TRANSITION REPORT 2013

European Bank
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About this report

The EBRD is investing in changing people's lives from central Europe to central Asia and the southern and eastern Mediterranean. Working together with the private sector, we invest in projects, engage in policy dialogue and provide technical advice that fosters innovation and builds sustainable and open market economies.

The EBRD seeks to foster the transition to an open market-oriented economy and to promote entrepreneurship in its countries of operations. To perform this task effectively, the Bank needs to analyse and understand the process of transition. The purpose of the *Transition Report* is to advance this understanding and to share our analysis with partners.

The responsibility for the content of the report is taken by the Office of the Chief Economist. The assessments and views expressed are not necessarily those of the EBRD. All assessments and data are based on information as of early October 2013.
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Country abbreviations

Albania	ALB	Montenegro	MNG
Armenia	ARM	Morocco	MOR
Azerbaijan	AZE	Poland	POL
Belarus	BEL	Romania	ROM
Bosnia and Herz.	BOS	Russia	RUS
Bulgaria	BUL	Serbia	SER
Croatia	CRO	Slovak Republic	SVK
Egypt	EGY	Slovenia	SLO
Estonia	EST	Tajikistan	TJK
FYR Macedonia	FYR	Tunisia	TUN
Georgia	GEO	Turkey	TUR
Hungary	HUN	Turkmenistan	TKM
Jordan	JOR	Ukraine	UKR
Kazakhstan	KAZ	Uzbekistan	UZB
Kosovo	KOS		
Kyrgyz Republic	KGZ	France	FRA
Latvia	LAT	Germany	GER
Lithuania	LIT	Italy	ITA
Moldova	MDA	Sweden	SWE
Mongolia	MON	United Kingdom	UK

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Executive summary

Can the transition region ever catch up with the living standards of the world's most advanced market economies?

Economic growth remains well below pre-crisis levels and many countries have turned their backs on the reforms that could put economic expansion back on track.

The evidence suggests that countries can promote and accelerate the return of reform, particularly if international integration, domestic leadership and broader social movements work hand in hand.

Chapters 1 to 5 of the *Transition Report 2013* look into the relationship between transition and democratisation, the scope for strengthening economic institutions, the state of human capital in the transition region, and the inclusiveness of economic systems.

The last two sections of this report examine the regional macroeconomic developments and outlook as well as recent trends in structural reform during 2013.

In addition, assessments of the economic performance of individual countries in the transition region are available online at www.tr.ebrd.com

Convergence at risk

Economic reform has stagnated in the transition region since the mid-2000s, even in countries that are still far from reaching the transition frontier. Progress in transition has been closely correlated with political systems: countries which are more democratic have come further, in terms of reform, than their less democratic counterparts. However, public opinion turned against market reform after the 2008-09 financial crisis, especially in the more democratic countries. This is reflected in an increased number of "downgrades" in EBRD transition indicators since 2010, particularly in EU countries.

The results of a long-term forecasting model suggest that under current policies and institutions, productivity growth will likely remain modest over the next 10 years – around 2-4 per cent on average – and decline further in the following decade. At that rate, convergence with the living standards in western Europe would stall in some countries and slow to a crawl in many others. Only the countries of central Europe and the Baltic states would reach or exceed 60 per cent of the EU-15 average per capita income in the next 20 years. Most countries in the transition region would remain far below this threshold.

To revitalise growth, it is important to invigorate reforms and improve economic institutions. There is no shortage of advice in this regard, including in the Country Assessments that are available in the online version of this report. But reforms face political, social and human capital constraints. The purpose of this *Transition Report* is to investigate how countries can circumvent or loosen these constraints. The report analyses (i) the forces shaping political institutions; (ii) the scope for strengthening economic institutions within prevailing political systems; (iii) the relationship between human capital and growth; and (iv) the inclusiveness of institutions in the transition region.■

Political institutions

Since the onset of transition in 1989, many countries in the region have become consolidated democracies, while in others democratisation has stagnated or even gone into reverse. Why do some countries succeed in building sustainable democracies and others not? What role does economic development play in the process? Does transition to a market-based economy led by the private sector strengthen the medium and long-term prospects for democratic consolidation?

