

**THE INFLUENCE OF
“BEHIND-THE-BORDER”
POLICIES AND INSTITUTIONS**

Roles of Domestic Competition and Governance in the Region's International Integration: A "Two-Way" Street

Introduction

Institutions and incentives that engender competition among enterprises and sound governance practices, including the protection of property rights, are the sine qua non of a market economy. There is much empirical evidence that these are among the most critical factors accounting for differences in the progress of development among the countries of Eastern Europe and the Former Soviet Union since the start of the transition. Among other studies, recent cross-country research that focused on the seven Southeastern European economies and Moldova marshaled firm-level statistical analysis and numerous case studies on individual businesses that provide strong support for such linkages.¹ One of the ways in which the prospects for growth in the Region have been enhanced as a result of stronger competition and governance is through the effects these institutions and incentives have had on the countries' trade performance and other dimensions of international competitiveness.

This chapter assesses the extent to which vigorous interenterprise competition and sound governance are important behind-the-border elements that deepen the international integration of the countries in the Region and leverage the salutary effects that increased trade has on growth in the area—independent of the direct effects of trade policy.

While these linkages have been examined in the literature, they have been analyzed largely on the basis of anecdotal evidence or with respect to a relatively small number of countries. Our approach is to assess these relationships systematically among all of the countries in the Region, bringing to bear the most recent empirical evidence available.²

To be sure, there is actually a multifaceted set of behind-the-border institutions that are central to boosting the growth-enhancing effects of increased trade flows beyond the fundamental ones of competition and governance. These include (i) development of a modern national infrastructure and related institutions for trade facilitation; (ii) liberalization of trade and private investment in, and regulatory reform of, backbone and network services sectors; and (iii) reform of the FDI policy regime to exploit opportunities for global production-sharing network trade. These latter three topics are analyzed in detail in subsequent chapters of this book.³

There are two principal findings from this chapter. First, the notion that two “trade blocs” have been emerging in the Region over the course of the transition—a “Euro-centric” bloc, mainly comprising the EU-8, and a “Russia-centric” bloc, largely comprising the CIS countries—is increasingly apparent in the relationship between the extent of a country’s international integration and the state of its domestic competition and governance regimes. The SEE countries lie somewhere between these two blocs, but many of them are increasingly gravitating to the Euro-centric bloc. Among other findings in this regard, there is clear evidence that a larger number of firms in the EU-8 and SEE countries have managed to gain much greater international exposure and reach new markets for their products and services through exports than have firms in the CIS countries. At the same time, although import competition has induced the efficiency of enterprises throughout much of the Region, its effects have been much stronger among businesses in the EU-8 and SEE countries than among those in the CIS. Moreover, the EU-8 (and, to a lesser extent, SEE) countries have been more successful than the CIS countries in fostering competitively structured markets, and these stark differentials appear to be closely correlated with the success of businesses in these locales in integrating internationally. Finally, where corruption and weak governance are more pronounced, the propensity of firms to integrate internationally is generally weaker.

Second, complementing trade liberalization and other “border” reforms that have been expanding trade flows in the Region, the behind-the-border strengthening of competition and governance appears to be important in both achieving *and* maintaining the economywide gains from these greater trade flows. Without competitive

conditions at home, trade in the Region has become impeded. Indeed, without strong, competitive domestic markets, a country's firms would not be successful traders. Stated differently, the evidence suggests that "success at home breeds success abroad." At the same time, greater exposure to foreign commerce and adherence to commitments under international trade agreements that embody rules-based disciplines appear to engender pressure on domestic firms to become more competitive and efficient; they also appear to curb incentives and opportunities for government officials (as well as businesses) to engage in discretionary behavior and corruption. In essence, then, there is an important two-way, mutually reinforcing relationship between trade policy reforms and strengthening behind-the-border competition and governance.

The chapter is structured as follows. It opens with an analysis of the various channels of international integration that the Region's firms pursue and their effects on the competitiveness of domestic market structure. Next, the patterns of the international integration of the Region's firms are assessed. The roles that barriers to entry and barriers to exit, respectively, play in conditioning the extent of the Region's trade flows are then examined. The Region's firms' relationships with the state and how these affect competition and international integration are also explored. Property rights protection and contract enforcement, as well as the effects of corruption and weak governance on the Region's international integration, are also addressed. Next, we integrate these various dimensions of the domestic business environment and investigate empirically their effects on the performance of a sample of firms in the Region. Finally, we provide an assessment of the institutions that have been developed in these policy areas and highlight where the Region's governments can work to strengthen this capacity. We close the chapter with some policy recommendations.

Interrelationships between Competition, Market Structure, and International Integration

The importance of domestic competition in influencing the international integration of businesses located in the "home" market—controlling for other factors—has long been recognized in the literature in a variety of locales worldwide.⁴ In Eastern Europe and the Former Soviet Union, for countries where domestic competition has been relatively stronger, international integration has been greater; conversely, where competition has been weaker, international

integration has been more limited. New cross-country econometric analysis—covering all of the 27 countries in the Region over the period 1995–2003—suggests that the observed differentials in trade openness (measured as the ratio of the sum of exports and imports to GDP), controlling for tariff levels, are strongly statistically correlated with an index of the effectiveness of a country’s competition policy regime and the extent of the country’s FDI inflows as a percentage of GDP (a measure of the extent of business entry).⁵

One of the primary means through which international integration can improve the competitiveness and productive efficiency of domestic firms and, in turn, the allocative efficiency of the national economy, is by the entry (indeed even the threat of entry) of new foreign competitors. Entry can occur through several channels (see table 4.1). Initially it is usually through imports—that is, sales—and, if successful, subsequently through investment.⁶ Conceptually, the competitive effects depend to a large extent on the *ex ante* and *ex post* structure of the market. Entry can affect market structure not only by altering the relative market shares of sales, but also the number of producers; thus, the effects of foreign business entry on domestic market structure and competition may vary.

When entry occurs through foreign firms *importing* into the market, seller concentration in the domestic market unambiguously decreases as more goods and services become available domestically. All other things being equal, market shares of incumbent firms decrease as a result of competition from imports or falling prices. It is this pressure from imports that creates incentives for domestic firms to become more efficient. Over the course of the Region’s transition, especially in the EU-8 countries, this has been the rule rather than the exception. Foreign firms have introduced new or higher-quality products and services into the domestic market, which created incentives for local firms to restructure and improve their own performance. By contrast, in the CIS countries, import competition has been stifled through protectionist policies, and these salutary impacts have been far more muted.

TABLE 4.1
Channels of Entry and Effect on Domestic Market Structure (Concentration)

Channels of entry	Effect on market concentration			
	Import	Greenfield investment	Domestic takeover	Merger
Entrant sells output in host market	Decrease	Decrease	Neutral	Increase
Entrant sells output abroad	n.a.	Neutral	Increase ^a	Increase ^a

Note: a. Assumes that, prior to entry, existing firm(s) sold output in domestic market.
n.a. = not available.

Entry through foreign *greenfield investment* in new production facilities can increase the number of sellers and increase competition in the "host market," depending on where the output is sold. If sold in the host market, the competitive effects will be analogous to import competition. In countries in the Region where entry by foreign firms has been through such investments, this has helped the breakdown of former state-owned monopolies and increased competition. However, the domestic competitive effects of a new greenfield entrant might be neutral if the firm sells all its output abroad.

Entry through *mergers or takeovers* by foreign firms can have variable effects on domestic competition. If entry occurs through the takeover of an existing firm, the domestic effects on market structure can be neutral if there is simply a change in ownership. However, if the takeover results in sales of output being reoriented to a foreign (for example, a third-country) market, domestic concentration can increase. If entry occurs by a merger with one or more existing firms operating in the host market, the number of producers and sellers will be necessarily reduced and market concentration will increase. Horizontal mergers that consolidate the number of otherwise independent competitors can therefore lead to concerted efforts to raise prices artificially above (and reduce output below) competitive levels.

To be sure, there are also effects on the domestic economy from "outward" international integration by national firms. Through exporting (that is, outward international integration by sales) or making direct investments abroad, domestically based businesses can be exposed to competitive pressures in the host country that may result in corporate-wide efficiencies that affect the competitiveness of operations in the "home market." This can be manifested in a variety of factors, including adoption of new production or processing techniques that lower costs; use of advances in technology transferred from abroad; and utilization of innovative marketing techniques, among others.

In the sections that follow, our empirical assessment of the interaction between domestic competition and international integration of firms in the Region focuses primarily on the sales channel—importing and exporting. We touch only relatively briefly on the investment channel, because FDI is discussed in detail in chapter 7.

Variation in International Integration among the Firms of the Region

Import penetration. In countries in the Region where import penetration has been greater, there is new empirical evidence from firm-level

surveys that businesses are more prone to reduce production costs and innovate. Not surprisingly, this finding is strongest for firms of smaller scale and those with greater private ownership, often operating in less concentrated markets. Particularly telling is that private *foreign-invested* firms operating in host markets have been more likely to react to import competition than have their domestically owned counterparts (see table 4.2). This suggests that, on average, a foreign firm operating in a country in the Region may well be more “fleet-footed” than domestic incumbents; this finding is consistent with others in the literature analyzing import competition in other regions of the world.

More important, in the countries where there has been less progress in fostering a competitive market environment—especially in the CIS—the effects of imports on business decisions have been more muted than in countries, such as those in the EU-8 and, to a lesser extent, SEE, where markets are more competitively structured as a result of more advanced reforms. Thus, while import competition is inducing efficiencies, its effect appears to be weaker in the CIS countries than in the rest of the Region.

Export propensity. There is a trend of higher export intensity at the firm level in the EU-8 and SEE countries than in those of the CIS (see figure 4.1). Export receipts are the smallest among surveyed firms in Uzbekistan and Kazakhstan, where the average firm exports below 5 percent of annual sales, and largest in Slovenia, where the average firm exports more than 20 percent of total annual sales.⁷ In the Region’s countries where there has been greater introduction of private sector participation in the economy—whether through privatization of existing firms or through de novo investment—the export intensity by businesses (that is, the percentage of export revenues as a share of total sales revenues) tends to be higher.

