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THE NECESSARY INSTITUTIONAL FRAMEWORK TO TRANSFORM FORMERLY PLANNED ECONOMIES: With special emphasis on the institutions needed to stimulate foreign investment in the formerly planned economies

by

Gunnar Eliasson, Tad Rybczynski and Clas Wihlborg

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Postadress
Box 5501
114 85 Stockholm

Gatuadress
Industrihuset
Storgatan 19

Telefon
08-783 80 00
Telefax
08-661 79 69

Bankgiro
446-9995

Postgiro
19 15 92-5

10.92 10 000

940308, FDI-IUI.PAP, KM/hd, disk 821

The Necessary Institutional Framework to Transform Formerly Planned Economies – with special emphasis on the institutions needed to stimulate foreign investment in the formerly planned economies

Gunnar Eliasson, Tad Rybczynski, Clas Wihlborg*

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Note: This document is a short version of a more comprehensive document with the same title and the same authors (IUI Working Paper No. 389, 1993) analysing the institutions supporting investment incentives, and the transformation of formerly planned economies into market economies.

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* We are grateful for research in Estonia by Mare Kukk, and Vello Vensel.

the institutions supporting investment incentives in general in, and the transformation of formerly planned economies into market economies.

EXECUTIVE SUMMARY

Investment in various forms constitute the core growth machinery of an economy. It is now generally recognized that acceptable and sustainable growth rates in the formerly planned economies can only be socially, politically and economically achieved through significant inflows of foreign direct investment. The ambition of this document is to understand and to advise on how the institutions of the formerly planned economies can be best organized to effectively support foreign direct investment incentives such that the desired macro economic performance is achieved. Our analysis, hence, is particularly concerned with identifying the instituions that are necessary both to transform the formerly planned economies into market economies and to make them *attractive economies for foreign investors.* The institutions and measures needed to achieve that end, however, essentially appear to be the same as those needed also to stimulate indigenous investment and growth in any market economy. Hence, our analysis turns out to be surprisingly general, but nevertheless precise in its recommendations.

Policy should be directed through the establishment of the appropriate institutions that support efficient dynamic markets, notably capital markets. This is a necessary condition for the successful transformation of a planned economy. This policy becomes precise when we have identified and characterized the institutions needed. It is obvious already at this stage that institutions supporting property rights and trade are critical.

Direct investment means that owners of capital, irrespective of type of owner (Government, firm or individual) invest for the purpose of achieving a private return.

Foreign direct investments took place also in planned economies but under the non-market, predictive circumstances of a planned economy. The returns to the investment could be regulated already in the contract.

Investors in a market economy, on the other hand, are subjected to large risks. The possibility of predicting these risks depends on the stability of those institutions that guarantee basic property rights. In the advanced industrial countries such risks are restricted mainly to business risks. In the formerly planned economies, where institutions have not stabilized, there are also political risks, and possibly *very large such risks.*

The conditions making a formerly planned economy attractive for investors can therefore be expressed in terms of business and political risks. The purpose of this publication is to show *how* these risks, notably the political risks can be minimized through the appropriate organization of the economy. The organization of the economy, in technical terms, can be expressed in terms of the institutions (laws, conventions, practices etc.) that support markets.

We classify the risks facing the investor in transition economies. The three types of *political risk* are caused by uncertainty about:

1) major *non-economic events* such as civil war,
2) *macroeconomic failure* causing, for example, hyperinflation or depression,
3) the formal and informal institutions restricting arbitrary political treatment of market agents.

Two types of *business risk* are caused by uncertainty about

4) *opportunistic behavior* of parties to economic transactions, and
5) *competitive conditions* in markets.

The third and the fourth types of risk depend directly on institutional development with respect to the legal framework for contractual arrangements among the firms and its stakeholders. Controlling these risks is a precondition for the growth-process, which in turn is a condition for reducing the first two types of risk.

The major conclusions are the following:

1) There is potentially a time-bomb in the slow progress of financial sector reform and privatization of state enterprises. Unless bad debts of banks' and firms' balance sheets can be reduced dramatically and, at the same time both banks and state enterprises are forced to operate under a "hard budget constraint", the incentives of management in banks and firms will remain skewed, resources will continue to be wasted, and inflationary pressures will remain. The period of hardship during inevitable restructuring with the potential for civil strife and depression, might be delayed, but the costs of delay are more severe than the restructuring problems.

2) Legal reform in formerly planned economies has progressed rapidly in most countries but the capacity of the legal system to implement and enforce a complex legal structure does not exist. Investors therefore have to worry about how contractual relations can be made self-enforcing before irreversible investments in relations with suppliers, or customers are made. One way for investors to achieve self-enforcement is to limit economic relations to businesses and individuals with a reputation at stake. As long as privatization has not progressed sufficiently, too few such businesses will, however, exist.

3) The political risk related to uncertainty about the institutional framework supporting property rights would probably be significantly reduced if governments in transition economies focused on a few, critical and necessary areas of law. A complex legal structure in combination with lack of judicial capacity rather causes new uncertainties about the implementation of law.

4) Property rights to real estate are still in a state of flux with the consequence that property cannot be used as collateral. An important source of start-up capital for new business ventures is therefore lacking.

5) Regulatory hindrances for business establishment differ among countries. In the two countries we report on, government regulation does not hinder business establishment severely. Traditions and conventions are not developed, however. A shift in government may therefore quickly lead to substantial change in regulatory activity.

6) In one case studied (Estonia) there was uncertainty among firms about the degree of restrictions on temporary lay-offs. In many formerly socialist countries there are substantial costs of reductions in firm employment.

7) Foreign exchange controls do not generally restrict remittances of profits or payments for services provided by a foreign parent. Domestic residents are however often subject to exchange controls. Exchange controls reduce the credibility of Governments' macroeconomic stabilization programs, add to political risks (of the third kind) and increase transactions costs in the economy, all three factors reducing investment spending and future economic growth.

The rest of this text elaborates on the institutions supporting property rights and investment incentives.