This chapter reviews the literature on economic development and democratic change. Although the academic community remains divided on this issue, there is strong empirical support for the proposition that economic development – measured in terms of GDP per capita – leads to advances in democracy over time, up to a point of diminishing returns. Furthermore, countries that cross a threshold of economic development are less likely to experience democratic reversals. The main exceptions are countries with large natural resource endowments, where state authorities can monopolise resource rents so as to avoid reliance on a system of broad taxation of the population – and therefore face less pressure to accept accountable representation. In addition, democratisation is less likely in the context of high inequality.

Empirical analysis confirms that most of these findings also hold for countries in the transition region. Those with higher levels of per capita income are more likely to democratise and less likely to experience reversals in the process. Large resource endowments are found to impede, or at least slow down, democratisation. There is also evidence that, among countries with similar levels of per capita income, early and more vigorous market reforms help to consolidate democracy. This is consistent with the view that economic liberalisation can prevent the formation of vested interests that benefit from weak political institutions.

In order to support countries in their long-term transition to democracy, it therefore makes sense to encourage policies and institutions that underpin economic growth, foster market reforms, and assist countries that are rich in natural resources as they seek to diversify their economic base.■

Economic institutions

How can countries in the transition region improve their economic institutions? Cross-country analysis shows that the quality of such institutions depends not only on the level of democracy, but on several other factors. Some are immutable or hard to change, such as history, natural resource endowments, ethnic divisions and eligibility for EU accession. Others such as openness and the design of democratic institutions are easier to alter. The analysis finds that countries with greater openness to trade and finance tend to have better economic institutions. Furthermore, political systems with proportional representation seem to have worked better in the transition region than majoritarian electoral systems.

A comparative study examining the success or failure of reforms at "critical junctures" –political shifts that opened a window of opportunity – in Georgia, Romania, the Slovak Republic and Ukraine confirms the relevance of the factors mentioned above. It also suggests that early transition histories were important because they sometimes gave rise to vested interests that became entrenched. Political polarisation makes the success of reforms less predictable and reformers and civil servants more hesitant. External anchors and international backing can have strong supportive effects, particularly when sought by the reformers. In addition, the background and conviction of leaders play a critical role in determining the success of reforms.

The chapter concludes with a survey of the options available to reformers who have to operate within the broad constraints of the prevailing political system. What can they do to help improve economic institutions? First, they can promote both economic and intellectual integration with advanced economies – through trade, finance and education. Second, they can seek to benchmark themselves internationally and become members of organisations with high institutional standards. Third, in some settings, they may also be able to pursue constitutional or electoral reform – for example, introducing proportional representation, which although not a panacea, can improve decision-making, particularly in societies that are less polarised or where vested interests are weak. Lastly, they can improve the transparency of political institutions at the regional and local level, as they play a key role in the shaping and reform of the business environment.■

Executive summary

Human capital

Education is critical for building a human capital stock conducive to economic growth and development. Primary and secondary education in most of the transition region compares favourably with that in developing countries in terms of quantity and quality and matches what many advanced economies can offer. At the tertiary level, however, transition economies perform much worse, and the gap with advanced economies has increased over the last decade. Southern and eastern Mediterranean (SEMED) countries are embarking on their own transition with lower stocks of human capital and are lagging significantly behind, particularly in terms of the quality of primary education.

The financial returns from tertiary education ("returns to education") are critical to the successful development of a high quality human capital stock. Unless the returns are sufficiently high, individuals will be unlikely to pursue education beyond secondary level. The chapter shows that the returns to tertiary education depend not only on the supply of tertiary-educated workers and the quality of tertiary education, but also on the quality of a country's economic, legal and political institutions. Institutions affect the link between human capital and growth, because they influence how human capital is used and the flow of migration.

A country's ability to retain and attract skilled people is another important factor for building a high quality human capital stock. Countries in the transition region and SEMED have experienced emigration of their skilled workers, but have also received skilled immigrants in turn. However, only a few have managed to attract sufficient incomers to replace those who leave. By 2000, in most of these countries net emigration stock rates had increased compared to 1990. Due to the global economic crisis and to the accession to the European Union of 11 countries in the transition region, this trend is likely to have continued.