TABLE 4.2
Importance to the Region’s Businesses of Competition from Imports

Percentage of surveyed firms in 2002 indicating that competition from imports is very or extremely important

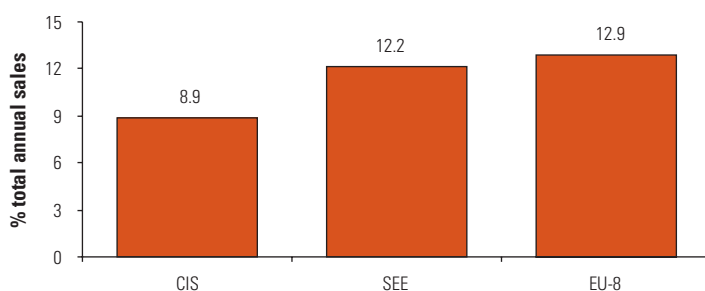
Ownership	CIS	SEE	EU-8
Domestic	27.1	37.6	30.5
Foreign	27.3	48.5	40.0

Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

FIGURE 4.1**Export Intensity of Businesses Is Greater in the More Advanced Countries**

Average export revenues as a share of total annual sales, 2002



Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

Moreover, export intensity tends to be greatest for foreign-invested firms than for domestically owned businesses (see table 4.3). This is further evidence of the two-way relationship between international integration and behind-the-border competition: foreign firms investing in countries in the Region are more prone to react to import competition than are their domestic counterparts, and at the same time they are more likely to further their host countries' integration into world markets than are domestic businesses.

Consistent with the notion that less competition exists in the typical CIS domestic market than in other markets in the Region are data indicating that over the past decade, firms located in the EU-8 countries have exported to more numerous "new" markets than have firms in Central Asia and the Caucasus (see table 4.4). Similarly, a larger share of surveyed firms in the EU-8, closely followed by the firms in SEE, have been engaged in export compared with the relative share of exporting firms in the CIS.

TABLE 4.3**Export Intensity**

Average export as a share of total annual sales, 2002

By ownership	Average exports in sales
Domestic, of which:	
State	11.8
Privatized	14.9
De novo	8.9
Foreign	20.2

Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. Countries included are the Region and Turkey.

TABLE 4.4
Export Propensity by Sub-Region

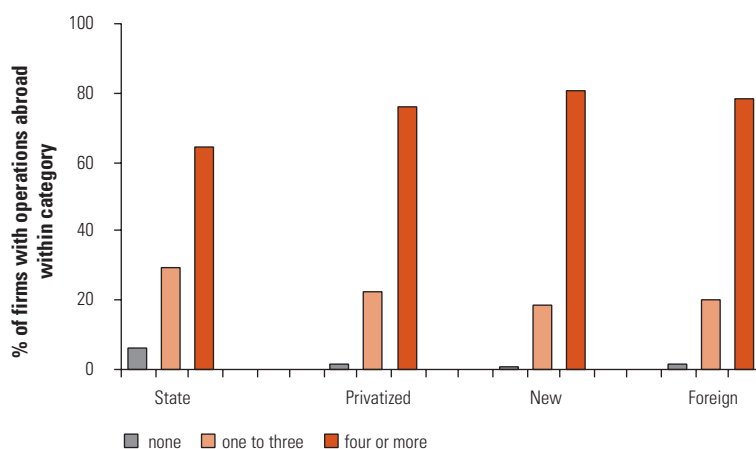
Sub-Region	Exporter (% of all firms)	Exported to a new country between 1998 and 2002 (% of all firms)
CIS	22.1	10.9
SEE	32.3	18.6
EU-8	36.3	16.9

Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

Outward international integration via FDI abroad. By the same token, countries in the Region whose markets are more competitively structured—as measured by the number of competitors in various markets—tend to have more firms integrating into global markets through outward direct investment than do countries where markets are less competitively structured. On average, among recently surveyed firms in the Region, domestic state-owned enterprises tend to have less extensive direct investments abroad than do counterparts with other ownership forms—whether privatized, de novo private, or foreign-invested firms (see figure 4.2). To the extent that there are likely to be more infrastructure and utility businesses in the state-owned category

FIGURE 4.2
Number of Competitors and Operations Abroad



Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. Countries included are the Region and Turkey.

than in the others, this result is to be expected. More important, regardless of firm ownership structure, as the number of competitors in the local market increases, there is a greater propensity for businesses to integrate abroad. Consistent with the broader literature, this suggests that as prospects for profits "at home" become more constrained, the drive for market opportunities abroad increases.

Impacts of Entry and Exit Barriers on International Integration

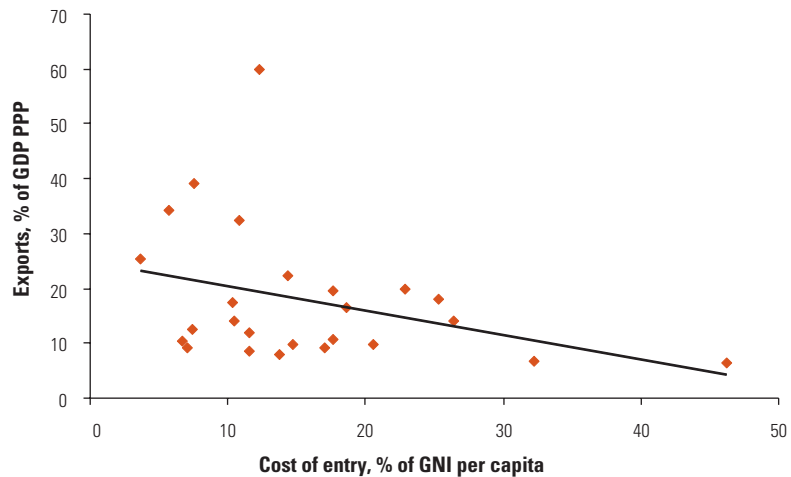
How do the underlying elements of market structure that determine the intensity of domestic competition relate to the extent of international integration by businesses in the Region? There is fairly clear evidence that countries in the Region that have high barriers to entry for business start-ups or high barriers to exit for money-losing firms are less integrated internationally and less able to capitalize on reallocation of capital and human resources stemming from exposure to trade so as to promote growth.

In-Country Barriers to Entry

Several worldwide studies in the literature have advanced the idea that high entry costs and cumbersome regulations not only make imports and inward foreign direct investment difficult, they also deter exports from enterprises operating in a country's domestic economy.⁸ For Eastern Europe and the Former Soviet Union, the empirical evidence suggests that in the countries where the cost of entry is highest—measured, for example, by the time and resources required to get a new business license and registration—international integration is being hindered. The data suggest that the easier the new business entry into the Region's countries, the higher the export volumes (see figure 4.3).⁹

Worldwide, overcoming barriers to entry in a market by foreign firms requires that such firms have some form of competitive advantage because, by definition, domestic firms are more familiar with local market conditions. Such an advantage is usually in the form of firm-specific or proprietary assets: technological, organizational, or marketing knowledge; goodwill; or brand naming.¹⁰ In fact, these factors appear to play a significant role in determining the profitability of firms operating in the Region. Of course, local firms also face barriers to entry in domestic markets, and it is important to distinguish between those and the barriers that firms engaged in international integration into the Region face to see whether and how they differ. New data collected through business surveys offer an opportunity to

FIGURE 4.3
Export Levels (2003) and Cost of Entry in the Region



Sources: Export data based on UN COMTRADE Statistics and IMF DOT Statistics; cost-of-entry data from Doing Business (2004).

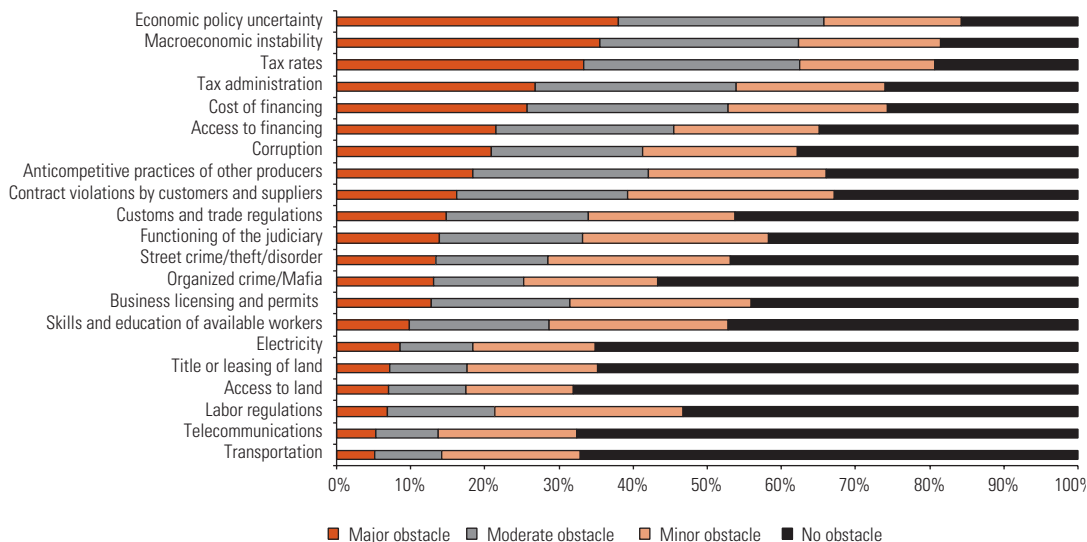
Note: GNI = gross national income. Each diamond represents one country in the Region; Turkey is also included.

assess which barriers are more important for each set of firms, thereby shedding light on the roles of various entry barriers in international integration.

For domestic firms, the data suggest that economic policy uncertainty, macroeconomic instability, and high tax rates are seen as the most severe entry barriers (see figure 4.4). More than 30 percent of the domestic businesses surveyed in the Region see these three policy-related factors as “major obstacles” to business development and operations. Interestingly, so-called administrative barriers are not perceived as the most critical impediments for starting businesses by domestic firms in the Region. This finding, at odds with the conventional wisdom of the 1990s and as recently as a few years ago, is also supported by recent empirical evidence at the sub-Regional level.¹¹

For foreign firms, however, different entry barriers appear to be more impinging on business start-ups. Local anticompetitive business behavior and contract violations are seen as “major obstacles” by more surveyed foreign firms than other potential barriers to entry in the Region (see figure 4.5). Anticompetitive behavior and contract violations are perceived by roughly 40 percent of the surveyed foreign businesses as major obstacles. Thus, the most severe barriers to entry facing firms engaged in international integration in the Region are more of an institutional nature—and more specific—than those facing domestic firms. These findings suggest important policy impli-

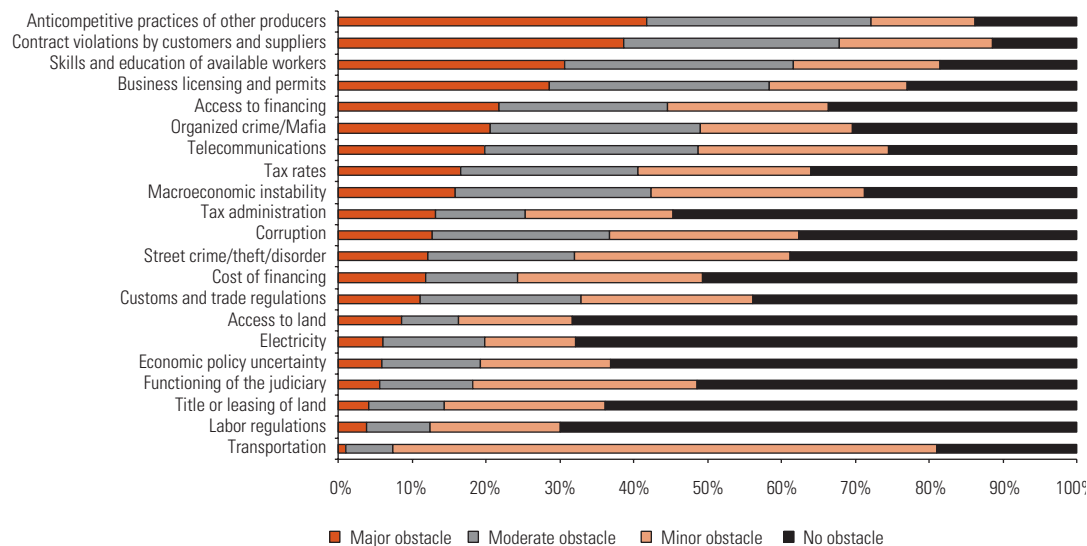
FIGURE 4.4
Severity of Entry Barriers in the Region, Domestic Firms, 2002



Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. Countries included are the Region and Turkey.