In separate tables we specify in some detail areas of law supporting property rights, and illustrate the great variety of law defining user rights for property. Table 5 in particular enumerates about 50 areas of legal code of particular importance for the investment decision.

1. Introduction

Political risk is an inevitable aspect of most investment decisions. In most western economies such risk plays a relatively unimportant role for investment activity relative to conventional business risks. This is a reflection of stability of political systems and the legal framework for business activity. In transition economies, however, local and foreign investors are likely to face substantial uncertainty related to the political situation as well as the institutional structure for business activity. This uncertainty is likely to remain for the foreseeable future. Nevertheless, governments in transition economies can do much to reduce risk. Risk facing investors depends on a wide variety of political and institutional developments under some degree of control by governments, parliaments, central banks, and the judicial system.

In this paper we attempt to structure the concept of political risk of direct relevance for investors and to distinguish the political risk from the conventional business risk. We then discuss major sources of risk of investment in the transition economies. These risks are both political and more conventional business risks but they have in common that they are politically or institutionally determined.

Thinking about political risk from the point of view of the investor, there are some obvious sources, such as risk of direct warfare inhibiting all but the most basic economic activity. There are also more subtle sources of risk relating to institutional development including the legal framework defining the ability of a firm to carry out transactions with some degree of security about adherence to agreements by all parties. Many of the institutions we are discussing are usually taken for granted in the West.

The lack of a well-developed legal framework and a judicial system capable of enforcing existing law may deter many investors. The western businessman need not avoid business projects in transition economies on these grounds alone. There are often ways to structure business transactions in order to assure adherence to agreements. In economic terminology, we talk about *self-enforcement mechanisms* in contracts. Such self-enforcement also implies that governments in transition

economies have to think about what laws and other institutions are really necessary and when self-enforcement and contractual relations do substitute for detailed law.

When political risk of investment in both poor and rich western economies is discussed, it is common to focus on the uncertainty about rules and regulation influencing foreign investors in particular. When discussing the formerly socialist economies, this limitation is inappropriate, because macroeconomic and political developments depend crucially on whether domestic investment activity will be sufficient to generate growth and employment. We will take a broad view of both political and business risks that depend on institutional development.

We focus on the role of institutions in the growth process. Institutions including law, the court system, conventions and traditions have gained increasing attention in economic analyses during recent years as demonstrated by Douglass North and Robert Fogel, the winners of the price in Economics 1993 in memory of Alfred Nobel. Issues of macro economic stabilization of the demand side of economies are discussed only when they have a bearing on risk and investors' behavior.

Before going further into details, we will define three types of political risk and two types of business risk in order to clarify how political and institutional development affects the risks facing the investor.

2. Political and Business Risk

The present value of future profits, or the value of the firm depends negatively on the level of risk of the business, as seen by providers of funds in the stock market or by firm management itself, when considering future long term commitments. There are business risks associated with demand and supply conditions in the firm's markets and with the behavior of parties to transactions and contracts. Other risks are associated mostly with uncertainty about policies and legislative acts by governments. The firm is supposed to be competent in understanding and controlling its exposure to demand and supply shifts and to enter contractual

relations. While business risks can either be traded, shared and spread in financial markets or managed by contractual arrangements, other risks are often non-insurable, in the sense that the market is unwilling to trade in them and no business institution is willing to insure such risks for a fee.

Three types of political risk

We distinguish between three types of risk associated with the behavior of political, legislative and regulatory authorities. Such risks are called *political risks* in Table 1. The *first* type of risk is truly political and covers the collapse of the political system, including civil war, military take-overs etc. Under this heading we should also list nationalization of industries and sudden political demands of majority ownership in foreign companies. Some of the former Soviet Republics are clearly associated with this type of risk.

The *second* type of political risk concerns the break-down of the economic system, notably the stability of the monetary system, including a runaway inflation and a severe reduction of the productive capacity of an economy of such a magnitude that the conditions under which economic transactions have been conducted change fundamentally. A large share of firms and households would be unable to fulfill contractual obligations under severe economic hardship. Some of these risks may be managed within very large corporations, but they are potentially so large that even insurers may go bankrupt if a "bad" event occurs. They cannot normally be diversified because events occur so infrequently that the probability of a certain event happening cannot be estimated beforehand. The market is notoriously bad at creating hedges for such risks, and fees will be very high, making normal business investments unprofitable.

Some macro risks are in principle insurable as long as the magnitude of change is within "normal" ranges. For instance, the interaction of inflation, the exchange rate and the interest rate follow certain regularities in the long run, and the overall financial risk exposure can be reduced by appropriate arrangements of the balance sheet.

The *third* type of political risk is of a more subtle kind. It refers to unpredictable behavior on the part of governmental authorities in the form of changes in the institutions of the economy that regulate everyday economic behavior, notably the property rights institutions, and the legal framework for contractual arrangements among firms, their financiers, and other stakeholders. This type of risk may affect a very broad range of activities. In broad terms, it refers to uncertainty about property rights and associated user rights as defined by the range of feasible contractual arrangements that a property owner can enter. These issues are discussed in Section 3.

The three types of political risks are to some extent interdependent. A breakdown of the monetary system of a country often compels its political authorities to lay down restrictions on the rights regulating market transactions, like removing convertibility, imposing credit controls etc. Insufficient or uncertain protection of property rights could hinder economic development and cause risks of civil disorder, or macroeconomic decline.

The role of law and precedent is to give credibility to contracts, but there are also market mechanisms working on the establishment of such credibility. Informal provisions supporting the development of conventions in the market, in fact may often be more efficient than legal code. It should be remembered that the Common Law of England and the US developed very much in this way. For economies in transition, lacking judicial capacity, decisions must be made specifying the coverage of explicit legal institutions and on the scope for development of informal contractual arrangements based on tradition and self-enforcement. We return to this issue below.

Two types of business risk

Entrepreneurial behavior and long term financial commitments require that business firms and individuals can be confident that the only circumstances preventing them from capturing expected rents associated with ownership of a resource are *mistaken business decisions* within the management sphere of expertise.

