Foreword

by Erik Berglof

Stuck in transition?

For more than five years, the transition region has been buffeted by the fall-out from the global recession of 2008-09, and the eurozone crisis of 2011-12. Beyond their short-term impacts – collapse in output, followed by stagnation or sluggish recovery – these shocks have triggered doubts about the ability of the transition region to return to "convergence": the process of catching up with the living standards in advanced market economies. The main reason for such doubts has been the decline of international capital flows to the region, which have been an important element of the "growth model" of countries in transition.

This *Transition Report* shows that convergence is indeed at risk in most countries in the transition region – but for different reasons. Although they will not return to their pre-crisis highs (nor should they, since in many cases these reflected an unsustainable bubble) capital flows will eventually recover. In addition, several countries are rebalancing toward home-grown sources of finance, which is generally a positive development as these economies mature. A more compelling concern is the stagnation in reforms and in improvements to market-supporting institutions in most countries in the region since the mid-2000s, including many that are still far from the transition frontier. Furthermore, following the 2008-09 crisis there have been reform reversals in several of the more advanced economies.

How can reforms regain their momentum? The *Transition Report 2013* seeks to answer this question based on an area of analysis that was first studied in the *Transition Report 1999*: the political economy of reform and institutional development.

The 1999 report showed that successful reforms during the first decade of transition were more likely to have occurred in countries with stronger political competition and less polarised electorates. Contrary to conventional wisdom, political turnover benefited reforms, while strong executives tended to deter them. These findings were explained by the influence of political and economic elites who – in the absence of appropriate checks and balances – profited from state subsidies, insider privatisation and weak enforcement of the rule of law.

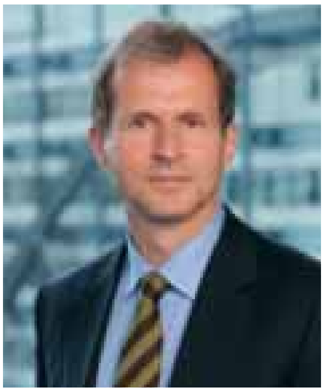
With the benefit of considerable hindsight, this report confirms some of these findings. Its analysis particularly supports the presence of a strong causal impact of democracy on the success of reform. At the same time, the report expands the analysis of economic reform in four directions.

Chapter 2 investigates the causes of democratisation. Why do some countries succeed in building sustainable democracies and others not? Does market reform help or hinder the medium and long-term prospects for democratic consolidation? This is particularly important in the wake of the changes that the Arab world has been undergoing for the past two-and-a-half years, as the international community looks for the most effective ways to support these countries in their political transitions.

Based on international evidence and data from the transition region, the chapter finds that (i) economic development makes democratisation more likely, (ii) natural resource endowment holds back democratisation, and (iii) market reforms appear to influence future democratisation – at least in the sense of preventing reversals to less democratic systems. This could be because economic liberalisation weakens the power of interest groups who benefit from less democracy. Hence, the causal links between democracy and reforms appear to run in both directions.

Chapter 3 takes a broader view of reform, focusing on the quality of economic institutions. Beyond liberalisation, stabilisation, and privatisation, this encompasses regulation, effective government, strong rule of law, low corruption, and other aspects of the business environment. It finds that determinants of institutional quality include history, geography, initial reform experiences, and other factors that are beyond the control of policy-makers. But economic integration, human capital, and the design of democratic institutions matter as well. Furthermore, countries with difficult histories of reform sometimes benefit from a second chance. The chapter compares such "critical junctures" in four countries in order to understand why some experienced permanent improvements in institutions while others did not.

"This year's *Transition Report* explains why some countries may be 'stuck' in traps with little or no reform, but also indicates ways to break out of them."



Chapter 4 investigates the state of education and human capital in the transition region. Most formerly communist countries have good primary and secondary education systems. In some of these countries, they are on a par with the equivalent systems in more advanced economies in the Organisation for Economic Co-operation and Development (OECD). Tertiary education, however, is much weaker. In addition, the returns to university education are comparatively low, particularly in countries with weak economic institutions. Just as in the case of democracy and good economic institutions, economic institutions and human capital appear to complement each other.

Chapter 5 investigates a dimension of economic institutions that is rather overlooked by traditional measures of institutional quality, but is key to the long-term success of market systems – their ability to provide economic opportunities to individuals regardless of gender, region of birth or social background. The chapter measures economic inclusion in the transition region for the first time: from a *bottom-up* perspective, by examining how household assets and educational attainment are influenced by circumstances at birth, and *top-down*, by rating the inclusiveness of economic institutions. The results indicate severe inequality of opportunity in several countries, particularly in regard to employment practices, job opportunities and quality of education. This hurts young adults from less educated social backgrounds and from rural areas, but in some countries it also affects women.

Collectively, these findings not only explain why some countries may be "stuck" in traps with little or no reform, but can also indicate ways to break out of them.

External shocks, elections, or periods of popular discontent can offer windows of opportunity. During these windows, political and economic institutional reform can become politically feasible and have permanent impact – particularly if used to build supportive constituencies and to strengthen the incentives for further reform. The chances of such reforms succeeding are higher in societies that are less polarised and in which vested interests are less powerful, but they also depend on leadership and external support.

In addition, there are policies that can promote successful, if gradual, economic reform in normal times – even in less democratic environments. These include openness to foreign investment and other forms of international integration. The presence of foreign companies can generate demand for better government services and set standards for better corporate governance. International institutions can provide inspiration, expertise and commitment, while external benchmarks can encourage improvements in certain aspects of the business environment, such as cutting red tape.

There is often scope for political reform that supports economic reform. Even where incumbent elites or vested interests prevent the reform of political institutions at the national level, it may be possible to reduce corruption and foster transparency at local and regional levels. Research shows that business environment reforms are more likely to be effective in the presence of transparent local institutions. In turn, this can foster the entry and growth of small businesses which in turn generate pressure for reform at the national level.

Non-governmental organisations have an important role to play in demanding transparency and holding government institutions to account. Social media and the internet have additionally created an instrument to enforce rules and regulations and disclose abuses. Social media can also galvanise broader bottom-up reform movements, as in some Arab countries. Furthermore, the traditional media continue to play an important role in restraining politicians and bureaucrats alike. Ensuring media independence and protection from legal harassment is critical for this check on the system to be effective.

The findings of this report pose important challenges for the EBRD and other international financial institutions (IFIs). There are clearly limits to what can be achieved at the project level without improvements to national economic and political institutions. At the same time, some projects can spur sector reform and ultimately wider improvements, particularly when they involve equity investment by large companies. Corporate governance improvements, the separation of political influence from management and transparency of corporate accounting can be critical in the fight against vested interests. The participation of IFIs in infrastructure projects can also encourage transparency in procurement and draw end-users and consumers into the design and delivery of public services. Such grassroots involvement should also increase the prospect of genuine political democracy in the long term.

The recent history of transition has shown that weak political institutions and entrenched interest groups can cause countries to become "stuck" in transition. However, evidence suggests not only that time is on the side of reform but that countries can promote and accelerate reform, particularly if international integration, domestic leadership and broader social movements work hand in hand.

Erik Berglof
Chief Economist
EBRD

EASILY ACCESSIBLE INFORMATION NOW ONLINE

Watch the video

Erik Berglof, Chief Economist of the EBRD, highlights the main findings of the *Transition Report 2013*.

Look out for these icons

These indicate (left to right) online and print versions, video and audio content, and downloads.