only from their contractual nature, but also from the obligation to liberalize placed on the countries of the region: the SEE countries will have to open up to competition from EU suppliers, and the business climate can be expected to make efficiency gains thanks to harmonization with the EU and with the extension of EU assistance.

The Southeast Europe Region Takes Steps toward Deeper Integration

These regional trade initiatives and the Stability Pact process also provided mechanisms and momentum to foster intra-regional cooperation. Recent developments in the countries themselves attest to the high priority placed by the region on expanding its participation in multilateral trade agreements as well as in deepening regional integration. In June 2001, the SEE countries signed a Memorandum of Understanding (MOU) on Trade Liberalization and Facilitation under the auspices of the Stability Pact based on negotiations conducted within the latter’s Working Group on trade. The MOU provides for a wide ranging agreement on a set of measures to promote trade within the region. In particular, the countries agreed to negotiate free trade agreements between themselves by end-2002 based on the abolition of all export duties, quantitative restrictions on imports or exports and import duties being abolished on at least 90 percent of mutual trade by value and tariff lines. They also agreed to adhere to WTO rules on free trade agreements and on safeguard measures, and to liberalize and make non-discriminatory public procurement, state aid and state monopolies’ position in the trade agreements.

The region has also undertaken to simplify customs procedures, harmonize procedures with the EU as well as to include in free trade agreements a clause foreseeing the future liberalization of trade in services in accordance with GATS, Article V. The region has, furthermore, agreed to harmonize company and banking law, accounts, and taxes with the EU, move to common implementation of standards, upgrade legislation on intellectual property protection in line with WTO agreement on TRIPS, and maintain an open trade regime with the rest of the world, whilst pursuing further multilateral liberalization within the WTO. In trade and growth-promoting effects, these steps are likely to be at least as important as the establishment of the free trade areas.

The MOU on Trade Liberalization and Facilitation is potentially a powerful instrument promoting regional integration and stability, and is, therefore, of considerable importance. It commits the countries to work in a regional context and to work together in an equitable manner forging links and patterns of cooperation. It involves time-bound commitments of mutual liberalization and establishes minimum standards—and these standards are at least as high as those in the CEFTA agreements, so far the most liberal in the broader region.

It deserves to be emphasized that this agreement will realize its potential only if the SEE countries undertake concurrently substantial multilateral liberalization and standardization of the

---

bilateral free trade agreements. Without these steps, tensions may arise between the more
developed countries of the region and the less developed ones as has been shown in many cases
of attempted trade integration between developing countries. Clearly, it would be highly
inimical to the growth prospects of the region and, therefore, highly undesirable, if the intra-
regional trade liberalization efforts were to crowd out efforts by the countries of the region to
undertake multilateral liberalization.

There has been intense activity with the region on liberalizing trade in general and on
fostering intra-regional trade. All SEE countries are now members of the WTO with the
exceptions of Bosnia and Herzegovina, FYR Macedonia and FR Yugoslavia. These countries
have applied to accede to the WTO and are at various stages of the accession process.

Albania has been reducing average tariffs and tariff dispersion as a part of an attempt to
harmonize with the EU tariff structure. In Bosnia and Herzegovina, the powers of the state to
effectively formulate and enforce trade policy have been strengthened, inter alia, through the
establishment of a state border service, harmonization of inter-entity regulations is being
negotiated (for example, to remove the anomaly of different fee structures for imports across the
entities), and a free trade agreement with Croatia has been signed.

Bulgaria’s trade policy has been driven by the Europe Agreement which seeks to
establish a common tariff free area for trade in manufactures by 2002 and under which Bulgaria
has signed a number of free trade agreements. Moreover, Bulgaria has made commitments
towards a liberal trade regime in telecommunications and financial services. Under bilateral
agreements within the auspices of CEFTA, Bulgaria has a highly liberal trade environment with
the other CEFTA countries. Free trade agreements have recently been concluded with the Baltic
states, Israel, Morocco and Turkey and, within the SEE region, with FYR Macedonia. Romania’s
trade policy has also been driven by the Europe Agreement. In this context, Romania
has taken progressive liberalization steps and by 2002 will remove all barriers to manufacturing
imports from the EU. It has also committed itself to liberalization in telecommunications and in
financial services. The trade relationship with other CEFTA countries is liberal, though barriers
have not been fully removed.

Croatia has also engaged in significant liberalization in the context of WTO accession. In
addition, as a result of a number of free trade agreements being negotiated, at end-2001 90
percent of trade was covered by free trade agreements. Trade policy is conducted within the
framework of WTO membership and the recently initialed Stabilization and Association
Agreement with the EU. A liberalized tariff schedule came into effect in mid-2000 that reduces
average protection as well as tariff dispersion significantly. Further tariff reductions for both
industrial and agricultural products are scheduled to take place over the next five years in line
with the WTO accession agreement. As noted, free trade agreements with Bosnia and
Herzegovina, the Czech republic, Hungary, FYR Macedonia, Poland, Slovakia, Slovenia and
EFTA exist; an agreement with Turkey has been reached but not yet signed, and negotiations are
taking place with Albania, FRY and Romania.

FYR Macedonia’s trade liberalization has been much less than that of other SEE
countries: tariff rates and schedules remain little changed in terms of the degree of protection and
dispersion (despite revisions), but bilateral trade has been liberalized. Moreover, a system of licensing has been retained which is incompatible with WTO provisions and which continues to provide significant protection to several sectors and generate large distortions, rent and corruption. Free trade agreements exist with Bulgaria, Croatia, Slovenia, Turkey and FR Yugoslavia, negotiations have been concluded for that with EFTA countries and the Ukraine, are underway with Albania, Bosnia and Herzegovina, and are planned with Romania. The accession discussions with the WTO and the Stabilization and Association Agreement with the EU will provide the framework for further liberalization.