FIGURE 4.5
Severity of Entry Barriers in the Region, Foreign Firms, 2002



Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. Countries included are the Region and Turkey.

cations for deepening integration in the Region: an emphasis on different reforms to reduce barriers to entry may well be needed if countries are to be more successful in integrating into international commerce.

In-Country Barriers to Exit: “Soft Budget Constraints”

Worldwide, “soft budget constraints” are the main mechanism through which unviable firms remain in the market.¹² There is abundant evidence over the course of the Region’s transition suggesting that soft budget constraints impede the exit of money-losing firms from the Region.¹³ Through greater fiscal and financial discipline (“hardening” of budget constraints), failing or value-subtracting firms in the Region have faced incentives to restructure or exit the market. The more difficult it is for such firms to go out of business, the less likely it is that the domestic market structure is competitive or that resources are allocated efficiently. Value-subtracting firms tie up productive assets, and in this way their presence deters entry of new business start-ups, distorts resource allocation, and constrains firm performance, including integration into the international marketplace. Here, we investigate soft budgets arising from two factors: (i) arrears in taxes, wages and social payments, utility payments, and payables to input suppliers and (ii) subsidies.

Recent survey data indicate that the incidence of arrears is greatest among firms in Central Asia and other CIS countries, although firms elsewhere in the Region also face this problem. Box 4.1 illustrates such a case involving an SEE firm in Republika Srpska. Across firms of different ownership forms, arrears are lowest among firms with significant private ownership, including those that are integrated internationally—that is, foreign-invested businesses. Significantly, there is evidence for the Region that in the countries where arrears are larger, the export performance (measured by the share of exports in GDP) is lower (see figure 4.6). This reaffirms the direct linkage between behind-the-border conditions and success in international integration among the countries in the Region: where there is a lack of domestic competition, firms’ abilities to penetrate foreign markets are dulled.

Regarding subsidies, available firm-level survey data suggest that the incidence of direct business subsidies is greater in the CIS than in the EU-8 and SEE. On average, direct subsidies received by firms for the Region as a whole amount to between 10 and 15 percent of their sales revenues (see figure 4.7). More important, these data also show that the majority of such subsidies come from regional or local, rather

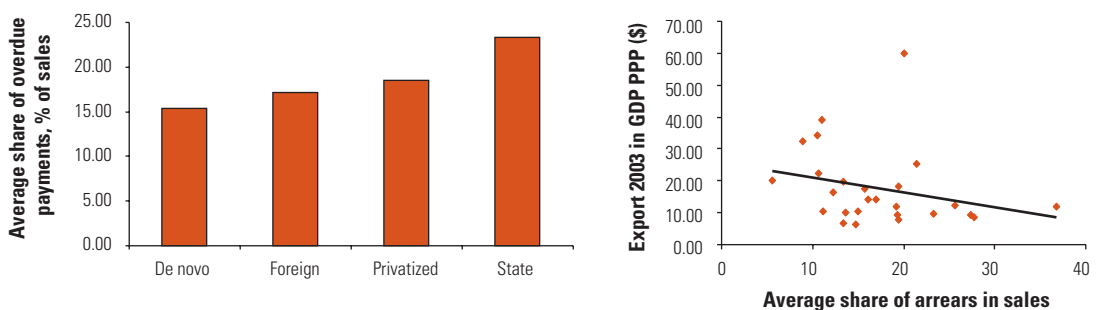
BOX 4.1

Arrears as Constraints on Firm Performance in SEE

The case of a large furniture manufacturer in Republika Srpska provides an illustration of how a poor business climate can hinder exports. Labor regulations and unresolved ownership status are the key factors affecting the performance of the firm in question. The company carries on its books 550 employees, of whom only 150–250 actually work. The company has been in arrears with pension contributions since 2000, which makes its workers ineligible for retirement. Moreover, political constraints prevent the company from laying off employees. There is little hope that the company will be privatized, as its total debt exceeds the market value of its assets by more than 50 percent. The company is in debt to the state, the IFC, and a commercial bank. Moreover, it has wage arrears and owes money to its suppliers. Currently, a large portion of its transactions take the form of barter. The unresolved labor situation leads to a vicious cycle: keeping the waitlisted workers on the books raises the arrears vis-à-vis the state and thus decreases the chances of privatization taking place. While the company's experience and reputation would allow it to receive additional orders from large multinationals, such as IKEA, fulfilling such orders is not possible because of a lack of working capital. In the 1990s, the company used to sell one container of products to IKEA every day. Currently, only two containers are shipped per month.

Source: World Bank staff.

FIGURE 4.6
Arrears and International Integration in the Region

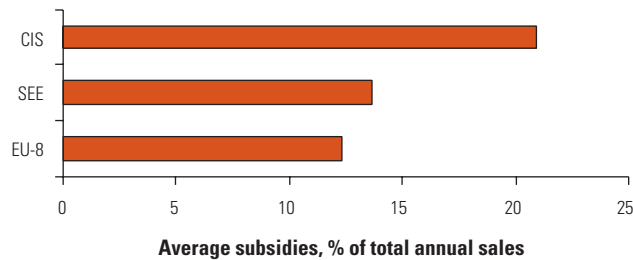


Sources: BEEPS2 and IMF DOT data.

Notes: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. Countries included are the Region and Turkey. The sample excludes firms with no overdue payments.

than central, governments. This makes the task of their reduction more challenging, in light of the difficulty of inducing change across multiple jurisdictional levels of government.

Taken together, the findings on arrears and subsidies corroborate the notion that the CIS countries have carried out less vigorous meas-

FIGURE 4.7**Size of Subsidies by Sub-Region, 2002**

Source: BEEPS2.

Notes: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. The sample excludes firms with no subsidies.

ures to induce competitive restructuring and ownership change in the enterprise sector than have other parts of the Region. Given that the CIS countries on average have privatized fewer corporate assets than other countries in the Region, it is not surprising that the evidence indicates that the least competitively structured markets in the Region are those heavily populated by domestic, state-owned firms, whereas the most competitively structured markets are those in which a greater number of foreign private firms operate.

At the same time, the data show that from a sectoral perspective, the Region's markets in the energy and natural resource sectors, as well as in infrastructure, tend to have the fewest competitors and highest concentration, because in these sectors state ownership is most dominant. In contrast, the trade and retail sectors, where private ownership is the rule and state ownership the exception, are populated by the greatest number of competitors.

Market Dominance and International Integration

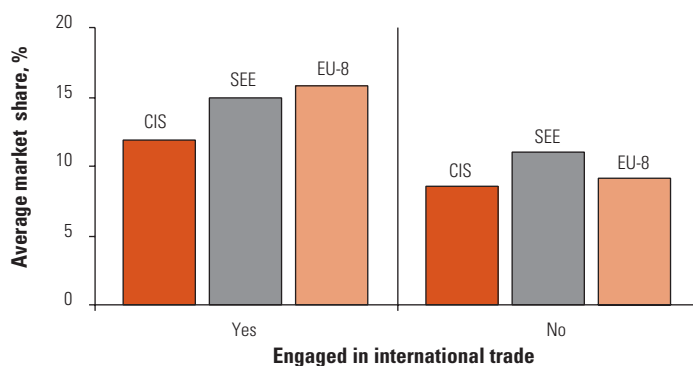
As elsewhere in the world, there is considerable diversity in the extent to which the Region's markets are populated by firms that have achieved dominant positions. This variance in the competitive structure of domestic markets can give rise to intra-Regional differences in the extent and consequences of international integration that take place.

How does domestic competitiveness affect the Region's firms' ability to integrate internationally? Recent survey data suggest that, throughout the Region, on average, firms with larger domestic market shares tend to have a higher propensity to export or import (see

figure 4.8). Indeed, the data show this to be the case across all of the constituent parts of the Region. However, firms in the EU-8 that engage in export or import activity tend to have larger market shares on average than their counterpart firms in SEE, which in turn have larger market shares than exporting/importing firms in the CIS. This finding suggests that all other things being equal, firms that have been successful at home are those most likely to be successful abroad. This notion is consistent with the broader literature on the determinants of international business performance.¹⁴ It also has important implications for national policies aimed at improving a country's international competitiveness: fostering a competitive business environment domestically can have payoffs globally.