Mistaken business decision under a given legal framework for property rights and user rights could be due to misjudgments about the behavior of suppliers, customers, lenders or other stakeholders (item 4 in Table 1) or to mistaken perceptions about demand and supply factors for a firm's products (item 5 in Table 1.

The first type of business risk can be quite large if property rights are not well defined and contractual enforcement weak. The distinction between this business risk and risks caused by uncertainty about the legal framework is naturally blurred. Business risks are often (but not always) due to lack of information about the behavior of another party to a transaction. Such risks can potentially be reduced by formal or informal contractual arrangements, while the third political risk discussed above is caused by uncertainty about the rules for entering and enforcing contractual arrangements.

In the following we focus on the three types of political risk and the business risk caused by contractual uncertainty. We consider these four types of risk determined by political and institutional developments in a country. Among these four risks we emphasize in particular the third and the fourth caused by uncertainty about legal institutions and uncertainty about contractual enforcement within a given legal framework. We consider these sources of uncertainty particularly important because economic growth requires that they are kept at a low level. If they are not, economic failure causes an increase in the level of political risk of types one and two as well.

3. The Legal Framework for the Firm's Contractual Relations

a) *Law and Risk of Opportunistic Behavior*

The behavior and success of firms are determined to a large extent by the institutional framework within which they operate. The institutions important for minimizing risks of opportunistic behavior in business relations are either formal (coded) or informally established as traditions and conventions. All western legislative practice rests on a vast structure of informal procedures relating to

implementation and interpretation on top of coded law and precedent. Investors in transition economies face political risks even when written law exists, because implementation and interpretation practices have not had time to develop. For the foreign investor there is the additional problem of differences in encoded rules. Some problems may be overcome by the employment of locals, with experience of the host-country of the firm. In this section we discuss how a new market orientation might be introduced in order to promote efficiency. Practices in transition economies are often different, however, with potentially severe consequences for both foreign and domestic investors.

Some formerly planned economies like the Baltic countries, Poland, the Czecho Republic, Slovakia and Hungary, and, of course, East Germany, can fall back upon a legal Germanic French tradition from a not too distant past; this tradition has to be reestablished and updated. In Poland, in particular, a functioning market economy based on pre-communist legal traditions has existed continuously. Thus, for Poland the transition to a market economy implies an expansion of the coverage of this tradition.

The legal system of western market economies is primarily negative in the sense that what is not explicitly forbidden in law is permitted. In the socialist economies prohibitions were instead often general. Under such rules economic actions had to be explicitly listed in law to be allowed. Other economic activities were forbidden. Law, hence, became de facto positive allowing, for example, trade in "personal property", while transfers that were "excessive" relative to "personal" needs (commercial trading) were forbidden (e.g. in Hungary). Obviously, the free establishment of business ventures requires that exceptions from the right to trade are well-defined. By well-defined is meant, for example, that the state cannot by administrative decree abrogate rights to trade on general grounds such as "the good of the people". The establishment of new ventures, although in principle permitted, may be stifled by requirements that a number of permits and licenses be issued by administrative decision, without a well-defined legal foundation.

In spite of the rapid progress of legal reform in many formerly socialist economies a number of sources of uncertainty for business ventures exist. The *first*

source of uncertainty is that *the socialist legal system was not generally abolished.* Old laws have been allowed to remain in effect until new laws have been explicitly substituted for them. Similarly administrative procedures granting licenses have remained. Thus, vested interest have been able to hinder new ventures by means of, for example, permit-requirements. New and old laws may also be conflicting and principles for resolving conflicts lacking.

A *second* source of uncertainty regarding legal rules is *enforcement.* The court system, including judges and lawyers, has to learn to implement a new set of laws without a tradition to build on. The capacity to deal with a new set of cases is often insufficient. The lack of a strongly enforced legal structure need not, however, be a serious obstacle to a wide variety of business relations.

A *third* source of uncertainty is that *property* and *legal persons* are *not* always *sufficiently well-defined and registered* to ensure that transfers are effective and that contracts are enforceable (see Table 2). A particular and important problem arises if property cannot be used as collateral for bank lending. In particular, individuals' real estate can be an important source of collateral for loans supporting entrepreneurs.

Areas of particular importance for the functioning of a market economy are laws for real property, company, labor relations, contract, bankruptcy, competition, intellectual property, foreign investment, and financial institutions. Constitutional law may also contribute to the definition of general rules for a market economy. These areas of law contribute to (i) the definition of property rights, (ii) the specification of means to exchange rights, (iii) the definition of rules for competitive market behavior, (iv) the enforceability of credit transactions, and (v) the definition of rules for corporate governance. Progress and problems in these legal areas are discussed briefly below. First we ask what *minimal legal framework is necessary to promote growth in a market economy by enabling economic activity,* while reducing the risk in economic transactions. We ask this because it is often taken for granted that economic progress requires that a country develops the whole complex structure of law that western industrialized countries have in place. We do not believe that this is correct. It is important, however, that existing laws

are credible and enforceable. Firms need not in all cases abstain from investing in transition economics because legal institutions do not cover all areas of economic activity.

As a starting point for our discussion we list in Table 2 legal requirements for property rights to be meaningfully defined, and in Table 4 dimensions to what we call user rights to property. Law areas supporting property rights are listed in Table 3, while Table 5 lists areas of law specifying and restricting the owner's ability to use property for desired purposes. What stands out in Table 5 in particular is the wide variety of law that specifies and regulates user rights in industrialized countries.

Since transition economies lack legal convention and judicial capacity it is important to ask which laws are necessary for markets to function. Laws that cannot be enforced generally may contribute to uncertainty for investors.

b) A Minimal Legal Framework and Self-Enforcement

As mentioned, the socialist economies have substituted new law for old law and often retained administrative procedures governing business. An alternative strategy for the transition could have been to abrogate a whole set of commercial laws, thereby (implicitly) freeing a large range of activities previously prohibited.