The authorities in FR Yugoslavia carried out a significant liberalization applicable to Serbia in mid-2001 with the near-elimination of quantitative restrictions and licensing requirements and a significant reduction in the rate and dispersion of tariffs. The remaining quantitative restrictions (on steel) can be expected to be removed in the context of WTO accession negotiations. Export quotas on certain foods will be eliminated as domestic supplies increase. Montenegro instituted a much more liberalized trade system than FR Yugoslavia over the past two years and intends to extend further trade openness. The difference in the trade regimes in Montenegro and Serbia requires the maintenance of checkpoints at their boundary line. Kosovo instituted a highly simple and liberal trade regime under UN administration with a flat tariff of 10 percent with few exemptions. The authorities have stated their intention to reduce the tariff, with a corresponding revenue-neutral rise in the rate and/or base of VAT in the near future. FR Yugoslavia has bilateral free trade agreements with FYR Macedonia and the Russian Federation, which are also respected by Kosovo and Montenegro.

Recent Patterns in Trade Flows

Trade liberalization and improved macroeconomic conditions have resulted in increased trade openness in the region during the past three years (Table 1). Albania and Bosnia and Herzegovina are however showing only a modest rise in the trade to GDP ratio, and the shrinkage of the trade sector in the economy of FR Yugoslavia reflects the effect of sanctions and disruption caused by the 1999 conflict.

<table>
<thead>
<tr>
<th>Country</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>41.3</td>
<td>55.2</td>
<td>59.3</td>
</tr>
<tr>
<td>Bosnia &amp; Herzegovina</td>
<td>98.4</td>
<td>78.2</td>
<td>77.1</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>97.7</td>
<td>99.6</td>
<td>122.1</td>
</tr>
<tr>
<td>Croatia</td>
<td>88.8</td>
<td>89.2</td>
<td>95.8</td>
</tr>
<tr>
<td>FYR Macedonia</td>
<td>99.8</td>
<td>98.0</td>
<td>114.4</td>
</tr>
<tr>
<td>Romania</td>
<td>56.1</td>
<td>62.6</td>
<td>73.7</td>
</tr>
<tr>
<td>FR Yugoslavia</td>
<td>66.4</td>
<td>56.0</td>
<td>81.2</td>
</tr>
</tbody>
</table>

Source: Direction of Trade, IMF (2001)

Developments in trade for the SEE countries between 1998 and 2000 in the aggregate show some effect from the trade measures taken by these countries themselves and the EU—the full effect will be felt only with a lag of several years. The imports of the SEE from the EU show a significant rise—10 percent in nominal dollar terms. (The underlying increase adjusting for sanctions on FR Yugoslavia would be even greater.) The imports of the SEE countries from partner SEE countries also shows a significant increase—again 10 percent in nominal dollar terms.
These developments in the aggregate mask substantial differences between the countries.\textsuperscript{15} Albania and Bulgaria recorded very high rates of import growth, which reflect both trade liberalization and economic recovery following the macroeconomic crises in 1997. Bosnia and Herzegovina, Croatia and FR Yugoslavia showed significant falls in imports, which reflected necessary external adjustment. Within the SEE group, several observations can be made. Two countries suffered significant declines in their trade with their SEE partners—Bosnia and Herzegovina and Croatia. Bilateral trade between Bosnia and Herzegovina and Croatia fell markedly, following a re-orientation of the Croatian economy and trade toward Europe and the world, and a reduced focus on economic assistance to the ethnic Croat-majority areas of Bosnia and Herzegovina. Overall, much of the dynamism in trade of the SEE region comes from developments in Bulgaria and Romania.

\textbf{Greater Efforts at Integration over the Medium Term Are Necessary}  

It appears important to capitalize on the momentum of trade liberalization that lies at the heart of the reform programs of the SEE countries and the opening being accorded by the EU. The liberal access to EU markets offered within the Stabilization and Association process together with regional trade integration envisaged in the MOU on Trade Liberalization and Facilitation will create more attractive conditions for domestic and foreign investors. Over the medium term, trade will continue to dominate the reform agenda.\textsuperscript{16}

The EU has taken the path of negotiating Stabilization and Association Agreements that envisage free trade within a maximum period of ten years involving asymmetric liberalization consisting of improved EU preferences. As the EU signs more SAAs, SEE countries would also be linked through free trade agreements with each other, which is an obligation under the SAA; this is also a commitment under the recent MOU on Trade Liberalization and Facilitation, agreed by all SEE countries, discussed above. The key questions for the EU that arise under such a strategy are the degree of preferences to be accorded, their time-frame, scope and nature; the similarities between the different bilateral agreements; and the relationship of such agreements to the Europe Agreement. It appears desirable that the EU establish strongly coordinated and

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|c|}
\hline
\textbf{Imports from} & \textbf{EU Other SEE Total} & \textbf{Total} \\
\hline
Albania & 19% & 55% & 30\% \\
Bosnia & -5\% & -38\% & -12\% \\
\& Herzegovina & Bulgaria & 28\% & 75\% & 31\% \\
& Croatia & -16\% & -41\% & -11\% \\
FYR Macedonia & 46\% & -5\% & 10\% \\
Romania & 8\% & 10\% & 10\% \\
FR Yugoslavia & -33\% & 72\% & -23\% \\
SEE-7 & 10\% & 10\% & 7\% \\
\hline
\textbf{Exports to} & \textbf{EU Other SEE Total} & \textbf{Total} \\
Albania & 22\% & -38\% & 25\% \\
Bosnia & 39\% & -56\% & 5\% \\
\& Herzegovina & Croatia & 17\% & 113\% & 15\% \\
Bulgaria & Croatia & 14\% & -19\% & -1\% \\
FYR Macedonia & Croatia & 14\% & 6\% & 2\% \\
FR Yugoslavia & Romania & 23\% & 66\% & 25\% \\
SEE-7 & -41\% & -18\% & -37\% \\
FR Yugoslavia & SEE-7 & -2\% & -1\% & 2\% \\
\hline
\end{tabular}
\caption{Direction of Trade Flows of the SEE Countries, by Major Partner, 1998-2000 (percentage changes)}
\end{table}

\textsuperscript{15} The direction of trade data have to be treated with caution: they were distorted by sanctions on FRY, and by incomplete recording of intra-SEE trade.