However, market dominance can also cut the other way. The sustainability of new entrants able to penetrate markets already populated by dominant firms will be determined, in large part, by the extent to which anticompetitive conduct—in terms of price setting, production decisions, investment activities, and cozy relations with government, among other things—by the incumbent firms with large market shares is practiced. There is evidence that when there is a significant share of firms that possess market dominance and face relatively few competitors in the Region, there is a greater ability for incumbent businesses (whether domestic or foreign-owned) to exercise discretionary behavior—conduct that is generally at odds with the notion of competitive practice, where (in theory) firms are “price takers” and not “price makers.” Available survey data on the price sensitivity for firms in the Region show that businesses with the

FIGURE 4.8
Market Share and International Integration



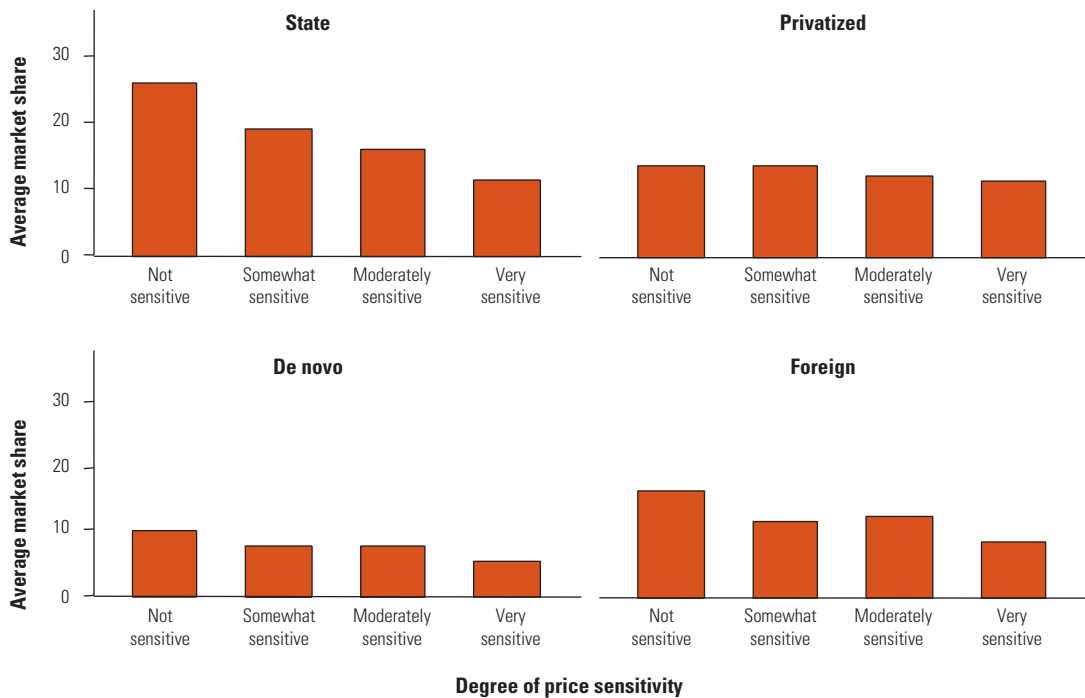
Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

largest market shares—generally the state-owned firms—indicate that they are the least sensitive to price changes (see figure 4.9).¹⁵ On the other end of the spectrum, firms with the smallest market shares—generally de novo firms and foreign-invested firms—indicate that they are the most sensitive in their business decisions to changes in prices. Indeed, where there is a decrease in market dominance, we consistently observe a larger proportion of firms—across all ownership categories—that become increasingly sensitive to price changes.

Market dominance can arise as a result of extensive horizontal integration—the consolidation of multiple enterprises under one common corporate roof—within a market. Such integration is most pronounced in the CIS because of the legacy of central planning and agglomeration.¹⁶ Although horizontal integration can exploit economies of scale and scope in certain sectors, such as utility services or other infrastructure sectors, an excessive level of such integration in most manufacturing sectors is likely to have little economic or technological justification. In such cases, in markets

FIGURE 4.9
Market Share and Price Sensitivity in the Region, by Ownership Category, 2002



Source: BEEPS2.

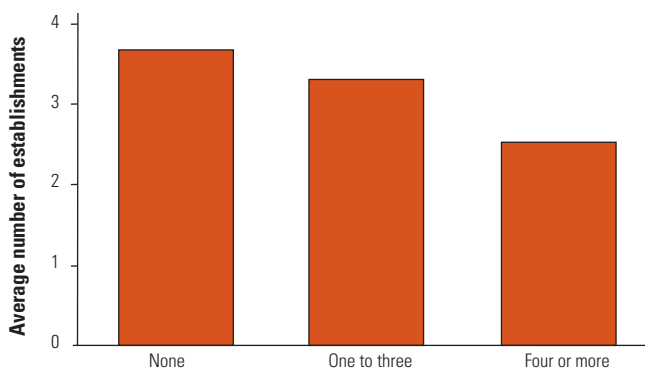
Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. Countries included are the Region and Turkey.

where a concentrated number of sellers already exist, dominant incumbents engaging in extensive horizontal integration can create opportunities to exercise market power and anticompetitive behavior. Firm-level data for the Region suggest that there is a clear negative association between the number of competitors firms face and the extent of horizontal integration. Among surveyed firms, those with no competitors have on average close to four business establishments within the boundaries of a national market, while firms with more than four competitors are less horizontally sprawled (see figure 4.10.)

Transactions with the State

Purchases of goods and services by national governments—through participation in “state orders” or other forms of public procurement—in a number of the Region’s countries constitute a significant portion of business transactions for many firms and, as a result, can have a significant impact on competition in the market. In turn, this can have an influence on the extent and pattern of the Region’s international integration. Not surprisingly, firms’ commercial ties with the state are more extensive in CIS countries relative to other countries of the Region. For example, the average Uzbek firm surveyed earns about 34 percent of sales revenues through public procurement, while the average Belarusian, Kazakh, and Tajik firms surveyed earn between 22 and 24 percent of sales revenues from such transactions.

FIGURE 4.10
Competition and Horizontal Integration in the Region



Source: BEEPS2.

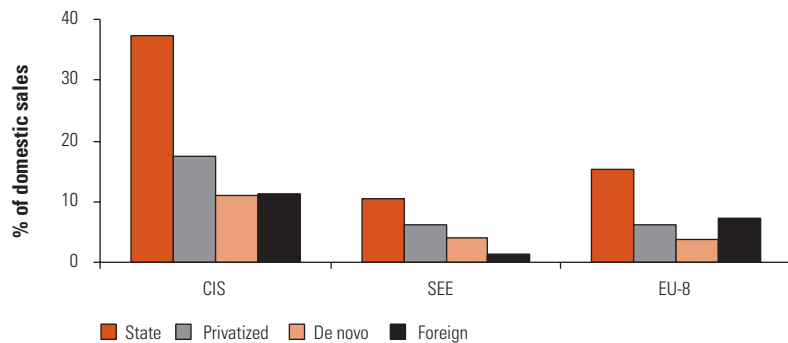
Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. Countries included are the Region and Turkey.

These profiles contrast significantly with EU-8 and SEE businesses. For example, the average surveyed firm operating in FYR Macedonia or the Czech Republic earns 3 percent or less of sales revenues from government purchases. On average, about 10 percent of combined sales revenues of all of the surveyed firms in the Region are earned from purchases by government entities.¹⁷

While there is a relatively clear trend across the Region of a heavy reliance on sales to governments by domestically owned enterprises—especially state-owned and privatized enterprises—relative to foreign-owned firms operating in the market, this is most strikingly evident in the countries of the CIS (see figure 4.11). In contrast, in the EU-8 countries, although state-owned enterprises still dominate government purchases, there is much more balance across firm ownership categories. This suggests a more competitive public procurement market in that part of the Region.

Still, as elsewhere in the world—including in the OECD countries—the Region’s governments discriminate against foreign players, often for political reasons. In varying degrees, the Region’s governments follow rules and procedures for awarding contracts and making purchases that favor only selected—and often only domestic—market participants (see box 4.2). Adherence to WTO-based rules regarding government procurement that provide for open competition, transparent procedures, and nondiscriminatory treatment to domestic and foreign firms alike can be an important reform in minimizing existing distortions in international trade and investment in the Region and in fostering international integration.

FIGURE 4.11
Commercial Ties with the State of the Region’s Firms



Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. Average sales to governmental entities by ownership type and by sub-Region, 2002.

BOX 4.2**The "Home-Grown" Construction Sector in SEE: Evidence from Business Case Studies**

Most of the sales of construction firms in SEE are concentrated in the domestic market and, in some cases, in the municipal market in which they are located. Bidding on government and (to a lesser extent) private contracts with neighboring or more distant countries is increasingly attempted but is not always successful. Neighboring country firms complain that they are subject to discrimination as foreign enterprises and that preference is shown to local companies, especially in the case of public procurement contracts. Consequently, home governments have sought to help their domestic firms win public contracts abroad through political persuasion.

In general, SEE construction firms find home government contracts quite attractive—some companies do more than 70 percent of their business with the government. However, the "competitive" selection process is not always transparent, and often the government agencies do not pay promptly, necessitating litigation. Some firms note that to be successful in the domestic public procurement construction business, they must be politically well connected. In some cases, ministries ask for pro bono construction, design, or engineering advice, which the firms readily give in order to build goodwill.

A few construction firms concentrate on winning construction contracts from domestic private companies or foreign private multinational subsidiaries located in the local market. Interestingly, complaints about the lack of transparency in the contracting process are voiced here as well, but these complaints are much more muted than they are in the case of domestic public procurement contracts. Some of these firms are interested in pursuing government contracts, but without a public procurement law in place, they are reluctant to do so.

Source: Broadman et al. 2004.

Property Rights Protection and Contract Enforcement

As has been well documented in research over the course of the transition, there is in many parts of the Region a lack of security in the commercial contracting process. Faced with this obstacle, many enterprises—not only foreign, but also domestic—have had to face the resulting higher cost of doing business (and in some cases have voted "with their feet" and taken their business elsewhere). In so doing, however, efficiency is lost in the transaction process, and resources are diverted from more productive activities. There is evidence that where there is relatively weak contract enforcement in the Region, international integration is relatively muted. Data from case studies of individual businesses in the Region reveal that foreign firms

lose confidence in the durability of their transactions when property rights in the country they export to or invest in are not adequately protected.¹⁸ On the other hand, domestic firms that want to engage in international trade through imports or attract foreign investors are constrained in doing so when the institutional and legal systems in their home countries cannot adequately protect and guarantee their contractual rights. International transactions become more risky and increase the likelihood of commercial disputes.¹⁹

Given the sizable commercial risks in many parts of the Region engendered by nascent legal institutions, what methods do firms operating in these countries use to reduce such risks? Firm-level survey data show an appreciable incidence of transacting on the spot or of using prepayment. Not surprisingly, the use of these mechanisms varies significantly within the Region. For example, surveyed firms in much of the CIS, especially Azerbaijan, Belarus, Tajikistan, Ukraine, and Uzbekistan, require prepayment for at least 40 percent of their sales. In contrast, surveyed firms in Armenia, Bulgaria, Hungary, and Slovenia, on average, use prepayment in less than 10 percent of sales. Box 4.3 illustrates how advance payments are used to diminish the risk of renegeing on a contract in Bosnia and Herzegovina.