Obviously, however, some law is necessary. It is not acceptable, for example, that physical force or the threat of violence define property rights or become the primary means for contract enforcement. In a legal vacuum with no enforceable prohibitions and/or no rules regulating allowed transactions, mafia type regulation and enforcement will develop to make socially necessary commercial transactions possible. This is, however, a very inefficient system with high transactions costs. A viable market economy requires that parties to a voluntary transaction must feel secure that traded property changes hands securely, with a minimum of transactions costs, and each party must have some recourse to corrective action, other than threat of violence, in case of non-performance by the other party to the transaction. One requirement for this security is that the buyer knows that the seller has the right to sell. For many kinds of property simple possession

satisfactorily defines ownership, but real estate transactions require more formal proof of ownership in the form of registration and title of ownership. This area is still unsettled in many of the formerly socialist countries (see Table 2).

Enforcement of financial contracts requires that property of a delinquent borrower can be identified. Similarly, contractual arrangements with and among firms require that property of the firm, and individuals signing for the firm are identifiable. Thus, firms as legal persons must be registered with the names of individuals acting as their agents.

Apart from these registration requirements for some property, legal persons and their agents, security of contractual relations in the absence of detailed law requires that the state enforces voluntary and "reasonable" contracts, i.e. those that are not entered under duress. Some kind of arbitration and dispute settlement mechanism is necessary, although such a mechanism can be agreed upon in contracts. Most important is that decisions of arbiters or courts are enforced by the state, even if arbiters and courts are foreign.

In the absence of state supported enforcement parties to contracts must rely on *self-enforcement*. An important question for economies in transition is how far self-enforcement in the market substitutes for legal enforcement, legal expertise and experience if the latter is lacking.

We can distinguish between three different kinds of self-enforcement:

1) Reputation

2) Internalization

3) Bonding arrangements (hostages)

Contractual agreements are often self-enforcing, because parties do not want to risk their reputation in the market. Reputation is the standard enforcement mechanism in small matters, but it is important for any firm with repeated transactions with groups of firms and individuals. Internalization of transactions within firms in the form of, for example, vertical integration is a common way of solving difficult contractual arrangements. For example, if contracts between suppliers and a firm cannot be made credible, then suppliers may be integrated as

subsidiaries. Some countertrade arrangements, such as buy-backs, are also within this category.

Bonding arrangements imply that firms demonstrate their credibility and honest intentions relative to, for example, suppliers, which must devote resources before payment is received, by putting valuable resources (bonds) at risk. It must be done so that it is automatically lost if a contract is breached. Reputation is in essence such a "bond" but the bond can take more concrete form such as goods or a forward-dated cheque in storage with the supplier.

Enforcement is particularly tricky for foreign investors operating in a foreign legal system. Arrangements by which contract-parties specify an arbitration mechanism or a law-system (foreign) that regulates their mutual transactions are possible. Even in these cases domestic authorities must provide legal "enforcement of last resort", however, unless reputation is sufficient to enforce decisions of an arbiter or a foreign court.

Self-enforcement is no doubt important for contracts among firms when transactions require some investment of resources in the form of specific machinery or specific training without simultaneous payment.

c) Company Law

Does the principle of self-enforcement extend to more complex contractual forms between the firm and those supplying risk-capital? Are, for example, company law and bankruptcy law unnecessary? The answer is a qualified no. Most likely entrepreneurship and a wide variety of business-ventures would exist without such laws but "standard form contracts" defined in law lower transactions costs and information requirements for stakeholders.

The absence of company law would oblige founders of firms to construct the corporate charter they like. The corporate charter protecting outside stakeholders,defining the liability of investors, and setting the rules for corporate governance would have to be submitted for registration and be made available to stakeholders. The main disadvantage with lack of standard form contracts is that suppliers of financial resources to a firm would have to study each corporate

charter and devote resources to understanding specific conditions. With standard form contracts lawyers in a country are able to specialize and become experts on specific types of contracts. Similarly, judges who resolve conflicts become experts on a particular set of contracts, and interpret general aspects based on common business practices. The incentives of founders of a firm to choose a known contractual form in order to make the firm attractive to financiers, would reduce these disadvantages associated with the absence of explicit company law. Thus, standard form contracts and general business practices are likely to develop in any case.

Although standard form corporate charters are likely to develop without explicit law, there is a positive role for legislation and the state to play. First, legislation specifying what issues a corporate charter must address helps the relatively inexperienced supplier of risk-capital to identify important areas of potential conflict. Second, by registering corporate charters the state makes them easily accessible and contributes to lowering information and enforcement costs.

The positive role of legislation can be realized without specific legislation about the exact contractual relationship between the firm and stake-holders. Specific legislation with mandatory rules for the relationship among management, board members, shareholders, and other suppliers of risk-capital may even deter foreign investors, if the rules differ from those in the investors' home country and contribute to loss of control.

d) Bankruptcy Law

The new Russian bankruptcy law claimed its first victim in September 1993. At this time the greatest obstacle to implementation of the law is the dearth of qualified judges, managers, and auditors to handle bankruptcy proceedings. Russia has this problem in common with all of the formerly planned economies.

The reason for the low number of bankruptcies actually taking place is neither the lack of law nor the lack of legal expertise. Instead, governments continue to keep the large number of state enterprises alive by means of subsidies and, especially, bank loans ultimately financed by the governments (see Section 4).

If this support were to be withdrawn a very large number of enterprises would go under in all the transition economies and the legal capacity would be insufficient except for a minor part of the cases.

The tremendous back-log of potential bankruptcies implies that the foreign investor must structure its business dealings with Russian firms with the knowledge that there will not be any structured procedure in case of default. These considerations add to the importance of self-enforcing mechanisms discussed above to manage business risk.

There is also the political risk for the foreign investor because the existence of bankruptcy law in combination with the lack of capacity to implement the law implies that the firm with claims on a potentially bankrupt firm is uncertain about bankruptcy procedure. This uncertainty is amplified by the lack of a properly budget-constrained banking-system. A bank may or may not step in to take over a firm at a very low price but the bank's policy depends on the government's ability and willingness to support the bank's bad debt. The treatment of different creditors will continue to be a political issue until firms and banks have been privatized on a large scale (compare with Section 4).