\textsuperscript{16} See “The Road to Stability and Prosperity in South Eastern Europe,” World Bank, 2000, for a medium term trade strategy; this section is based on that document.
virtually identical bilateral trade arrangements with Albania, Bosnia and Herzegovina, and FR Yugoslavia—countries as yet without SAAs, though such agreements would have to reflect, where necessary, differing levels of economic development.

The agreements offered by the EU should embody liberal access in all sectors. It would be desirable on efficiency and implementation grounds if in the SAAs exceptions involving separate protocols were kept to a minimum and a common list of such exceptions negotiated. Sensitive EU sectors could be protected through surveillance rather than outright quotas, as currently done for textiles. Consideration should also be given to a more ambitious timetable than currently envisaged for the establishment of a free trade area. On the linking of or similarities between preferential arrangements, the EU should give full stimulus to the agreement amongst the SEE countries to establish free trade areas and consideration should also be given to wider integration by means of membership of the non-CEFTA SEE countries to CEFTA. Assistance towards improvements in trade agencies remains an important element of EU cooperation with the region. The SEE countries would need to effect a sustained, general liberalization of all trade, implement the agreement reached in mid-2001, and multilateralize existing bilateral agreements to other countries in the region. The establishment of a low uniform tariff range with very few rates and with minimal exceptions is an important goal. The MOU on Trade Liberalization and Facilitation provides a framework for countries to closely coordinate their liberalizing reforms so as to minimize distortions and incentives for smuggling and corruption. Such coordination will greatly facilitate an eventual move to a common external policy such as that of the EU.

A substantial upgrading of customs services of SEE countries will be necessary to make a free trade area effective, particularly on implementation of rules of origin. Both widened access to the EU and technical assistance offered by the EU represent powerful incentives to reform. The World Bank, in partnership with other donors, is also assisting in improving customs administration, customs information systems, and border crossing infrastructure and equipment.

The SEE agreement provisions on eliminating obstacles to intra-regional trade, on standstill on restrictive measures and on multilateralization of bilateral trade preferences should be implemented forcible and according to timetable—such measures will go a long way to promoting regional integration.

In the medium term, i.e., from 2004 and beyond, both the EU and the SEE countries will have to assess progress made and the next steps to be taken in common. During this period, the SEE countries should have established complete free trade areas with each other and with the EU. The EU will eliminate remaining restrictions on imports in line with agreements reached. It will be necessary for the EU to decide, once all countries and the EU constitute a free trade area, what steps for further integration are most appropriate for each country.
CHAPTER 3: ENCOURAGING FOREIGN INVESTMENT

Under the auspices of the Stability Pact, SEE countries undertook to improve the climate for foreign investment through developing open, stable, non-discriminatory policies and a comprehensive legal framework towards foreign investors; affording fair treatment of domestic and foreign investments with protection of property rights; establishing predictable customs regimes; and pursuing vigorously the privatization of public enterprises in a transparent and competitive manner, specifying clearly the scope for foreign participation. In addition, countries undertook to take anti-corruption measures as well as various policy steps to strengthen the business climate – these are discussed in other chapters of this report.

Donor Efforts

The recent past has been characterized by concerted donor efforts directing at assisting countries create a propitious climate for foreign investment. The Investment Compact under the Stability Pact provides a broad based process and instruments for countries to develop reform programs to promote investment – domestic and foreign – covering a range of policy measures. The OECD and other donors have provided a great deal of support to this initiative. The monitoring of country reform programs and achievements undertaken by the countries themselves under the Investment Compact serves to exert peer pressure among the countries, to learn from experiences elsewhere, and helps to ensure the neutral and even implementation of reforms. Within the World Bank Group, the Foreign Investment Advisory Service (FIAS) has undertaken diagnostic studies of the main barriers to foreign investment in the region and made policy recommendations to governments. FIAS studies have covered not only issues of foreign investment directly, but also general barriers to investment – administrative, tax, and the like – commercial legal frameworks for private sector development, and foreign investment promotion agencies. Furthermore, bilateral governments have also extended technical assistance in preparing legislation or regulation and in setting up institutions.

Reform Efforts in the Region

Initiatives to improve the prospects for foreign investment have been taken by most SEE countries over the past five or six years. These predominantly legislative initiatives ensure equal treatment for foreign and local investors, permit the free movement of capital into most sectors (military and mass media sectors being the main restricted ones) and free transfers of earnings, and provide for arbitration mechanisms in cases of investment disputes. Current efforts center on improving enforceability of legislation and regulations, increasing transparency, and minimizing bureaucratic requirements. The entire region is clearly making a sound effort at attracting foreign investment, but the success of the effort will depend greatly on improving the overall investment climate, and not just the removal of discriminatory measures against foreign investors.

---

17 This chapter limits itself to foreign investment; the broader environment for domestic investment is considered in Chapter 4.
18 Investment Compact of the Stability Pact (paraphrased here).
Much effort in the region has been devoted to strengthening foreign investment promotion agencies. Some of this effort has been related to the privatization of enterprises and the need to secure foreign capital in the process, but now the effort has to be broadened to “market” the region or the country rather than a specific transaction. In this regard, there is much to be done as FDI promotion agencies in most SEE countries are weak and inexperienced in the use of marketing, promotion and outreach tools – Bulgaria is a significant exception.

Albania is preparing an action plan to implement the recommendations of a FIAS study that identified weak governance, complex tax, customs and business laws and regulations, and difficult access to land and construction permits as the major factors deterring foreign investment. Actions focus on the establishment of independent offices for the resolution of commercial disputes, ratification of agreements on arbitration, and strengthening of judicial bodies and tribunals as well as business simplifications. The government has endorsed a draft law and statutes of an FDI promotion agency – this agency will be responsible for promoting privatization as well as servicing existing and potential investors in line with FIAS recommendations. At a later stage, investment promotion will focus on attracting greenfield investments.