While genuine progress has been made in some of the Region's countries—most notably the EU-8—regarding the establishment of relatively well-functioning, market-based legal institutions that facilitate resolution of commercial disputes, in many other countries—largely the CIS but also a significant portion of SEE—such problems are either resolved through extra-legal means, are not resolved, or go unrecorded. For these countries, establishing credible legal institutions for commercial dispute resolution is a major unfinished agenda item.²⁰

Governance and Corruption

Worldwide, weak governance and corruption impede international integration and the realization of the benefits of open trade. At the end of the day, consumers pay higher prices as the (tangible and intangible) costs of corruption are internalized into the final cost of internationally traded products or services. Product or service quality can also suffer. The real costs associated with corruption may well diminish the ability of domestic firms to export abroad and deter foreign firms' decisions to export to (or invest in) the domestic market. On the other hand, greater international integration, especially when governed by legally binding rules-based trade agreements, such as WTO membership, can *improve* the quality of domestic governance institutions and

BOX 4.3**Using Prepayment to Reduce Contractual Risks in Bosnia and Herzegovina**

Companies interviewed as case studies often mention prepayment as a means of forestalling business disputes. Asking clients to pay a considerable proportion of the price in advance seems to be the norm in many SEE firms, regardless of sector, size, or ownership characteristics. A state-owned steel foundry in Bosnia and Herzegovina described three recent cases of business disputes and how it went about resolving them. In two of the cases, the firm was the creditor, and in one case, it was the debtor. One of the former cases is quite telling. The company produced goods to order for a Serbian metalworking company and delivered half of the order in 1995, but the company did not receive payment at the time. Several years ensued, and the Serbian firm closed down production. Even though the Bosnian company attempted to negotiate with the Serbian firm's administration on several occasions, the debt was still due seven years later. The Bosnian company's management is planning to pursue this case through the Bosnian court system. Even though a written contract exists, the management still faces uncertainty as to the duration and costs of the court procedure.

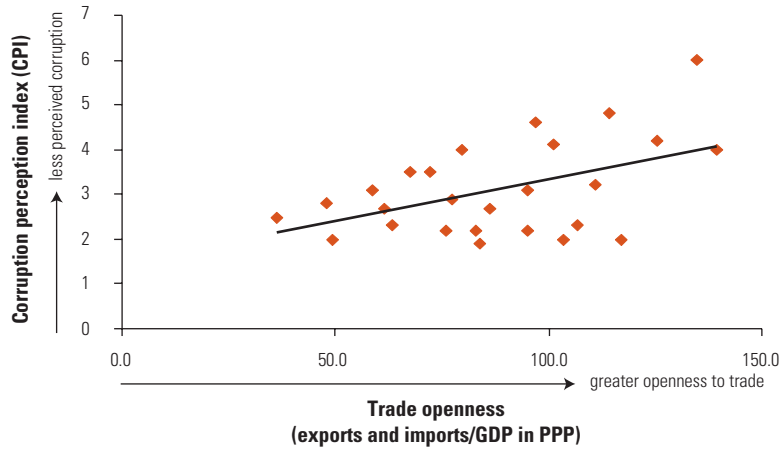
The risk associated with contracts for goods made to order is well illustrated in this case. The other half of the goods made to order are still stocked in the steel foundry's warehouse, but they have no alternative commercial use. Given this situation, it is hardly surprising that the same steel company now requires a 50 percent advance payment on its orders, with the remaining 50 percent falling due within five days after delivery. Furthermore, new clients must pay the full price of the model good in transactions for which the good is made to the client's order. Subsequent deliveries and payments are scheduled in five installments. In this manner, transactions and payments are structured to avoid the occurrence of payment disputes.

Source: Broadman et al. 2004.

help reduce opportunities for discretionary behavior and corruption. Evidence in the literature supports these propositions: countries that engage in freer trade tend to have better-quality institutions, and, conversely, countries with better-quality institutions tend to engage in freer trade.²¹ Such findings suggest that there is a two-way, mutually beneficial interaction between increased international integration and improved governance and reduced corruption.

How consistent are these global findings with evidence from the Region? The incidence of corruption among countries in the Region is quite varied. More important, new data suggest that these differences appear to be associated with the extent of international integration— independent of the level of a country's development—among the countries in the Region (see figure 4.12). In particular, countries where corruption is more prominent tend to be those with the least amount

FIGURE 4.12
Greater Trade Openness and Reduced Corruption in the Region:
A Two-Way Relationship



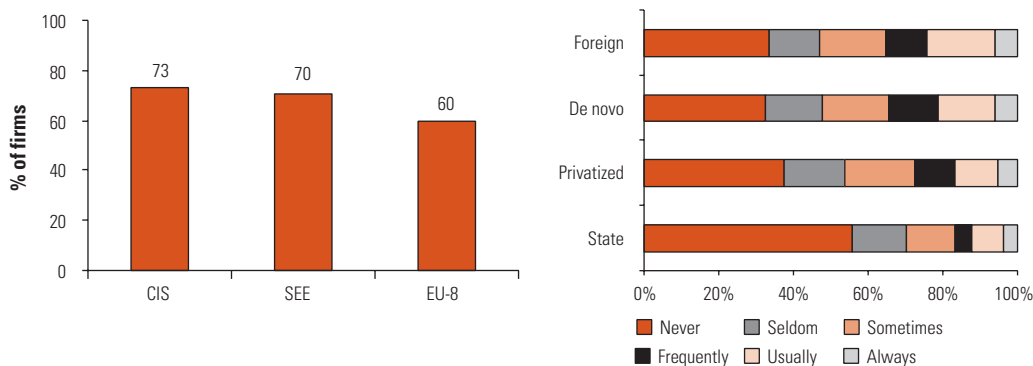
Sources: CPI from Transparency International; export and import in output (PPP) data from World Bank World Development Indicators.

Note: CPI ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. It is a composite index, drawing on corruption-related data in expert surveys carried out by a variety of reputable institutions. It reflects the views of business people and analysts from around the world, including experts. The higher the CPI, the lower the level of perceived corruption.

of integration into the world economy. The scatter plot indicates a positive association between greater international integration and less (perceived) corruption. These results are bolstered by multivariate regressions that indicate this positive association remains statistically significant even when the level of a country’s development (measured by GDP per capita) is taken into account.²²

One widely used measure of the quality of governance institutions is the use of irregular payments by businesses with the aim of “greasing the system.” Firm-level analysis shows that there is an appreciable expectation among businesses operating in the Region that in order to effectively get things done in dealing with public officials, bribes need to be paid, with the frequency of such activity varying across the countries of the Region and the type of firm ownership. The incidence of bribes tends to be the highest in the CIS, followed by SEE countries; it is lowest in the EU-8 (see figure 4.13). More than 72 percent of surveyed firms in Albania, more than 63 percent of surveyed firms in Tajikistan, and more than 62 percent of surveyed firms in Georgia and Russia indicate that they pay bribes to ease their business transactions. More important, the data reveal that a greater proportion of the Region’s foreign-owned firms—that is, those businesses that have integrated internationally—indicate that they pay bribes with greater frequency than do domestically owned privatized or

FIGURE 4.13
Frequency of Bribes by Sub-Region, 2002



Source: BEEPS2.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

state-owned firms. Indeed, more than one-half of the domestic state-owned firms surveyed indicate that they never resort to bribes. While this may suggest that domestic firms do not engage heavily in explicit payments to facilitate dealings with the state, it does not imply that such firms do not use other, perhaps less explicit, means to accomplish the same objective.

Impact of Competition and Governance on Firm Performance in the Region

The analysis in the foregoing sections suggests a variety of ways in which the extent of interenterprise competition and the soundness of governance affect (or are affected by) the degree of international integration of firms operating in the Region. To what extent do competition and governance systematically influence the business performance of such firms, which, in turn, affects the degree to which greater international integration and open trade can be leveraged to have salutary effects on job creation, income, and growth in the Region? In other words, all other things being equal, is there a systemic difference in the performance of the Region's firms that have participated in international integration to a greater degree than those who have not?

In order to test these hypotheses, a regression model of firm-level determinants of business profitability was estimated on approximately 6,000 firms operating in the Region. (The data used were from the 2002 BEEPS2 survey; see the annex for a description of the

dataset). The specification of the model is consistent with mainstream models of firm profitability widely found in the industrial organization literature.²³

Two variables were constructed to assess how international integration affects firm profitability: one that specifies whether the firm engages in export or import activity—*international trader*; the other, whether the firm is a foreign-owned business (operating in a “host market” in the Region) and thus has necessarily integrated internationally—*foreign ownership*.²⁴ Drawing on the arguments advanced in the preceding analysis, a series of variables chosen to capture the impact that certain dimensions of competition and governance are likely to have on firm performance was included. The variables depicting a firm’s competitive position include the extent of the firm’s *market dominance*, the degree to which it faces *low entry barriers*, the extent of the firm’s *horizontal integration* and *vertical integration*, and two measures of the *softness of budget constraints* faced by the firm. The measures for governance are the extent to which the firm has *transactions with the state* and the degree to which the firm’s commercial conduct reflects *contractual risk aversion*. Finally, firm-specific control variables that are also likely to impact profitability were included in the model: the extent to which the firm engages in *product differentiation*, the firm’s *technological prowess*, and the firm’s *size*. (The regression results are reported in table 4.5.)

The empirical results offer a number of insights. First, the estimated coefficients on the two variables depicting international integration are positive and statistically significant. This suggests that, all other things being equal, international integration enhances the performance of firms in the Region.

Second, firms in the Region that have achieved larger market shares tend to have higher profitability than those with smaller market shares, after controlling for firm size and other characteristics, such as vertical and horizontal integration, a finding consistent with the larger empirical literature.²⁵ In addition, the regression results suggest that relatively high entry and exit barriers have a significant and negative impact on firm performance.²⁶

Finally, the estimated coefficient on intensity of business-state transactions is positive and statistically significant, suggesting that closeness with government—a measure of governance—“pays off.” However, the estimated coefficient on the measure of property rights protection—utilization of prepaid sales, to depict degree of confidence in contractual relationships—does not differ statistically from zero.

Overall, the estimated model gives credence to the notion that the Region’s firms that engage in international integration tend to out-

TABLE 4.5
Determinants of Business Profitability in the Region, 2002

Explanatory variables	Dependent variable Profit-to-sales ratio		
	Estimated coefficient	t test	Level of significance
Market dominance (market share)	0.002	2.44	**
Low entry barriers (price sensitivity)	-0.098	-7.36	***
Horizontal integration (number of establishments)	0.003	1.48	
Vertical integration (share of sales to a parent company or affiliated subsidiary)	0.001	1.27	
Softness of budget constraints (share of arrears in total sales)	-0.006	-4.41	***
Softness of budget constraints (share of subsidies in total sales)	-0.004	-1.73	*
Transactions with state (share of sales to government agencies)	0.001	2.15	**
Contractual risk aversion (share of prepaid sales in total sales)	0.000	0.76	
International trader (exporter or importer)	0.052	1.73	*
Foreign ownership (foreign firm) ^a	0.546	7.10	***
Domestic ownership (de novo firm) ^a	0.563	12.13	***
Domestic ownership (privatized firm) ^a	0.304	5.58	***
Product differentiation (share of advertising in total sales)	0.009	2.95	***
Technological prowess (share of R&D in total sales)	0.008	3.10	***
Size (number of employees)	0.000	0.01	
Constant	3.670	31.74	***
Number of observations	5,786		
R-squared	0.09		

Source: Author's calculations using BEEPS2 data.

