

## Appendix 1.1 Indicators of Institutional Change

### Governance and Enterprise Restructuring (ER\_ST)

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

### Competition policy (COMP\_POL)

1. No competition legislation or institutions;
  2. Competition policy legislation and institutions set up: some reduction of entry restrictions or enforcement action on dominant firms;
  3. Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions;
  4. Significant enforcement actions to reduce abuse of market power and to promote a competitiveness environment;
- 4+ Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

### Banking Reform and Interest Rate Liberalisation (BR\_I)

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

## **Securities markets and non-bank financial institutions (S\_NB)**

1. 1= Little progress;
  2. Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities;
  3. Substantial issuance of securities by private enterprise; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework;
  4. Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalisation; well-functioning non-bank financial institutions and effective regulation;
- 4+ Standards and performance norms of advanced industrial economies; full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation.

## **Legal Transition Indicators (O\_LE)**

### **Commercial Law**

#### *Extensiveness*

1. Legal rules concerning pledge, bankruptcy and company law are very limited in scope. Laws impose substantial constraints on the creation, registration and enforcement of security over movable assets, and may impose significant notarisation fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Bankruptcy laws do not provide for certainty or clarity with respect to the definition of an insolvent debtor, the scope or reorganisation proceedings or the priority of distribution of creditors following liquidation. Laws in these substantive areas often have not been amended to approximate those of more developed countries and the laws that have been amended contain ambiguities or inconsistencies.
2. Legal rules concerning pledge, bankruptcy and company law are limited in scope and subject to conflicting interpretations. Legislation may have been amended but new laws do not necessarily approximate to those of more developed countries. Specifically, the registration and enforcement of security over movable assets has not been adequately addressed, leading to uncertainty with respect to the registration and enforcement of pledges. Pledge laws may impose significant notarisation fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Laws may contain inconsistencies or ambiguities concerning, among other things, the scope of reorganisation proceedings and/or the priority of secured creditors in bankruptcy.
3. New or amended legislation has recently been enacted in at least two of the three areas that were the focus of this survey - pledge, bankruptcy or company law - but it could still benefit from refinement and clarification. Legal rules permit a non-possessory pledge over most types of movable assets. However, the mechanisms for registration of the security interest are still rudimentary and do not provide parties with adequate protection. There is scope for enforcement of pledges without court assistance. Company laws may contain limited provisions for corporate governance and the protection of shareholders' rights. Bankruptcy legislation contains provisions for both reorganisation and liquidation but may place claims of other creditors above those of secured creditors in liquidation.

4. Comprehensive legislation exists in at least two of the three areas of commercial law that were the focus of this survey - pledge, bankruptcy and company law. Pledge law allows parties to take non-possessory pledges in a wide variety of movable property and contains mechanisms for enforcement of pledges without court assistance. The legal infrastructure, however, is not fully developed to include a centralised or comprehensive mechanism for registering pledges. Company laws contain provisions for corporate governance and the protection of shareholders' rights. Director and officer duties are defined. Bankruptcy law includes detailed provisions for reorganisation and liquidation. Liquidators possess a wide variety of powers to deal with the property and affairs of a bankrupt.
- 4+ Comprehensive legislation exists in all three areas of commercial law that were the subject of this survey - pledge, bankruptcy and company law. Legal rules closely approach those of more developed countries. These legal systems have a uniform (that is, centralised registration) system for taking and enforcing a security interest in movable assets and also provide for adequate corporate governance and protect shareholders' rights. In particular, the rights of minority shareholders are protected in the event of the acquisition by third parties or less than all of the shares of a widely held company. Bankruptcy law provides in a comprehensive manner for both reorganisation and liquidation. Liquidators possess a wide variety of powers and duties to deal with the property and affairs of a bankrupt, including wide powers of investigation of pre-bankruptcy transactions carried out by the debtor. There are specialised courts that handle bankruptcy proceedings. Liquidators must possess certain minimum qualifications.

### *Effectiveness*

1. Commercial legal rules are usually very unclear and sometimes contradictory. The administration and judicial support for the law is rudimentary. The cost of transactions, such as creating a pledge over a movable asset, is prohibitive so as to render a potentially extensive law ineffective. There are no meaningful procedures in place in order to make commercial laws fully operational and enforceable. There are significant disincentives for creditors to seek the commencement of bankruptcy proceedings in respect of insolvent debtors.
2. Commercial legal rules are generally unclear and sometimes contradictory. Few, if any, meaningful procedures are in place to make commercial laws operational and enforceable.
3. While commercial legal rules are reasonably clear, administration or judicial support of the law is often inadequate or inconsistent, creating a degree of uncertainty (for example, substantial discretion in the administration of laws and few up-to-date registries for pledges).
4. Commercial laws are reasonably clear and administrative and judicial support of the law is reasonably adequate. Specialised courts, administrative bodies or independent agencies may exist for the liquidation of insolvent companies, the registration of publicly traded shares or the registration of pledges.
- 4+ Commercial laws are clear and readily ascertainable. Commercial law is well-supported administratively and judicially, particularly regarding the efficient functioning of courts, liquidation proceedings, the registration of shares and the orderly and timely registration of security interests.