Bosnia and Herzegovina has adopted a liberal foreign investment law at the state level; the major challenge now is the adoption of consistent and similarly liberal implementation legislation at the level of the two entities. Such legislation should be harmonized and should address the key concerns: an overly complex business regulatory environment and uncertainties in foreign investor protection. The FDI promotion agency is being reinforced and a promotion program developed.

By the standards of the region, Bulgaria has had well developed FDI regime and institutions. On the legislative side, an international arbitration law is being prepared. Public administration on business related issues is being strengthened. Bulgaria has negotiated a number of bilateral investment treaties (including with Bosnia and Herzegovina) and is initiating negotiations on several others. Efforts are underway to promote FDI in both the country context and the SEE regional context, e.g., through the preparation of SEE investment guides and business information networks – an initiative of the Southeast Europe Enterprise Development (World Bank Group) and the Bulgaria investment promotion agency. Croatia and Romania have significant administrative barriers to foreign investment and procedures are complex. The key impediments are, in certain cases, visa and work permits delays, in other cases, real estate-related transactions and building of new premises. The authorities are considering policy reforms in these areas in line with FIAS recommendations. In particular, work is in progress in the difficult area of land and property titling. A one-stop shop for delivery of FDI facilitation is to be established.

FYR Macedonia’s attempts to secure foreign investment focus on easing restrictions on real estate ownership and use, on the release of state-owned land for investment, and streamlining cumbersome requirements of official permission and clearances for investors. Romania also intends to reduce and simplify requirements and procedures for foreign investors, reduce the high degree of discretion in investment decisions exercised by the authorities, and
update the relevant legislation. Preferential fiscal and trade treatment of some enterprises or regions have created distortions in resource allocation and led to budget revenue losses.

As the FRY emerges from its decade of near-isolation and noting the emphasis being placed by the authorities on FDI as a key instrument for growth, it will be important to clarify the respective policy and execution responsibilities of the federal, republic and provincial organs of government. The FDI law passed in January 2002 reflected modern requirements in some aspects, including the ownership and use of land. However, a significant impediment to foreign investment in FRY is posed by the constitutional requirement of reciprocity of treatment; this is anachronistic and serves to complicate and delay the approval process for potential investors.

Montenegro has adopted a liberal, comprehensive law on foreign investment, defined a strategy for attracting FDI, both general and sector specific (agriculture, tourism) and has established a promotion body. The interim UN administration in Kosovo is drafting legislation to support foreign investment within the broader context of strengthening the environment for private sector development. It is important that such legislation ensures a neutral as opposed to a preferential regime for foreign investors.

Investment promotion activities need to be intensified. Most countries already have or are in the process of creating agencies with this objective. Within the framework of the investment compact, best practices from the OECD are being introduced, and institutional capacity in attracting investment is being developed.

Patterns of FDI Inflows

The record of attracting FDI into the SEE region has been a disappointing one. Over the 1989-2000 period, the region obtained only $300 per head in cumulative FDI (Table ... ) as compared to $1,200 for central Europe and the Baltics. Within the region, Croatia’s record is impressive ($900 per head), but is weakening, whereas Bulgaria at half that figure has been accelerating. No other country is projected to turn in a strong performance in 2001, with the exception of FRY, where FDI is projected to increase sharply over the medium term. The volatility seen in FDI net flows is exacerbated in the region by the close tie between FDI and privatization transactions. Strategic sales to foreign interests often account for a large share or practically all of an annual FDI inflow. In Bulgaria and Croatia, sales of banks to foreigners accounted for about a third of FDI in each country in 2000, and Albania’s mobile telephone privatization in 2000 accounted for all of the FDI in that year. The early 2001 sale of

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>592</td>
<td>173</td>
<td>1.4</td>
<td>3.7</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>340</td>
<td>79</td>
<td>2.1</td>
<td>3.1</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>3,286</td>
<td>404</td>
<td>7.0</td>
<td>7.2</td>
</tr>
<tr>
<td>Croatia</td>
<td>4,274</td>
<td>938</td>
<td>7.6</td>
<td>3.9</td>
</tr>
<tr>
<td>FYR Macedonia</td>
<td>437</td>
<td>219</td>
<td>0.8</td>
<td>5.2</td>
</tr>
<tr>
<td>Romania</td>
<td>6,732</td>
<td>301</td>
<td>2.8</td>
<td>2.7</td>
</tr>
<tr>
<td>FR Yugoslavia</td>
<td>990</td>
<td>116</td>
<td>1.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Southeastern Europe</td>
<td>15,661</td>
<td>319</td>
<td>4.4</td>
<td>3.9</td>
</tr>
</tbody>
</table>

Sources: International Financial Statistics, IMF (2001-02)
the government’s stake in the FYR Macedonian telecom company brought in the equivalent of the cumulative FDI to that country in the preceding decade.

The low level of FDI into greenfield investments and existing private companies (in contrast to privatization-associated FDI) is a clear indication that the adverse external environment is not the main cause of the disappointing FDI performance in the region. Fundamental reforms are still incomplete, and success with FDI will greatly depend not just on removing discriminatory practices against foreign investors, but improving the overall business climate and, also, deepening integration with the EU.

Graph 3.1: FDI and Privatization Revenues Per Capita

Cumulative FDI per capita in US$, 1989-2000

Source: Transition Report, EBRD (2001)
CHAPTER 4: FOSTERING THE GROWTH OF PRIVATE MARKETS

This chapter contains a discussion of the progress made in the SEE region on reforms aimed at encouraging the growth of a private market economy, and the unfinished agenda that lies ahead. Given the breadth of the ground to be covered, the discussion is organized by three themes: (i) the commercial and the competition environment, encompassing enterprise laws, competition laws, the tax and regulation set-up, the accounting system, and the enforcement of laws and regulations; (ii) reforms relating to enterprise restructurings and privatization, and the fostering of small and medium enterprises; and (iii) banking and finance.