Note: Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region. Countries included are the Region and Turkey.

a. The estimated coefficients on these variables indicate the performance of the firms in these ownership categories relative to that of domestic state-owned firms. * = Statistically significant at the 10% level. ** = Statistically significant at the 5% level. *** = Statistically significant at the 1% level.

perform those that do not, all other things being equal. Moreover, where the business environment allows firms to compete with one another and provides for effective incentives for sound governance, there is better firm performance, all other things being equal.

Institutional Capacity for Competition and Governance

The evidence presented above indicates that enhancing both domestic competition and governance in the Region's economies is likely to be an important objective not only for deepening international integration but also for capitalizing on and leveraging the economywide benefits that such integration can engender for the countries. If this conclusion is correct, one implication for domestic policy makers is clear: in an increasingly globalized and competitive international economy, steps to enhance growth and improve national welfare should focus squarely on developing and strengthening the behind-

the-border institutional capacity for competition and governance. Strengthening these two areas will help domestic policy reforms be implemented effectively, help businesses compete more efficiently for international market share, and help countries garner greater foreign investment. To that end, what is the state of such institutions in the Region today, how do countries in the Region compare along these lines, and what are the priority areas for institutional capacity building in the Region?

Competition Policy Institutions

A country's competition policy regime comprises laws, rules, regulations, standards, and instruments to prevent and reduce or eliminate the exercise of market power by firms who possess dominant market positions or engage in restrictive business conduct so as to deter entry by new rivals or drive from the market firms that otherwise are profitable. Such conduct includes monopoly pricing, abusive or predatory practices, anticompetitive mergers, and price fixing, among other actions.²⁷ As indicated by the firm-level survey data presented earlier, foreign firms operating in the Region perceive such conduct as especially pernicious to cross-border integration and entry. Box 4.4 illustrates the use of anticompetitive practices from a business case study in Serbia and Montenegro. Taken together, the evidence suggests that greater attention should be paid to strengthening domestic competition policy institutions in the Region.

Despite the increasing number of countries in the Region with sound competition laws, there is almost universally weak enforcement of these instruments and substantial variation in implementation across the Region. Figure 4.14 provides a cross-country comparison along this score using a rating index. Not surprisingly, the most advanced reformers in the Region—the EU-8—are ranked highest. Indeed, all of the countries in that group have competition policy ratings that exceed those of all the countries in the two other sub-Regions, where the rankings are fairly similar. The high scores attained by the Czech Republic, Hungary, Lithuania, Poland, and the Slovak Republic reflect relatively sound competition laws and enforcement actions on the part of these countries' governments to reduce or eliminate abuse of market power (including the divestiture of some dominant firms) and to promote competitive business environments. In addition, these countries have made much progress in reducing policy-driven barriers to entry. In contrast, either no or significantly subpar competition legislation and institutions are present in Bosnia and Herzegovina, Serbia and Montenegro, Turkmenistan,

BOX 4.4**Market Dominance and Anticompetitive Pricing in Serbia and Montenegro**

The market structure in this sector is best characterized as a core of a few large, dominant firms and a competitive fringe of more numerous small- and medium-size firms. The combined market share of the three dominant firms—which are either privatized or de novo private enterprises—is approximately 45 percent. About seven other firms—all of medium size, mostly state-owned enterprises, but also some private businesses—have a combined market share of 15 to 20 percent. The remaining share of the market comprises many small private firms.

One of the private medium-size firms, which is affiliated with a major local bank, has been an aggressive marketer and has tried to break into the dominant core. Its market share in 2001 was 2.6 percent, but a year later its share had increased to 4.5 percent. The senior manager of this firm voiced great concern that his company was suffering from "unfair competition." In particular, pricing behavior in this market is often predatory, with the dominant firms lowering prices to try to drive out competitors. The result has been frequent price wars.

One of the price wars was so destructive to the bottom lines of the involved firms that this senior manager invited the two other chief executive officers over for lunch. In a discussion that lasted almost five hours, they agreed to fix prices on certain key products. One of the participants agreed to stop selling at a lower price for two months, another for four months, and the third for one month. Because they had the same or similar suppliers, they also agreed on markup margins. The margins were fixed at 25 to 30 percent for one firm, 22 to 23 percent for another, and 13 to 18 percent for the third. It is likely that the participants accepted the pricing deal in part because they were seeking credits from the firm affiliated with the bank. After four months, the predatory pricing resumed.

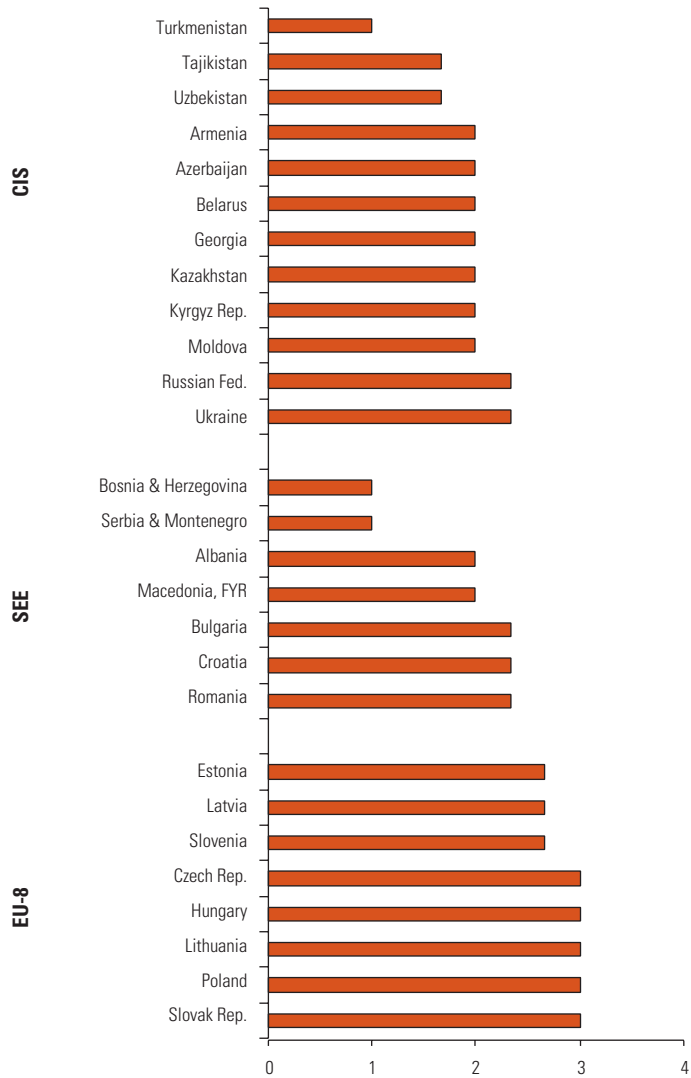
Source: Broadman et al. 2004.

Tajikistan, and Uzbekistan.²⁸ Overall, these data suggest that the emphasis on strengthening institutional capacity in competition policy regimes should be in SEE and in the CIS countries.

Bankruptcy Regimes

One way of ensuring low barriers to exit is through the functioning of an effective bankruptcy framework and related institutions. The quality of a country's bankruptcy policy regime can be measured in terms of the length and cost of insolvency procedures and by the efficiency with which the share of funds is recovered by creditors. Nearly all of the Region's countries have implemented new bankruptcy legislation or amended existing laws at least once since the early 1990s. How-

FIGURE 4.14
Index of Competition Policy Development and Implementation
in the Region

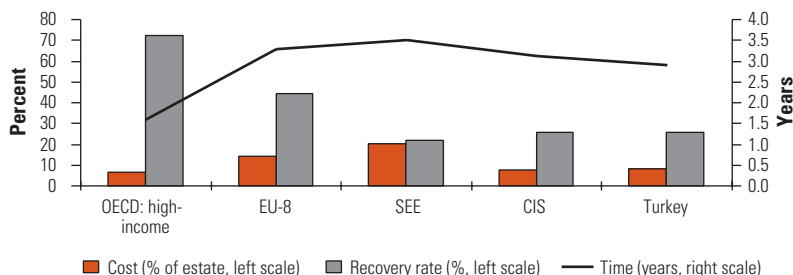


Source: EBRD 2004a.

Note: The index is defined as follows: 1 – no competition legislation and institutions; 2 – competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms; 3 – some enforcement actions to reduce abuse of market power and to promote a competitive environment, including breakups 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.

ever, throughout much of the Region—even in many of the EU-8 and EU accession and candidate countries—the insolvency process is comparatively lengthy and costly; further, investors do not recover a sizable share of their investments (see figure 4.15). Indeed, in most

FIGURE 4.15

Comparative Efficiency of the Bankruptcy Process

Source: World Bank (2004b) Doing Business database.

countries in the Region, the overall governing institutional framework for bankruptcy is still quite weak. In terms of progress in individual countries, only the Baltics, and to some extent Poland, match high-income OECD standards.

To be sure, only in part are the inefficiencies evident in the Region's bankruptcy regimes the result of poor legislation. Weak enforcement of creditor rights also results from the facts that basic property rights in many of the Region's countries are ill-defined and that powerful vested political economy interests would stand to lose from a reallocation of existing assets (and liabilities). At the same time, social pressures may constrain the reorganization or liquidation of failing businesses. Finally, as in other parts of the world, the notion of bankruptcy itself has negative connotations.

Developing effective bankruptcy institutions—whether in-court or out-of-court—is critical to improving the competitiveness of viable firms and to closing down, liquidating, or reorganizing firms that are value subtracting. Mechanisms that help in the reallocation of such resources—human as well as financial—will engender greater flexibility in the Region, which is key to ensuring growth and poverty reduction as the process of international integration continues.

Industrial Policy

Through a variety of fiscal and other instruments, such as export incentives, duty-free schemes, tax concessions, and accelerated depreciation allowances, some governments in the Region—like those elsewhere in the world—extend preferential treatment to select market participants as part of an overall industrial policy. Such treatment, however, can (though not necessarily) undermine the competitive nature of markets and ultimately distort the pattern and extent of a

country's international integration. Box 4.5 illustrates the experience of Turkey and its use of economic incentives to incumbent firms.