The political risk could even be lower if no bankruptcy law existed and banks and firms were free from political interests. In that case the behavior of different parties would be more predictable if based on economic considerations. Without formal procedures for liquidation and reorganization banks, as primary lenders and monitors of borrowers, would be able to establish control over firms in distress by withholding financing. Thus, the major conflicts of interest would exist between banks and other stakeholders, but banks would have incentives to ensure that suppliers of inputs and workers would not withdraw their services and force liquidation prematurely. For firms to gain access to direct borrowing in securities markets well-defined bankruptcy law is, however, necessary. Thus, the development of bankruptcy law is likely to be correlated with the development of financial arrangements discussed in Section 4.

4. Other Sources of Political Risk

In this section we discuss a few areas of law and regulation, that could be potential sources of substantial political risk for the foreign investor. Financial sector reform, privatization, capital account convertibility, and labor relations will be discussed in order.

a) Financial Sector Reform and Privatization

A crucial area of reform for the transition economy is the financial sector. In particular, a functioning banking sector is fundamental for the growth process without which both political and macroeconomic risk will become great. The financial sector also contributes to imposing harder budget constraints on enterprises. The lack of such constraints is a source of inflationary pressures in many countries.

A well-functioning banking sector includes a rapid and secure payment system, a mechanism for allocating savings to profitable projects without undue risk, and a mechanism for monitoring and disciplining managers' behavior and for substituting good management for an incompetent one. The latter role of the banking system is often neglected but of great importance in countries without deep capital markets as in the Anglo-Saxon countries.

Although most of the transition economies now allow private banks, the old state banking system in slightly restructured form dominates. There exist plans for privatizing these banks but, so far, only Poland has taken the first step in this process. Privatization, and the proper disciplining role of banks enforcing budget constraints on firms are hindered by the back-log of bad debts on the balance sheets. These bad debts were given to state-enterprises during the communist period and expanded further in the initial transition face, when the enterprises would simply have gone under were it not for cheap loans provided by the banks and other enterprises in turn financed by banks. The state enterprises have simply been allowed to build up debt to continue production of goods that are not in demand. In some countries (e.g. Russia) enterprise debt has expanded through

private banks set up by the enterprises with the sole purpose of tapping government funds.

The result of this process that still continues is that most banks as well as a large share of the state enterprises including their banks, have negative net worth making privatization difficult. Furthermore, the banks and firms with negative net worth do not have the proper incentives to finance healthy projects. On the contrary, they tend to finance high-risk projects with a small chance of a positive return, because it is irrelevant for bank and firm managers if the financial position deteriorates further.

There is a time-bomb ticking in this combination of bad-debt laden banks, and firms. Proper incentives can only be put in place by substantial debt-restructuring but the restructuring is going to be so obviously costly that it is politically difficult to implement. When proper incentives are put in place such a large share of the old enterprises will go bankrupt that high unemployment is inevitable for a period.

It is understandable that most countries try to delay facing the problems hoping that they can slowly improve the enterprises and avoid the big shake-out. In most cases, however, the problem is simply getting worse because many enterprises can never be saved and the others are not under proper monitoring by banks and owners. Managers' incentives remain skewed as described above. The build-up can be made even worse overtime by partial debt forgiveness schemes that do not go hand in hand with the composition of harder budget constraints on firms and banks. The build up can then be continued by managers expecting further debt forgiveness in the future.

Poland and the Check Republic have taken some first steps towards the cleaning up of firms' and banks' balance sheets with the help of EBRD, and Poland is trying a process of "commercialization" of boards of directors and management. In principle, supervisory boards with the explicit task of running banks and enterprises with commercial objectives are installed. How successful this process can be while the banks and the enterprises remain state-controlled and with negative net worth remains to be seen. There are reasons to be skeptical,

since successful commercialization requires that governments take a rather hard-nosed attitude towards new lending and employment consequences of commercially sound decisions.

We believe that most transition economies have in front of them a difficult process of restructuring of banks and state enterprises. This process is the source of substantial risk for all investors, since it may lead to civil strife, highly inflationary macroeconomic policies, and/or severe depressions for a period of time. Political risks of types one and two will remain substantial in countries that do not face up to these problems.

The payment system is another weak point in many transition economies. It is slow and sometimes unreliable, inducing an excessive amount of cash transactions. There are ways to deal with these problems for the foreign investor, relying on self-enforcement mechanisms, and fairly closely integrated structures, within which payment flows can be "internalized".

b) Exchange Controls

Transition economies are generally struggling to control inflation, to rebuild the capital stock with limited savings, and to develop new or redevelop old national identities. These struggles are often used as reasons for limiting capital account convertibility, even when current account transactions are generally liberalized. In other words, foreign exchange controls are imposed to limit capital outflows that, *first,* might cause depreciation of the currency and added inflation; *second,* cause a loss of financial resources that potentially could be used for domestic investment; and *third,* to prevent foreign nationals from claiming a large ownership share in the relatively poor economies. There is obviously a conflict of interest between the first and second objectives on the one hand, and the third objective on the other. If the Government prevents firms from claiming a large ownership share, capital inflows must be restricted, while at the same time capital inflows would alleviate balance of payments problems and contribute to the rebuilding of the capital stock.

Once foreign investors have been allowed to accumulate significant ownership, restrictions on capital outflows of any kind will be a signal of political

risk. Even limited restrictions on domestic residents can be seen as a signal either that the government lacks confidence in macroeconomic development, or that it plans to introduce policies that might reduce the rate of return on investment. Either way, the existence of such restrictions signals an increased probability that restrictions will be imposed on the remittances of foreign investors as well.

Economists are divided regarding the benefits and costs of exchange controls. Many argue that it is impossible for governments in emerging market economies to be perfectly credible in their reform policies. Capital outflows could hinder the progress of potentially successful reform programs. Correspondingly, restrictions could help progress. Some economies would argue that reform-programs based on regulation would always be inferior to open market policies, due to lack of information and competence on the part of authorities, and therefore a signal of a less attractive investment economy. Other economists argue that restrictions themselves reduce credibility and thereby hinder progress. In either case, they signal the existence of political risk, demonstrating governments' lack of ability to conduct sound and sustainable macroeconomic policies.