Over the past three years, substantial accomplishments in all these areas can be seen in the region. The countries have placed particular emphasis on legislation on enterprises, privatization, fostering the emergence and growth of small and medium enterprises, and establishing stricter banking supervision. The second generation of reforms to which attention must now turn lie in developing a competitive environment, making progress with large enterprise privatization, including utilities, and creating the legal and regulatory basis for the development of capital markets.

But much of the reform thrust in these areas over the medium term has to be placed on implementation as well as on the architecture of institutions that will enforce laws, draw up and enforce regulations, and help to create changes in entrepreneurial behavior consistent with a competitive, market economy.

The chapter finds close inter-connections amongst the three reform areas identified above. Notably, there is a clear linkage between the set of reforms planned or under way in the enterprise sector and that in the banking and financial sectors. Improvements in the competition and commercial environment, e.g., through greater transparency and predictability of administrative and regulatory decisions or through effective enforcement of bankruptcy laws, will help to foster growth in banking and equity markets; similarly, a growing role for bank intermediation accompanied by well-supervised banks that lend on commercial criteria solely will ease access to finance for the enterprise sector. It is encouraging that the region has been moved in tandem on these tracks with visible results, but many tough decisions lie ahead as does the difficult task of credibly enforcing rules and regulations in new conditions.

Finally, it should be noted that the accomplishments in the banking and financial sector reform agenda (as indeed in the enterprise and privatization agenda) has depended enormously on donor technical and financial assistance. This assistance has been well structured and sequenced, has required much coordination, has had to be sustained over years and will need to be available for yet several more. It has required working through differences in philosophical, legal and institutional approaches amongst donors and in adapting approaches to regional conditions as well as to the preferences of the countries. The basis now exists for extending the achievements in these essential reform areas over the medium term.
The Commercial and Competition Environment

The region has made sound progress in setting up an appropriate environment for the formation and functioning of enterprises through the passage of laws on enterprises, laws governing entry and exit (e.g., opening up sectors previously reserved for the state and bankruptcy laws), laws on collateral and secured lending, commercial codes, but the effective and even-handed administrative and judicial enforcement of these laws and codes remains a major problem. Much less progress has been recorded on the establishment of a competitive environment or of agencies to effectively police anti-competitive behavior.

The reform achievements, therefore, have largely been of a legislative character in these areas thus far, with the next necessary step being the setting up of supporting and enforcing institutions that will not only bring about the policy changes but will also explain to the general public and to enterprise managers the new legal or regulatory obligations that they face. There are indications that for most of the region work is in hand to carry the agenda forward.

The lack of consistent and transparent implementation of commercial laws emerges as a major impediment to the formation of a competitive economy in the region. In Albania and Bulgaria, adequate company laws and commercial codes exist, but several factors undercut the effectiveness of the new legal environment: the failure to implement such laws, regulations, and procedures in a consistent and reliable manner, the failure to operate licensing requirements in an unambiguous and predictable manner, and the imposition of lengthy and confusing procedures. Inconsistent implementation and interpretation of laws and regulations gives rise both to discrimination between different types of investors or different types of activity and, thereby, to corruption. The cost of doing business and the competitive disadvantage incurred relative to a less harshly treated rival can be great, indeed.

The status of competition regimes shows considerable variations across countries, ranging from those where setting up a competition authority is still in preparation to those where competition authorities are established and beginning to operate on the basis of EU regulations. Efforts are underway to complete legal and judicial frameworks and to provide training for sound implementation (e.g., in Albania) or to both harmonize legislation with EC rules and to establish a commission or reinforce an existing commission for protection of competition (as in the cases of Bulgaria and Croatia). The Bulgarian commission is increasingly basing its decisions on acquis norms, and that of Croatia is to be strengthened and will benefit from legislation harmonized with EU norms. An important task confronting competition enforcement bodies in the region is review of the competition implications of proposed privatization transactions, particularly in cases where transactions may lead to increased concentration.

Similar efforts are required – training, capacity building – in the field of bankruptcy for example; it is notable that during the five years such legislation has existed in Albania no company has been declared bankrupt, and in FYR Macedonia bankruptcy legislation cannot be enforced until specialized training has been completed.

Many technical deficiencies and recommendations for improvements in the range of commercial and competition legislation of SEE countries can be found in FIAS reports; this section eschews such detailed analysis, limiting itself to broad observations and trends.
In certain cases, fundamental legislative reforms are still awaited. In Bosnia and Herzegovina, the commercial and competition framework is still deficient: there exists a labyrinth of formal and informal rules across state, entity, cantonal and municipal levels leading to a fragmentation of the current commercial framework, despite the wide-ranging legal reform program of the recent past. The company laws of the entities need to be harmonized and a single economic space for the country created. Competition legislation has not yet been drafted and is required to prevent the emergency of post-privatization anti-competitive practices; the planned Competition Commission will need much capacity building assistance. Croatia is to consider legislation to address key barriers to investment: visa and work permits for foreign investors, expensive business registration and special sector licensing requirements, and regulation on land and building location and use.

The FRY sees the need for a radical change in the whole range of commercial legislation as well as in the clarification and protection of property rights, not least to ensure that private investors compete on equal terms with state-owned firms that enjoy many financial and other advantages. The Serbian government has proposed amendments in the Company Law, Bankruptcy Law and Entrepreneurship Law in these directions; these should be approved later this year. The enforcement agenda is large and still to be addressed in FRY given the recent history of politicization and cronyism in courts and poor competence of most regulatory and enforcement bodies.

Legal and tax uncertainties constitute a serious obstacle to efficient investment outcomes in the region. Both Bulgaria and Romania suffer from frequent and unpredictable revisions of tax and other laws (even while EU-consistent laws and standards are being designed) as well as from arbitrary interpretation of tax and customs laws. In Romania, the volatility and unpredictability of the general legal framework for business adds a significant cost. As efforts to implement competition legislation gets under way (Bulgaria is a notable early example), the consistency and professionalism of decisions by competition commissioners and their adherence to EU rules will be of particular importance.