### Financial Regulations

#### *Extensiveness*

1. Legal rules concerning banking and securities regulation are very limited in scope. For example, capital adequacy standards and restrictions on affiliated lending in banking do not exist. There may be no functioning stock exchange in this jurisdiction, or the capital markets' legal infrastructure may be in its earliest stage of development.

2. Legal rules governing financial markets are somewhat limited in scope. Although regulations in banking have been amended to accord with core principles, at least one important area of regulation remains deficient - for example, capital adequacy, use of international accounting standards or use of consolidated comprehensive supervision. Oversight of securities markets is limited and regulation of securities intermediaries and investment funds, for example, are either non-existent or rudimentary.
  3. Legislation for financial markets is reasonably comprehensive but would benefit from further refinement in some areas. Banking regulations generally conform with the Basle Committee's Core Principles, although regulations concerning bank insolvency and deposit protection may not have been adopted. Further refinement to regulation of securities intermediaries and/or investment funds and creation of shareholder depositories and registers are needed to achieve conformity with minimum international standards.
  4. Comprehensive financial market legislation conforms generally with minimum international standards. However, refinement is still needed in at least one important area of either banking or securities regulation. For example, many jurisdictions still need to enact rules concerning money laundering or bank insolvency. Legislation concerning shareholder depositories and registries tends to be in its early stages of implementation.
- 4+ Banking and capital markets legislation and regulation are comprehensive and conform with minimum international standards.

### *Effectiveness*

1. Legal rules governing financial markets are usually very unclear and often contradictory. Regulatory support of the laws is rudimentary. Supervisory mechanisms are either non-existent or poor. There are no meaningful procedures to make financial laws fully operational.
  2. Legal rules are somewhat unclear and sometimes contradictory. Supervision of financial institutions exists only on an ad-hoc basis. There are few, if any, meaningful procedures in place to enforce the law. There may be a lack of adequately trained staff in either banking or capital markets regulatory authorities.
  3. Although legal rules governing financial markets are reasonably clear, regulatory and supervisory support of the law may be inconsistent, creating a degree of uncertainty. Although the regulator may have engaged in corrective actions against failing banks and securities market practices, enforcement problems still exist.
  4. Legal rules governing financial markets are readily ascertainable. Banking and securities laws are well supported administratively and judicially, particularly regarding the efficient functioning of enforcement measures against failing institutions and illegal market practices. For example, the regulator has taken corrective action to liquidate failing banks. Enforcement actions against individuals and securities intermediaries are evident, but would still benefit from more systematic and rigorous enforcement. Courts have the authority to review enforcement decisions of other corrective actions for banks and/or securities firms.
- 4+ Regulators possess comprehensive enforcement powers and exercise authority to take corrective action on a regular basis. Examination of securities intermediaries and licensing of intermediaries is frequent, as is the use of corrective action, such as prosecution for insider dealing, revocation of bank licences, and liquidation of insolvent banks.

## Appendix 1.2 Causes of Institutional Change

### Reform Measures

#### Small Scale Privatisation (SCP)

1=Little progress; 2= Substantial share privatised; 3= Nearly comprehensive programme implemented; 4= Complete privatisation of small companies with tradable ownership rights; 4+= Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

#### Price Liberalisation (PL)

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

#### Years with price liberalisation (YPL)

#### Years with trade restrictions lifted (YTL)

#### Years with privatisation (YP)

### Trade

Share of of trade with EU:

Exports to EU as a share of total exports.

Share of trade and ROW:

Exports to the rest of the world as a share of total exports.

### Political Factors

Civil Liberties (CV)

Political Reform (PR)

Freedom Rating (FR)

### Macro Causes (YEARSIBD)

No. of years since the start of transition in which a country had less than 30% inflation and a budget deficit below 5% of GDP, divided by the length of transition in each country.

## Appendix 1.3: Initial Conditions

1. GDP per capita in 1989, at PPP exchange rates; pre-transition growth, where pre-transition refers to 1985-89 in CEE and 1987-91 in the FSU;
2. a dummy for wealth in natural resources (ranging from 0 to 2);
3. the share of the population living in urban areas;
4. the distance between the country's capital and the EU (Brussels);
5. the share of employment in industry, agriculture and services, all relative to market economy benchmarks;
6. the value of trade with the CMEA over GDP in 1989;
7. a measure of repressed inflation (derived from the difference between wage growth and productivity);
8. the black market exchange rate premium in 1989;
9. the years a country lived under central planning;
10. the initial private sector share in GDP;
11. a dummy for state capacity, set equal to 2 in all established nation states, 1 in all dominant states in a federation (Russia, the Czech Republic and former Yugoslavia) and 0 for all new CIS states and the Slovak Republic.