Nearly all transition economies have imposed exchange controls of various degrees of severity. In most cases, however, remittances of profits and legitimate payments for services are considered valid reasons for payments back to the foreign parent.

c) Labor Relations

Workers held a special position of status in the communist countries, although individuals and unions were not able to work freely in their own interest. The special status will, nevertheless, influence labor relations also in the transition economies. In most transition countries political pressures to favor labor are strong, when state enterprises are to be privatized.

Another reason why labor holds a strong political position in eastern European countries and the former Soviet Union is that most workers are more educated than the work-force in developing countries with the same level of economic wealth. The labor force is in many respects more comparable to that in

Western Europe although the economic system has hampered workers' productivity in Eastern Europe.

Employees in the transition economies are not formally protected by the battery of laws and regulations existing in the west. Nevertheless laws remain in many countries making it costly to reduce the work-force. Such costs of reducing the number of employees increase the risk of investment, as well.

5. Cases: Institutional Development in Transition Economies[**]

The transition of law from socialist economies to market economies has progressed rapidly in most countries of eastern Europe. Problems of enforcement and conflicts among old and new law, however, exist. As an illustration the development of formal law in Hungary and Estonia is reviewed here. We will follow the classification in Tables 2 and 3 for requirements of property rights and dimensions of user rights. Thereafter we report on an interview study of Estonian firms covering a broader range of hindrances for enterprise developments than formal law.

a) Hungary

Requirements For Property Rights (Table 2)
The *constitution* establishes protection of private property and general rights to freedom of association. It lists a number of fundamental rights as is common in democracies. Those rights are no longer subject to interpretation in terms of the higher "interests of socialism".

Real estate ownership and rights associated with it has been defined in "Act I of 1987 on Land". A private Hungarian may acquire real estate without any legal

[**] The World Bank has published reports on the development of relevant law in many transition economies. OECD has also published a number of reports dealing with the business and investment climate in transition economies.

limitation. There is still ambiguity with respect to title to land, that was nationalized during the socialist years.

Foreign ownership of agricultural land is generally prohibited. Other types of land can be owned by foreigners if permission is granted. Hungarian subsidiaries of foreign corporations can own land for purposes related to the objectives of the corporations.

Foreign ownership of firms and real property is allowed with no percentage restriction. No permission is needed and foreign investors are guaranteed compensation in case of expropriation.

Rights to intellectual property exist or are proposed, but enforcement capabilities are lacking. Although rules are, or will soon be harmonized with the European norm, infringements are not easily curbed.

User rights for property (Tables 3 and 5)

Table 5 specifies in greater detail than Table 3 the many areas of law influencing how property can be used. Laws are divided into three groups. The *first* determines managers' and "owners'" ability to establish and run a business as they desire. The *second* group influences how profits can be used according to owners' discretion, and the *third* group determines owners' rights to trade resources of different kinds. The groups overlap to some extent but provide a rough classification scheme and it illustrates the wide-ranging fields of law influencing different aspects of a business operation.

Without going into details of the Hungarian laws specifying user rights, a few observations illustrate the progress that has been made and the problems that remain.

User rights to real estate are still restricted or ambiguous as a result of regulation from the socialist period. For example, restrictive eviction procedures remain. Authority over zoning and building regulation is unclear. A number of public authorities previously involved in giving permits still exist and clear procedures for seeking permits have not been established.

Company law recognizes a number of business forms. It is a Roman based law as distinct from the Anglo-Saxon approach. Procedures for registration of firms as legal persons are well-defined and reasonably simple (this is not the case in all formerly socialist economies).

A new *bankruptcy law* exists. It deviates from international norms in one respect. Claims of creditors secured by lien on assets have lower priority than claims for wage and severance payments. This provision could dampen the supply of credit against security. A major problem of implementation exists, as well. The capacity to deal with the surge of bankruptcies simply is not there.

Regarding *ownership rights*, Hungary has removed legal impediments to trading for commercial purposes and private property is granted the same level of protection as state property.

Contract law incorporates standard western concepts but many obsolete administrative requirements and restrictions remain. Courts do not have much experience in dispute resolution. Thus, the substance of contract law and the extent of freedom of contract will be determined over the years.

A new *competition law* took effect in 1991. It gives wide discretion to the antimonopoly office and the courts. Interpretation and application of the law is a challenge for the future.

Profit repatriation is allowed provided the firm has local currency (forint) on reserve. Thus, profits must be received in the forint before repatriation is possible. Hard currency accounts in Hungarian banks can be maintained. These rules are liberal relative to many formerly socialist economies.

The corporate tax is 40 percent but the law offers industry-specific tax incentives for foreign investors. The incentives are temporary, as well as time-limited, however.

In summary, Hungary has moved quickly to establish the legal framework necessary for a market economy. Efficient markets for trading in privately owned land are hindered by inaccurate land registry and a surviving inefficient regulatory structure. These institutional deficiencies prevent property from being used as collateral. Implementation of the new legal structure is made difficult by a lack of

court capacity, and legal expertise, as well as by a lack of well-established business practices in the new environment. Thus, foreigners trading with Hungarian firms and individuals must rely heavily either on self-enforcement by dealing with parties with a reputation at stake, or on contractual arrangements for dispute resolution by foreign courts or arbiters.

***b) Estonia*[3]**

Requirements for Property Rights (Table 2)

The Estonian constitution states that citizens, foreign citizens and stateless persons enjoy equal rights, liberties and duties, listing all fundamental rights common to a democratic state.

Private property rights are given basic guarantees by the constitution, but ownership rights are stipulated in more detail in the Property Act (13.06.90) which defines the rights the owners enjoy and confirm the equality of the owners before the law. Private and state property are equal before the law. The owner is vested with the right of control, use, and disposal of his property. (Property Act, § 4, 1). This act also states that the fruits, yield and revenue obtained from property belong to the owner of the property, unless provided otherwise in the law or in contract (§ 6, 2).