Strengthening corporate governance is a critical element for improving the business environment. Throughout the region, some progress has been made in bringing accountancy standards up to international standards, but there is much still to be done. In some countries legislation is still to be adopted (Albania, Romania, FRY), in others (Bosnia and Herzegovina) it is still to be fully put into effect. In Romania, international accounting standards in the banking system is being applied from 2002. Much technical assistance will be required by the region if the phased adoption of EU rules for the public sector and of international standards of accounting as planned is to take place successfully. Initiatives to this end have been taken within the framework of the investment compact.

Enterprises, Privatization, and Private Participation in Infrastructure

Enterprise restructuring and privatization have been major elements in the structural reform program of the region for close to a decade, with much progress having been registered throughout the region, with the exception of FRY. Such progress can now be expected in FRY on the basis of laws adopted in mid-2001 to undertake privatization. The FRY privatization laws
aim to offer at least 70 per cent of every enterprise to strategic owners, not give preferential treatment to employees or management and to carry out transactions under fully transparent rule.

The principal impediments to enterprise restructuring, particularly labor-shedding, have been political, have also found resistance on grounds of social cost, with some governments taking the easy path of extending public subsidies. In Romania, for example, adjustment was much delayed with the result that a large fiscal cost had to be borne and the realization of efficiency gains was much delayed. Country authorities have now understood better the costs of delayed restructuring and privatization and are showing a firmer resolution to complete the task, but a stronger, credible commitment to openness in transactions is required. With greater attention now being paid to fiscal sustainability and economic stability, and with a clearer realization of the economic costs of delayed enterprise restructuring and privatization, most countries are now showing firmer intent to restructure and to complete the transformation of ownership to private hands.

The legislative framework for privatization has been in place for most countries for several years; Serbia has now adopted suitable legislation; Montenegro passed its laws in 2000, and the UN administration in Kosovo is currently considering a privatization decree. In the light of experience, amendments to the legislation have been found necessary so as to promote greater transparency and use of clear competitive sales methods in parts of the region, e.g., Bosnia and Herzegovina, Bulgaria, and FYR Macedonia. A widespread problem in the region – and one that needs further legislative treatment – is lack of clarity of ownership of assets, including land, and how to deal with past confiscations or nationalizations. This affects, in particular, the successor states of Yugoslavia. Progress on these questions will be important if privatization is to be completed on efficient terms and with foreign participation.

In FRY, privatization will re-commence in Serbia (some sales took place during the 1990s under the seriously flawed program of the previous regime) in a significant way this year; in Montenegro, with the issuance of citizens vouchers, mass privatization program has begun. In Bosnia and Herzegovina, small enterprise privatization is expected to be completed in both entities soon – a process that has taken three years; in other parts of the region, small enterprise privatization is largely complete, but, notably, several hundred such enterprises are still in state hands in Romania.

The main thrust of the policy effort is now on refining privatization methods and on preparing the large enterprises, including utilities, for sale. This has required work on restructuring enterprises or liquidating them, removing the state support schemes, as well as unbundling activities, restructuring balance sheets, resolving debt, and creating, where necessary, the post-privatization regulatory environment. Moreover, the specific nature of the sale, the terms of the tender offer, cash or investment requirements, and such details have to be settled prior to sale. These tasks require coordination within the government, sector-specific and marketing knowledge, working with the enterprise, and high standards of probity and transparency, if sales are to be effected most efficiently and honestly. The traditional environment in the region – a legacy of the socialist past – has not been an encouraging one in these respects. Thus, a heavy burden of complex tasks has come to rest on privatization agencies and government bodies, and donors have been generous with technical support. It is clear that
these set of complex, inter-related tasks will loom large in the private sector development agenda for at least the next two to three years, and will demand a heavy and generous commitment from donors, particularly international organizations.

In some countries (e.g., most notably, Bulgaria), large enterprises have been sold, usually under cash tender methods and usually involving foreign capital. In this respect, significant progress has also been recorded in Croatia and FYR Macedonia. In other parts of the region, plans for selling large enterprises are advancing. The problem of loss-making enterprises, with associated restructuring requirements, has proven to be the most intractable – progress in Romania, for example, has been limited, but Bulgaria has largely tackled this problem, and Croatia is making encouraging efforts to do so, despite judicial bottlenecks.

Similarly, utilities are being prepared for privatization and regulation is being developed. The telecommunications sector is one where sales have taken place (with foreign participation) in most countries and have been the backbone of FDI inflows. Further plans for selling both mobile telephony licenses and fixed line companies are being developed (e.g., in Albania, Bosnia and Herzegovina, and Croatia). In Albania, the telecommunications monopoly, Altelecom will be privatized by the end of 2002. In Bosnia and Herzegovina, mobile telephony licenses have been awarded, but not fixed line licenses.

The revenue proceeds of telecommunications privatizations will be substantial. The early 2001 sale of the government’s stake in FYR Macedonia’s telephone company generated as much FDI as the preceding decade. Even in countries where privatization has been retarded (Bosnia and Herzegovina, FYR Macedonia and FRY), there is a simultaneous effort to address large enterprise privatization (aluminum, cement, steel) and to begin the legislative and regulatory work for utility privatization (usually electricity). Croatia has adopted laws on the regulatory framework for energy utilities – electric, gas and oil – and established regulatory agencies.

The region has seen mixed progress in the involvement of the private sector in infrastructure services, with the exception of telecommunications. This limited progress is disappointing as the large capital requirements of the infrastructure sector can be met only with a high degree of private participation that includes foreign investment. Donor efforts (especially by the EBRD and the World Bank Group) have been directed towards preparing the ground for private investment through the policy measures and the establishment of appropriate regulatory regimes.