Perhaps the most important linkages between industrial policy schemes and international integration arise through policy actions by the Region's governments to extend preferential treatment not only to incumbent domestic enterprises but also to foreign firms operating in the national economies. Export-processing zones (EPZs)—intended to attract FDI—are such examples.²⁹ These instruments typically offer special incentives for export-oriented investment and take the form of free-trade zones, duty-free zones, free-investment zones, and offshore zones, among other schemes. The ownership composition of EPZ firms can be domestic, foreign, or mixed.

In many respects, EPZs can be thought of as attempts to apply trade policy instruments in limited locations to compensate for broader failures in a country's investment climate. In this way, EPZs can lead to the formation of "enclaves" from the national economy, where export-oriented firms may operate without undue interference from the state. This may well put EPZ firms at an advantageous behind-the-border position in comparison with non-EPZ firms. All other things being equal, this can impede non-EPZ firms' competitiveness in foreign markets. At the same time, it allows governments to avoid deeper or more extensive domestic liberalization and deregulation in the rest of the economy. Moreover, without proper safeguards, such policies can produce opportunities and incentives for discretionary behavior and corruption.

BOX 4.5

Economic Incentives in Turkey

Historically, Turkey has made frequent use of investment incentives and export incentives and has relied heavily on state-owned enterprises. The Turkish public enterprise sector is still large. State-owned enterprises have generally been poor economic performers as a result of soft-budget constraints—including direct transfers from the government, equity injections, and debt consolidation. In recent years, Turkey has eliminated most investment and export incentives. Similar progress could not be achieved in the case of public enterprises. Privatization gained momentum only after the 2001 crisis, when it was recognized that state-owned firms and the related structure of subsidies and soft budget constraints were a part of the problem underlying the large nonperforming assets of the banks. As Turkey moves forward with EU accession, it will have to align its state aid policies to those of the EU and apply the same competition policies to all firms, whether private or public.

Source: Hoekman and Togan 2005.

Although EPZs are not as widespread in the Region as they are in other parts of the world (including, among others, East Asia), they do exist in several countries. For example, they are currently utilized in Azerbaijan, the Kyrgyz Republic, and Uzbekistan, and used to be present in Hungary and Poland, among others. Other countries, such as Russia, are contemplating the establishment of EPZs. However, the experience of countries in the Region with EPZs has been mixed. On the one hand, some EPZs appear to have been effective in generating exports in the areas in which they were located (although it is difficult to truly ascertain this because there is no knowledge of the potential outcome from the opposite scenario [that is, the exports that would be generated in the absence of EPZs]). On the other hand, in some EPZs there have been only limited positive productivity or technological spillovers to the rest of the domestic economy. Box 4.6 illustrates this point based on the experience of the Kyrgyz Free Economic Zones.

The long-run net benefits to the Region's domestic economies from such preferential schemes—as elsewhere in the world—are of dubious size partly because such regimes can result in distorted enclave markets with limited positive spillovers to the rest of the economy and opportunities for corruption. Although political and vested interests will be strong, reform in the Region to phase out distortive special investment or export incentives—to domestic firms as well as foreign businesses—is recommended. Such reform could be conducted on a time-bound, sector-specific basis. It would likely be advantageous to countries' abilities to deepen international integration on an enduring basis and to exploit the benefits of increased international openness economywide.

Legal/Judicial Institutions for Governance

Effective legal and judicial institutions that provide the rules, procedures, and policies for sound governance are critical to enabling businesses in the Region to start, grow, and expand, including internationally. As noted earlier, in the discussion on bankruptcy, in many of the countries in the Region, although good legislation exists “on the books,” there is a significant implementation gap resulting from either a lack of or poorly designed institutions that allow for discretionary conduct on the part of government officials. In such a governance environment, businesses face an uneven playing field and the extraction of rents.

Of course the development of such institutions varies within the Region, in part because of “initial conditions” and other country-specific factors rooted in culture and history. Moreover, this variation is

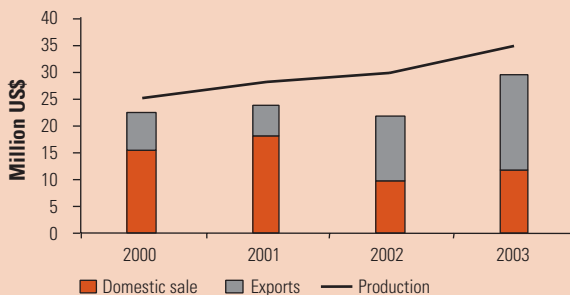
BOX 4.6

Free Economic Zones in the Kyrgyz Republic

Four Free Economic Zones (FEZs) were set up in the Kyrgyz Republic to attract FDI; investors in these areas were exempted from several taxes and duties, although, at present, only one of them (the Bishkek FEZ) operates effectively. Firms operating in the FEZs are exempt from profit taxes and most other taxes, including the VAT, emergency and road funds, and retail sales taxes when they export their products. Individual income taxes are collected from the employees, and a fee equal to 2 percent of revenues is collected from the firms. The fee is used for operation of the FEZ. The tax advantages of operating in the FEZ, combined with limited regulatory burdens, facilitate production efficiency for external markets, but create significant disadvantages for domestic producers, unless sales from the FEZ into the domestic market are subject to all required taxes. This results from firms operating in the FEZs maintaining their tax advantages when producing for local markets, both implicitly (that is, payment of some taxes may be delayed until goods are “imported into the Kyrgyz Republic”) and explicitly (that is, some taxes [such as the profits tax] are not paid). Despite improvements over the last several years, leakage from FEZs into domestic markets continues to be a problem (see figure).

With their improved investment climates, the FEZs have in principle been an important intervention for increasing foreign investment and technology transfer. The analysis of the FEZ production data suggests that firms in the FEZ in Bishkek have five-to-seven times higher productivity than the average Kyrgyz firm because of the improved business environment and because of the use of superior technology (for example, better machines, management practices, worker training schemes, market information, and so on). What is difficult to assess, however, are the technology transfer “spillover” effects from these FEZ firms to the broader economy. For example, some of the FEZ workers could, over time, leave their jobs to work for non-FEZ companies or to start their own firms, taking new technological ideas with them. Increasing the links between FEZ firms and the local economy can help to increase such beneficial spillovers.

Production, Exports, and Domestic Sale of Goods Produced in the Kyrgyz FEZ (mil. \$)



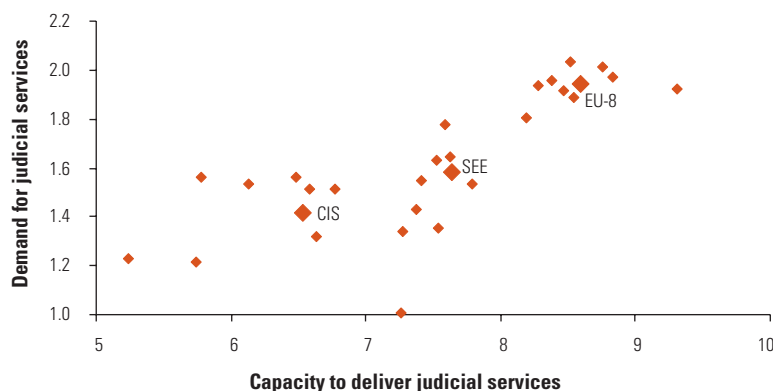
Source: World Bank staff.

also likely to be the result of cross-country differences, not only in judicial capacity (the "supply" side) but also in society's "demand" for well-functioning judiciaries. There is evidence that such demand and capacity are both positively associated with the progress of economic reform and a country's standard of living. This suggests that where demand for well-functioning judiciaries is weak, the institutional capacity to deliver high-caliber judicial services has been shallow, and vice versa (see figure 4.16).

Based on our earlier analysis, the demand for well-functioning judicial and legal institutions that protect and enforce property rights is likely to increase with the deepening of the Region's firms' international integration. In part, this will come from the firms' needs to reduce costs stemming from poor governance, and in part, it will be prodded by the need to comply with internationally binding standards embodied in trade agreements. In turn—if "the market" for legal/judicial services operates smoothly, largely a function of how well information flows—an increase in demand should facilitate a "supply response" for the creation of, or improvement in, sound legal and judicial institutions. Even more generally, however, as countries in the Region find it necessary to compete more vigorously for investment resources in the global market, this itself should produce such demand.

In the main, the need for establishing these basic institutions pertains to the CIS countries, but also to some extent in SEE. In the countries where some institutional capacity already exists—largely the EU-8 and some SEE countries—reforms should focus on refining cur-

FIGURE 4.16
Capacity and Demand for Judicial Reforms in the Region



Sources: James H. Anderson et al. 2005 and EBRD transition indicators.

Note: Capacity is the log of GDP per capita; demand is based on court usage and EBRD transition indicators.

rent rules and procedures and on rectifying remaining areas of weakness. These include strengthening judicial independence and accountability; improving court efficiency, performance, and accessibility; and facilitating development of alternative dispute-resolution mechanisms.³⁰

Conclusion

The fundamental conclusion from the analysis conducted in this chapter is that domestic, or behind-the-border, reforms that foster interenterprise competition and sound governance are important complements to policies that liberalize trade regimes to enhance the Region's countries' integration into the world economy and realize greater growth therefrom. At the same time, the analysis makes clear that governments of the Region should anchor these domestic reforms within international commitments that liberalize trade. These can take place at a variety of levels: globally through WTO accession; regionally through plurilateral RTAs, such as EU membership, or bilateral RTAs, such as those in SEE; or unilaterally through autonomous trade liberalization (see chapter 3). These legally binding commitments will not only help to lock in the behind-the-border reforms already achieved; the liberalization of trade engendered by such agreements and the associated disciplines embodied in them will themselves instill greater competition and stronger incentives for sound domestic governance. In short, there is a mutually beneficial two-way interaction between reforms that open trade and those that strengthen competition and governance, and this interaction should be fully exploited to enhance growth in the countries of the Region.

The chapter also has found broad empirical support for the notion that two "trade blocs" in the Region have been emerging over the course of the transition—a "Euro-centric" bloc, essentially comprising the EU-8, and a "Russia-centric" bloc, essentially comprising the CIS countries. The SEE countries lie somewhere between these two blocs, but many of them are increasingly gravitating to the Euro-centric bloc. There is evidence that firms in the EU-8 have managed to gain much greater international exposure and reach new markets for their products and services through exports compared with the firms in the CIS countries. In addition, export revenues as a percentage of sales have been weaker in CIS-based firms than in EU-8-based firms. Although import competition has induced efficiency throughout the Region, its effects have been much stronger among businesses in the EU-8 countries, compared with those in the CIS.