Real estate ownership and rights associated with it are defined in detail in the Law of Estate which also regulates mortgage and collateral transactions. Ambiguity remains with respect to title of real estate which

a) was nationalized and is now claimed back by former owners whereas the present owners (the state has given them the right to own the estate) have substantially improved the real estate under question (have built new buildings, etc. on it);

b) which has to be first re-nationalized (trade union property, etc.)

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[3] This section is taken from Kukk, M., 1993, *Privatization in Estonia: Political Risks for the Foreign Investor,* IUI, Mimeo.

Acquiring real estate is not limited to an Estonian citizen. Legal persons however, cannot be land-owners according to current law. This situation is expected to change in the course of time.

Foreign ownership of agricultural land is prohibited, but leasing land for foreigners is allowed. The Privatization Law enables a foreign investor to purchase land which is directly related to purchased property, provided the Government of Estonia so approves.

Foreign ownership of real property and firms is allowed and the regulations are reasonably clear and manageable. Nationalization, expropriation or confiscation of property is not allowed, except in cases listed by the law. In such cases the foreign investor has a right to fair compensation and appeal to the court in case of dispute.

Rights to intellectual property are acknowledged by the Property Act.The Trade Mark Act regulates intellectual property rights connected with business activities. The Copyright Act regulates protection of literary, artistic and scientific work. The implementation of the protection of these rights is, however, in the initial stage and is to a large extent dependent on contractual arrangements.

User Rights for Property (Tables 3 and 5)

User rights to real estate which is obtained by privatization or restoration of ownership, are clarified by the Land Reform Act and the Law of Estate. The former foresees several restrictions for using land acquired by restoration or replacement and privatization. Those restrictions also count for the lessees of land. Foreign enterprises can lease land under the same conditions as Estonian enterprises. User rights to real estate within a city or a borough can be limited by the local authority via licensing in case of establishing enterprises with foreign capital. The foreign investor can appeal to a higher state body and, finally, to court if the decisions by the local authority do not satisfy him.

No spheres of activity are prohibited for foreign investors. Licenses are, however, required to operate in the following fields:

- mining;

- energy, gasworks, and waterworks;
- railway and air transport;
- waterways, ports, dams and other water transport establishments;
- telecommunications, communication networks

There are fields of activity where all enterprises, even Estonian firms, require a license, such as the establishment of commercial banks, the provision of medical treatment, producing and selling medical substances, insurance, producing and selling alcoholic beverages and of firearms and ammunition, etc. Foreign investors have the right to export foreign currency which is received as a profit from the sale of their share of an enterprise's assets or from the dissolution of an enterprise.

The Enterprise Act recognizes a number of business forms. Procedures for registration of firms as legal persons are reasonably simple and clear. *The Partnerships Statute and Stock Corporations Statute* regulate the formation, liability and termination of general partnerships ("full partnership"), limited partnerships ("trust association") and joint-stock companies, as well as stock corporations. *The Leasing Act* regulates the use of property on the basis of a leasing contract which is rather common in Estonia.

The Accounting Law stipulates the responsibility of top managers and persons responsible for book-keeping of all enterprises. The law follows European standards in guaranteeing the presentation of correct data by entrepreneurs.

Rights to fair competition and to the safeguarding of business secrets are guaranteed by the *Competition Act*. This law also prohibits all action by the state authorities or local governments which is in contradiction with it, and is not allowed by other laws. The Competition Act will be in force after two stages: antimonopolist part after October 1, 1993, and contractual part after January 1, 1994. Implementation of this law will present a serious challenge for both the state agencies and the court system.

Foreign Investments Act establishes a legal platform to determine the benefits to foreign investors and guarantees on protection of foreign investments. Together with the Law on Tax Concessions for Foreign Capital Enterprises this act

establishes the main framework for foreign investments. As a general rule, all regulations which apply to Estonian enterprises equally apply to foreign-owned enterprises.

Foreign investors enjoy certain *customs benefits and tax relief.*

The Bankruptcy Act, largely based on the experience of Sweden and Finland, is the first of its kind in Estonian history. The fundamental principle of the Bankruptcy Act is that the rights of lenders are given strong protection. The concept of bankruptcy and bankruptcy proceedings are essentially the same in the law of Estonia as they are in the laws of other countries. The Estonian Bankruptcy Act reduces the functions of the court to give creditors a more active role to agree voluntarily. The trustee has a rather extensive, independent mandate to enable him to guarantee the claims and lawful interests of the creditors. The order of satisfying claims is: 1) secured claims (guaranteed by collateral); 2) wages and income which may be regarded as wages; 3) taxes and social security payments; 4) all other approved claims.

The Securities Market Act regulates the questions related to securities and stock markets in Estonia, stipulating that by November 1, 1993, all professional traders in the securities market have to adjust their documents and activities to this law. All professional traders of the securities market are licensed by the state authority. Stock markets and money markets exist in Estonia, but their activities have until now been rather limited.

The right to just treatment and appellation to court or arbitration is provided to the foreign investor by all the aforementioned legal acts, and, as stated in the constitution, before the law, the foreign investor in Estonia is equal to an Estonian citizen.

Besides the legal system of Estonia it has to be noted that a number of guarantees for the foreign investor are provided by international treaties and conventions. The Estonian constitution states that universally recognized principles and norms of international law shall be an inseparable part of the Estonian legal system. Investment protection and trade agreements have been negotiated between Estonia and other states.

Mutual investments have been protected under the provisions of investment promotion and protection agreements concluded with Finland, Sweden, Norway, France, Denmark, the Netherlands, and Germany.

Iceland and Sweden have concluded Most Favored Nation (MFN) agreements with Estonia.

Free trade agreements have been concluded with Finland, Sweden, Norway, and Switzerland.

Relations with EFTA are characterized by the joint declaration by EFTA member states and Estonia.

The Estonian Government is currently negotiating with several countries for the completion of bilateral agreement for the avoidance of double taxation.