Bulgaria and Romania have made advances with passing legislation permitting private participation, unbundling infrastructure services and creating a legislative and regulatory environment in telecommunications, electric power, railways, and water and sewerage services, but other parts of the region have made minimal progress. In this respect, the region is lagging behind the other transition regions (central Europe and Baltics, former Soviet Union). However, as noted, telecommunications has seen much reform as well as investment from the private sector. Legislation has taken place in Albania and Croatia; in Albania a second GSM license has been awarded to the private sector, and the main fixed line operator in Croatia was privatized. In Bosnia and Herzegovina, all three operators have international licenses, and the separation of

---

20 This section is based on EBRD Transition reports for 2000 and April 2001.
post and telecommunications is under way. In FYR Macedonia, 51 per cent of the fixed line company was sold to a foreign investor. The sale of a majority stake in the Bulgarian telecommunications company is awaited. In Romania, the fixed telecoms market will be fully liberalized in 2003.

In the electric power sector, private management has been introduced into power companies in Albania; and Bulgaria and Romania have established independent regulators – but their functioning in setting tariffs and other activities remains to be tested. Work is in progress in developing the regulatory structures. In both countries, privatization of power distribution can be expected in the near future. In other parts of the region, reform has begun and is expected to show results over the coming year.

In the water and sewerage sector, little progress has been experienced, but in Bulgaria the municipality of Sofia has awarded a concession to an international private investor for the operation of the Sofia water and sewerage system. Little progress has been made in transport (railways and roads) in the region on attracting private capital.

**Fostering the Growth of Small and Medium Enterprises**

Recognizing the critical role played by small and medium enterprises (SMEs) in fostering growth in transition economies, the region has placed a high priority on policies and institutions to create a propitious climate for the formation and growth of such enterprises. In general, attempts have been made to reduce administrative barriers such as registration requirements, permits and discretionary actions by public bodies for investment, payments, imports, liberalize labor market conditions, set up facilitation centers for enterprises, and encourage means of financing as well as reduce the risks associated with lending to SMEs. Donors have also accorded a high priority to technical assistance, partnerships to introduce modern technologies and marketing methods, and to participate in risk-mitigating schemes. Much of the assistance has been devoted to capacity building in local business service providers. A significant thrust of the assistance effort of institutions such as the EBRD and the World Bank has been in SME support.

The SME support framework is most advanced in Bulgaria. It has eased administrative burdens on SMEs (reporting, licensing and registration requirements), developed a network of regional agencies for business facilitation, and put in place a number of financing channels, a credit guarantee fund, a micro credit line as well as long term investment credit line. In Romania, legislation was introduced at the beginning of 2001 to support SMEs. In other countries (Albania and Croatia), policy decisions have been taken and legislation is being prepared to remove administrative barriers and to provide facilitation through public institutions. Initiatives are also being pursued on financing. Matters are at a considerably less advanced stage in Bosnia and Herzegovina and in FYR Macedonia; in the former, SME growth is a question for the two entities, but existing SMEs have benefited from credit lines from donors, whereas in the latter, a strategy has been drawn up, but awaits legislation, and a regional facilitation network is being created.

Within the FRY, Montenegro has devised an ambitious program of SME reform and support with the assistance of a wide range of donors. Besides a program of reduction of
administrative barriers, and the establishment of a decentralized system of facilitation, the authorities have developed schemes to assist in imports of technology and to train entrepreneurs. Work is now underway on designing specific financing and credit vehicles for SMEs. In Kosovo, the current environment is supportive for SME formation and growth with light business registration and other burdens, a favorable tax system, a liberal import regime, and with some donor financed credit lines making small loans. However, the existence of informal taxes and fees and of organized crime pose a burden on enterprises. A significant challenge for the rest of FRY will be to sweep away the ways of doing business of the recent past and to create a liberal, supportive environment for the SMEs.

Reforms in Banking and Finance

The region has made substantial progress in reviving banking intermediation through the establishment of a privately owned banking system and greater confidence on the part of the general public engendered by strengthened banking supervision and deposit insurance schemes. The liquidity and solvency conditions of banks has also improved, with market criteria playing an increasing role in bank decisions in contrast to the past where political and other factors determined the direction and volume of bank lending as well as links between banks and their founding enterprises.

The withdrawal of the state from the banking sector has consisted of closure of insolvent banks and the privatization of solvent ones; both processes have required major portfolio clean ups, given the volume of poor assets inherited from the past, often at significant fiscal cost. Bank privatization is complete in Croatia (with the exception of the postal bank) and is nearly complete in Albania, where work is in hand to privatize the savings bank in late 2002. In Romania, two small banks and one major bank, Banca Agricola have been privatized. Also, the largest commercial bank, the Romanian Commercial Bank, is slated for sale in by end-2002. In Bulgaria, the process is planned to be completed by 2003. Both, Bulgaria and Romania need to focus on efforts to improve and accelerate the asset recovery operations to dispose of bank bad assets. In Bosnia and Herzegovina, preparations to privatize banks have been extremely long drawn out because of lack of resolve in tackling insolvency issues as well as willingness to sell public development banks, but it is possible that both entities will undertake successful bank privatizations in 2002 and liquidations of insolvent banks in Republika Srpska may also take place over this year.

As is to be expected, bank privatization is at a much earlier stage in FRY, but encouraging progress has been made rapidly in restructuring and closing banks. Of the 82 banks, the authorities have closed 19 as insolvent, and merged 15 with other banks to ensure capital adequacy. Moreover, in early 2002, the courageous decision was taken to close the four largest banks, which account for 70 per cent of banking assets in Serbia.

Privatization has opened the door to foreign participation in the banking sector in most cases throughout the region; in addition, a number of foreign banks have made investments in private banks or opened new subsidiaries. This development has done much to increase confidence in banks and, more generally, in the region. Given the close relationships between foreign banks, trade links and foreign investment prospects in general, the entry of foreign banking interests augurs well as a major instrument integrating the region to the rest of Europe.
Past banking crises and insolvencies, confiscation of deposits in some cases, and links between state interests and banking decisions sapped public confidence in banks – particularly in the successor states of Yugoslavia – and drove bank intermediation down to near-negligible levels. The recovery in intermediation being now observed is owed in part to improved banking supervision and regulation and the setting up of credible deposit insurance agencies. Throughout the region, banking supervision methods and capabilities have been greatly strengthened by donor assistance; the unfinished agenda consists of bolstering credibility in the independence of supervisors and in their technical skills as well as in ensuring that supervisors’ decisions are enforced and not thwarted by political interests.