Moreover, the EU-8 (and to a lesser extent SEE) countries have been far more successful than the CIS countries in bringing about more competitively structured markets, and these stark differentials appear to be closely correlated with the success of businesses in these locales in integrating internationally. Governments in the CIS have been more reluctant in lowering barriers to entry, which has protected incumbent domestic firms with market power from competition from abroad. Successful competitive restructuring and ownership change of CIS firms also have been hindered by the presence of arrears and subsidies to incumbents, which have prevented the exit of value-subtracting businesses.

To be sure, checks on weak governance and corruption should be strengthened throughout the entire Region. But the incentives for sound governance are stronger in the EU-8 countries compared with the other countries in the Region. More important, where corruption and weak governance are most pronounced, the propensity of firms to integrate internationally is weakest.

The incidence of successfully resolving commercial disputes associated with international business transactions is highest in the Eurocentric bloc and weakest in the Russia-centric bloc, implying that there is likely an important relationship between the sophistication and availability of instruments for dispute resolution and the level of development of the relevant institutions. Not surprisingly, firms in the CIS have relied more heavily on bribes to resolve disputes associated with international trade transactions and to overcome related institutional hurdles than businesses in the rest of the Region.

Taken together, these findings indicate that policies that enhance the conditions for greater interenterprise competition in domestic markets should be a priority item on the reform agenda of most the Region's governments. Relatively few of the countries in the Region have either sufficiently established or strengthened the basic market institutions that protect firms and consumers from anticompetitive structures and conduct. In fact, promoting vigorous competition domestically is a critical prerequisite for developing a vibrant private sector populated by firms that can compete effectively in international markets. As has been suggested, firms that can compete at home are more likely to be able to do so abroad.

To this end, the Region's governments should work toward eliminating not only barriers to the establishment of new businesses and allowing for the continued entry of rivals but also barriers to the ongoing challenges that businesses face behind the border on a day-to-day basis. Reducing so-called administrative barriers for business start-ups and postestablishment operations were important "first gen-

eration” reforms. To a large extent, the most egregious of these barriers are being dealt with in many of the Region’s countries. Some of them are now in need of “second-generation” reforms—ones that deal with the more underlying and complex challenges in the national economies of reducing barriers to entry and exit and of enhancing competition. Although an increasing number of the Region’s countries have sound competition laws, widespread enforcement of these instruments is weak. Competition policy agencies in every country should have sufficient competencies to assess and penalize dominant firm structures and behavior, as well as other forms of restrictive business practices that harm competition. Of course, such agencies also must have the political “teeth” to make a difference; this means that strong political buy-in by the highest authorities is likely to be required.

On the exit side, the restructuring or liquidation of large loss-making enterprises that take up resources and economic space has not been facilitated sufficiently, in large part because vested interests stand to lose. Hardening budget constraints through the elimination of arrears and subsidies to businesses will go a long way toward ensuring that exit barriers are lowered. At the same time, developing an effective bankruptcy process and associated institutions, including courts staffed by competent judges and a pool of trained trustees, is essential. Taken together, such measures will improve the competitiveness of viable firms while exposing businesses that are no longer commercially viable and will provide mechanisms to reallocate resources—both capital and human—to higher values in use.

Only a relatively limited number of the Region’s governments systematically extend preferential treatment to select market participants to help promote the growth of exports through special zones as part of an industrial policy. Nevertheless, where they exist, such schemes may undermine rather than enhance the competitive nature of these economies’ markets, and they can distort the extent and pattern of a country’s international integration. Indeed, on net, the positive benefits to the domestic economy from the establishment of export processing zones in the Region’s countries are of dubious size. Existing schemes should either be phased out in accordance with a time-bound schedule or generalized to *all* sectors of the economy and to firms of *all* ownership forms.

Related to the issue of industrial policy is the way in which many of the Region’s governments conduct their public procurement with, and grant contracts to, the “outside” business world. Adherence to WTO-based rules regarding government procurement—which provide for open competition, transparent procedures, and nondiscrimi-

natory treatment to domestic and foreign firms alike—can be an important reform in minimizing existing distortions in trade in the Region and realizing the domestic benefits that can come from international integration.

Throughout much of the Region there is a lack of, or very weak, security in property rights. Businesses—not only domestic but also foreign—have resorted to extralegal methods to get around this obstacle, but in so doing lose efficiency in the transaction process and ultimately divert resources from more productive activities. While some progress has been made in some of the Region's countries regarding the establishment of relatively effective, market-based legal institutions that protect property rights and facilitate resolution of commercial disputes, in many countries these are major unfinished reform agenda items and the "Achilles heel" of the transition. Efficient settlement of commercial disputes is generally limited by lengthy procedures, lack of qualified and independent judges, and poor enforcement mechanisms. In addition, effective alternative out-of-court administrative channels for dispute resolution—such as the use of arbitration—do not effectively exist in many of the countries. Policies that provide for the simplification and cost reduction of formal legal procedures, as well as the establishment of out-of-court mechanisms for dispute resolution, will strengthen contract sanctity and improve the level of confidence that traders have in the business environment of the Region.

Finally, improving the quality of institutions to strengthen governance and reduce incentives for corruption is a critical component of the domestic reforms needed to deepen the international integration of the Region's countries. This will require greater transparency and accountability of public officials' conduct, a reorientation of the public sector incentive framework—for example, through civil service and public administration reform—and establishment of a stronger system of checks and balances.

Annex: BEEPS Dataset

The EBRD-World Bank BEEPS instrument was developed to study the environment in which businesses in 26 countries of Eastern Europe and the Former Soviet Union operate. Close to 6,700 firms from the Region took part in the survey in 2002. The firms operate in industrial sectors such as mining and quarrying, construction, and manufacturing or are active in services such as transportation, storage, communications, wholesale trade, retail trade, repairs, real

estate, renting, business services, hotels, restaurants, or other. With regard to firm size, the survey instrument was designed so that there is an intended overrepresentation of smaller firms in all 26 countries. With regard to vintage and ownership, the respondents were chosen to match sample quotas, so that state-owned firms, privatized firms, and newly established firms are interviewed in each country. For a complete description of the BEEPS dataset and survey methodology, see <http://info.worldbank.org/governance/beeps2002>.

A major caveat of the survey is that the sample of firms interviewed across the 26 countries is not representative of each national economy. Instead, the samples are stratified to cover firms with different characteristics within a country. This allows us to make comparisons among different firm characteristics. Annex table 4.1 summarizes the sample structure of the survey.

ANNEX TABLE 4.1
BEEPS2 Sample Structure

BEEPS2 sample	Number of firms
Industry	
Mining and quarrying	78
Construction	808
Manufacturing	1,685
Services	
Transport, storage, communications	524
Wholesale, retail, repairs	2,027
Real estate and business service	675
Hotels and restaurants	457
Other services	413
Size (number of employees)	
Small (2–49)	4,499
Medium (50–249)	1,248
Large (250–9,999)	320
Ownership	
State-owned	998
Privatized SOE	1,074
De novo	4,174
Foreign	365
Other	56
Vintage	
Oldest	1,800
Youngest	1,999
Average age	1,987

Endnotes

1. The study on Southeastern Europe is Broadman et al. (2004). Among other studies on the importance of competition and governance in the Region's transition, see World Bank (2002e).
2. We use extensively (i) official data from the countries in the Region; (ii) data from the 2002 EBRD-World Bank BEEPS; and (iii) the findings from numerous recently completed case studies of individual businesses located in selected countries in the Region.
3. Enhancing flexibility in factor markets to increase mobility of labor and capital is also a critical ingredient to ensuring that liberalization of trade improves the prospects for growth and reduction of poverty. This issue was taken up in chapter 4.
4. The relevant literature is large. The seminal pieces are, among others, Vernon (1966), Horst (1972 and 1974), and Caves (1996).
5. These statistical findings are generally robust regardless of model specification. The FDI variable can also be interpreted as a measure of the quality of the governance environment for business investment.
6. The literature is large. See, among others, Caves (1996) and Dunning (1993). For an application to Russia, see Broadman and Recanatini (forthcoming).
7. While covering firms in the mining sector, the BEEPS survey does not cover firms in the petroleum sector. This is important in interpreting the results regarding Kazakhstan. See the annex to this chapter.
8. Evidence for the less developed countries in Tybout (1997, 2000).
9. Similar evidence exists with regard to import performance and FDI inflows, which we do not report here.
10. See Caves (1996) and Dunning (1993).
11. See, for example, Broadman et al. (2004), which focuses on barriers to entry in SEE.
12. See Kornai et al. (2003).
13. See World Bank (2002e).
14. See Vernon (1966), Horst (1972 and 1974), and Caves (1996).
15. The BEEPS survey asks all firms a hypothetical question about the effects on their business decisions of a 10 percent increase in the market price of their principal product, which we use as a proxy for measuring price sensitivity.
16. See, in the case of Russia, Broadman et al. (2002). For other transition countries, see Kornai et al. (2003).
17. Based on the BEEPS2 data.
18. For case studies of firms in SEE, see Broadman et al. (2004).
19. See La Porta et al. (2000), Ramasastry (2000), and Schwartz (1998).
20. For evidence on Russia, see Hendley and Murrell (2002); for evidence in SEE, see Broadman et al. (2004).
21. There is a growing literature on this point. Jansen and Nordas (2004), for example, find a statistically significant positive association between government effectiveness, and quality of institutions and trade openness.
22. A typical regression result obtained was $CPI = -3.076 + .014 \text{ Trade Openness} + .565 \text{ GDP per Capita PPP}$, with the estimated coefficients on the

two explanatory variables statistically significant at the 95% level and an $R^2 = 0.63$.

23. See, among others, Scherer and Ross (1990).
24. To be complete, the model necessarily also includes the possible *domestic* ownership categories of firms. See the notes to table 4.5.
25. There is a strong bivariate correlation between vertical and horizontal integration in the dataset. This suggests that multicollinearity is present, which can diminish any independent effects that vertical and horizontal integration may have on firm performance.
26. We use price sensitivity as a proxy for entry barriers: as suggested earlier, price-sensitive firms operate in a more competitive environment, where new rivals face de facto lower barriers to entry. To depict barriers to exit, we utilize measures of arrears and subsidies as proxies for softness of budget constraints faced by firms in the sample. Consistent with the literature, technological prowess and product differentiation are also included to measure firms' competitive advantage in keeping rivals in check.
27. See, for example, Kwoka and White (2003).
28. For analysis of Uzbekistan's competition policy framework, see Broadman (2000).
29. For more, see, for example, Madani (1999) and Jayanthakumaran (2003).
30. For a detailed policy reform agenda, see Anderson et al. (2005).