In summary, like Hungary, Estonia has moved quickly to establish the legal framework for a market economy, but there is considerable uncertainty about land-ownership. Thus, real property can rarely be used for collateral for bank-loans. As in Hungary, the capacity of the judicial system is limited. Self-enforcement mechanisms like reputation of contracting parties will remain the most important enforcement mechanism for the foreseeable future.

c) An Interview Study of Hindrances for Establishment of Business in Estonia[4]

We report here on an interview study of Estonian firms' contractual relations and hindrances for business establishment. This report is based on a preliminary study of 24 firms in one country. Our plan is to extend the study to a larger number of firms and to repeat the study three years in a row. The study will hopefully be conducted in three other transition economies, as well.

The 24 firms reported on in this section were of varying size. Eleven firms have less than ten employees, six have more than 100. The state held a substantial interest in only four. Most small businesses are privately owned.

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[4] The study was conducted by a research team led by Vello Vensel, Tallinn Technical University.

Start-up financing
Private savings dominate as a source of start-up financing. Only one of the firms had obtained a bank-loan to finance the purchase of a building. No equipment had been financed with a bank-loan. This result indicates that the banking system fails in an important function.

Supplier relations
In 19 of the 24 cases suppliers had to be paid at the time of the order or cash on delivery, reflecting a lack of belief in the enforcement capacity of the legal system.

Customer-relations
The response here was similar to that for supplier relations. Trade credits were given domestically in only four cases. Credits were provided for export sales, however.

Banking services
Firms expressed dissatisfaction lacking the possibility to borrow short-term to finance working capital. There were also wide-spread complaints about the high level of interest rates. The speed of banking services, including payments seemed satisfactory, however.

Regulatory hindrances
The Estonian regulatory system does not seem to seriously hinder the establishment of new business, although 70 percent of the firms faced some difficulty in the form of requirements by the tax-authority, or bureaucracy in government offices.

Restrictions on the *closing of businesses* were perceived to be more severe. The government restricted the right to sell enterprises, and the cost of firing workers was perceived as burdensome, unless the whole firm was permanently

liquidated. Firms had different perceptions whether temporary lay-offs are legal or illegal.

Conflict resolution

All firms reported on conflicts in the form of non-payment by customers, non-delivery by suppliers, and failing transfers by banks. In the vast majority of cases, firms relied on direct bargaining with the other party to resolve disputes. The interviewers argued that Estonian legislation is not sufficient for the resolution of conflicts. Arbitration and, in one case, international arbitration, was used in six out of 85 disputes. Courts were used in seven cases.

General hindrances for business establishment

The most severe hindrance for business establishment or expansion in Estonia during 1991 and 1992 was a lack of demand and excess capacity in existing industry. Formal regulatory hindrances are nearly irrelevant but the government prevented the sale of enterprises and temporary lay-offs of workers are discouraged. There are severe financial constraints on business establishment as well as business operations. Start-up financing depends almost entirely on private savings. Retained profits is the dominating source of financing of operations. Conflict resolution must generally be handled informally.

Table 1
RISK HIERARCHY

<u>Political Risk</u>

1) **Force Majeure — first order risks referring to non-economic events.**
   — military etc.

2) **Force Majeure — second order risks referring to macro mismanagement**
   — e.g. collapse of monetary system

3) **Institutional Deficiencies controllable by political authorities**
   — third order risks

Business Risk

4) **Monitoring and controlling opportunistic behavior on the part of business agents. (Dependent on political and institutional development)**

5) **Uncertainty caused by uncontrollable shifts in demand and competitive conditions in the market for a firm's output and input**

Table 2 LEGAL REQUIREMENTS FOR PROPERTY RIGHTS

1. Property rights legislation
2. Registration of legal persons
3. Exact rules for identifying property rights with legal persons.
4. Court recognition of voluntary contracts
   a) implicit
   b) formal

Table 3 AREAS OF LAW SUPPORTING PROPERTY RIGHTS

Institution	
1. **Property rights**	- constitutional property rights - purchase law - land law - copyright law - patent law - trademark rights
2. **Registration of legal persons**	- criteria for possession
3. **Exact rules for identifying property rights with persons**	- land and property registers - company law - accounting law
4. **Court recognition of voluntary contracts**	a) Enforcement of voluntary contracts - laws regulating the resolution of disputes - instance of last resort b) Procedure and stability of law - enforcement - implementation - interpretation - change

Table 4 Economic Dimensions of user rights to property

Right to

1) *Manage* the property
2) *access* and use of profits
3) *trade* in the property rights.

Table 5 Areas of law defining user-rights for property

1. THE RIGHT TO MANAGE PROPERTY	**New Establishment/exit** (see also TRADING RIGHTS below) - entry restrictions - company law - bankruptcy law **Corporate Governance, Monitoring and Control** - Company law - Contract law - laws regulating mergers and acquisitions (commercial codex) - Laws regulating industrial (universal) banks in German and the corresponding Anglo-Saxon tradition - Poison pills, hostile take overs - Insider trading - Accounting law - Auditing law - Reporting requirements **Operations** - Contract laws - Labor relations law - Renting or buying land, buildings, machines - Licensing - Work permits for foreign nationals in local Subsidiaries (work permit regulations) - Work quotas for local people - Payment restrictions - Regional policy - Environmental and health standards - Liability and Tort law **Competition** - trade restrictions - anti trust law - restrictions on predatory pricing - patents

- price controls
- credit controls
- laws & regulations on transfer of technology
- discriminatory environmental laws

2 ACCESS AND USE OF PROFITS	- convertibility of currency/exchange controls - repatriation of profits - restrictions on the transfer of funds - tax law - income taxes - deductions - stamp taxes, etc. - double taxation rules - extraterritoriality - judicial appeal in tax matters - bankruptcy law - investment guarantees - laws on insider trading
3. TRADING RIGHTS	- Restrictions on selling assets in secondary market - Ditto, ownership contracts - Restrictions on investors to buy - Stockmarket law and regulations - Laws regulation foreign ownership - Rules of indiscriminatory treatment (level playing field) - Laws requiring local ownership - Special financial facilities to hedge