The region has an active program of near term reforms in the financial sector. Albania is to concentrate on saving promotion schemes, establish a rudimentary security market and institute a deposit insurance scheme. Bosnia and Herzegovina is fostering bank consolidation and efficiency through raising minimum capital requirements and supervision methods are being fine-tuned. On entity has operated a deposit insurance agency for the past two years, but now a common deposit insurance agency for both entities is being set up at the state level. Bosnia and Herzegovina also has completed an impressive and complex reform in transferring the payments system to commercial banks. The Bulgarian reform agenda is driven by the prospect of EU accession: regulatory harmonization to EU directives, further strengthening of supervision bodies, greater private sector participation e.g., in insurance and fostering of capital market development are the key elements. It has reformed its deposit insurance scheme to be self-financing.

The Croatian parliament is debating a bill intended to reinforce the supervisory powers of the central bank and its ability to act against banks out of compliance with laws and regulations. In FYR Macedonia, a new law to give independence to the central bank was adopted in early 2002. The authorities now seek to amend the banking law to enforce modern standards of bank behavior and permits foreign participation in banking. The supervision capabilities of the central bank in Romania is being strengthened by technical improvements including an early warning system and regulatory harmonization with the EU. A regulatory body for insurance is being set up. The FRY agenda is a largely unfinished one and a challenging one, given the legacy of politicization and of a resulting banking system in crisis. It is important to rapidly formulate a bank resolution strategy bearing in mind the severity of the position of banks and the competing demands for highly scarce public funds. Significant progress has been made in Montenegro and in Kosovo on establishing sound supervisory capabilities, but deepening intermediation, building up effective insurance markets, and other capital markets remain tasks for the future.
Recent World Bank Technical Papers (continued)

No. 463  Stephen Foster, John Chilton, Marcus Moench, Franklin Cardy, and Manuel Schiffier, Groundwater in Rural Development: Facing the Challenge of Supply and Resource Sustainability


No. 466  Barbara Nunberg, Ready for Europe: Public Administration Reform and European Union Accession in Central and Eastern Europe

No. 467  Quentin T. Wodon with contributions from Robert Ayres, Matias Barenstein, Norman Hicks, Kihoon Lee, William Maloney, Pia Peeters, Corinne Siaens, and Shlomo Yitzhaki, Poverty and Policy in Latin America and the Caribbean

No. 469  Laurian Unnevehr and Nancy Hirschhorn, Food Safety Issues in the Developing World


No. 471  Brian Pinto, Vladimir Drebentsov, and Alexander Morozov, Dismantling Russia’s Nonpayments System: Creating Conditions for Growth

No. 472  Jet B. S. Gill, A Diagnostic Framework for Revenue Administration

No. 473  Esen Ulgenerk and Leila Zlaoui, From Transition to Accession: Developing Stable and Competitive Financial Markets in Bulgaria

No. 474  Ioannis N. Kessides, ed., Hungary: A Regulatory and Structural Review of Selected Infrastructure Sectors

No. 475  Csaba Csaki, Zvi Lerman, and Sergey Sotnikov, Farm Sector Restructuring in Belarus: Progress and Constraints

No. 476  Katherine Terrell, Czech Republic: Labor Market Report

No. 481  Csaba Csaki, John Nash, Achim Fock, and Holger Kray, Food and Agriculture in Bulgaria: The Challenge of Preparing for EU Accession

No. 482  Peter Havlik, Trade and Cost Competitiveness in the Czech Republic, Hungary, Poland, and Slovenia

No. 483  Mojmir Mrak, Communal Infrastructure in Slovenia: Survey of Investment Needs and Policies Aimed at Encouraging Private Sector Participation

No. 484  Csaba Csaki and Laura Tuck, Rural Development Strategy: Eastern Europe and Central Asia

No. 485  Nina Bubnova, Governance Impact on Private Investment

No. 488  Tim Schwarz and David Satola, Telecommunications Legislation in Transitional and Developing Economies

No. 490  Jesko Hentschel and Radha Seshagiri, The City Poverty Assessment: A Primer

No. 491  Daniel Muller-Jentsch, The Development of Electricity Markets in the Euro-Mediterranean Area

No. 492  Tuntivate Voravate, Douglas F. Barnes, and V. Susan Bogach, Assessing Markets for Renewable Energy in Rural Areas of Northwestern China

No. 496  Jerry Lebo and Dieter Schelling, Design and Appraisal of Rural Transport Infrastructure: Ensuring Basic Access for Rural Communities

No. 497  Julian A. Lampietti, Anthony A. Kolb, Sumila Gulyani, and Vahram Avenesyan, Utility Pricing and Poor: Lessons from Armenia

No. 498  Gillian Perkins and Ruslan Yemtsov, Armenia: Restructuring to Sustain Universal General Education

No. 499  Rogrigo A. Chaves, Susana Sanchez, Saul Schor, and Emil Tesliuc, Financial Markets, Credit Constraints, and Investment in Rural Romania

No. 500  Zvi Lerman and Karen Brooks, Turkmenistan: An Assessment of Leasehold-Based Farm Restructuring

No. 501  Aldo Baietti, Private Infrastructure in East Asia: Lessons Learned in the Aftermath of the Crisis

No. 503  Ali Hashim and Bill Allan, Treasury Reference Model

No. 506  Omer Gokcekus, Nick Manning, Ranjana Mukherjee, and Raj Nallari, Institutional Environment and Public Officials’ Performance in Guyana

No. 507  Ranjana Mukherjee, Omer Gokcekus, Nick Manning, and Pierre Landell-Mills, Bangladesh: The Experience and Perceptions of Public Officials

No. 509  World Bank, Kosovo: Economic and Social Reforms for Peace and Reconciliation


No. 512  Geremia Palomba, Milan Vedopivce, Financing, Efficiency, and Equity in Albanian Education