A high quality institutional environment makes it easier to attract and retain skilled people, who will innovate and adapt to global technological changes, and so stimulate economic growth. It also provides rewards to tertiary-educated individuals, thereby maintaining the incentives needed to invest in education. Human capital development and institutional improvements are thus complementary, and policy-makers should pursue them in parallel.■

Economic inclusion

Economic inclusion, defined as broad access to economic opportunity, is essential for well-functioning market economies. If people are denied the chance to succeed, they will lack incentives to seek education, participate in the workforce, invest or otherwise engage in activities that lead to growth and prosperity. Furthermore, market reforms that fail to benefit the population at large will not enjoy public support for long.

This chapter provides some direct evidence on economic inclusion in the transition region. Inclusion is not automatically apparent in measures of democracy or economic institutions, and so merits independent analysis.

Two approaches are used to characterise inclusion in the transition region. A *bottom-up* approach focuses on the individual or household level, measuring the extent to which differences in wealth or education across households are attributable to circumstances at birth. The stronger the relationship between circumstances and outcomes, the further a country lies from the ideal of equality of opportunity. A *top-down* approach rates the institutions, markets and education systems in regard to the capacity of countries to extend economic opportunity to individuals regardless of gender and place of birth, and to young adults regardless of social background.

This combined analysis finds large variations across geographic regions and the dimensions of inclusion. Inequality of opportunity is highest in the Western Balkans and some eastern European and Central Asian countries. In part, this reflects a failure to provide young people with relevant education and job opportunities. Place of birth – urban or rural – turns out to be an important driver of inequality of opportunity. Inclusion gaps also exist in regard to gender, particularly in the SEMED region. Except in Egypt, Morocco, Tajikistan, Turkey and Uzbekistan, education is not a major factor contributing to inequality of opportunity suffered by women, and in most countries gender does not seem to play a role in explaining differences in tertiary education. At the same time, the analysis suggests that education – and its quality and economic relevance in particular – is likely to influence inequality of opportunity that is based on people's social or geographical origin.■

Macroeconomic overview

The economic slow-down in the transition region, which began in the second half of 2011 as a result of the eurozone crisis, has continued in 2013. However, external drivers and regional distribution of growth have recently shifted. While the eurozone returned to modest growth in the second quarter of 2013, there has been a downturn not only in key emerging markets like China and India but also in the three largest economies of the transition region: Russia, Turkey and Poland.

As a result, countries initially less exposed to the eurozone crisis have suffered weaker trade and remittances and declining growth. In central Europe and the Balkan states, and in south-eastern Europe exports have recovered and deleveraging has moderated. Nevertheless, the slow-down in their economies has continued, driven by a fall in domestic consumption and investment. Regional growth is projected to accelerate modestly in 2014, in line with a slightly improved external environment.■

Reform overview

Structural reforms in the transition region continue to face serious challenges. 2013 has once again seen a relatively high number of downgrades for sector and country-level indicators. At the sector level, reform reversals and increasing government interference in the energy sector are reinforcing the negative trends of recent years, in particular in central and south-eastern Europe. However, financial sector reforms enacted in the wake of the 2008-09 crisis have proven more resilient. There have also been other positive developments, with progress on public-private partnerships and the restructuring of utilities in infrastructure. The corporate sector continues to suffer following the crisis, but there are signs of recovery in certain countries.

At the country level, transition indicator downgrades outnumber upgrades for the first time. There have been three downgrades for Hungary and two downgrades for the Slovak Republic, mainly due to increased government involvement in the energy and insurance sectors which may negatively affect the confidence of domestic and foreign private investors.■

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.

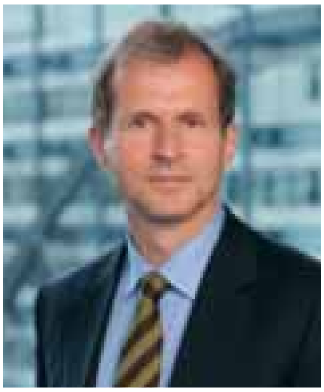
With the benefit of considerable hindsight, this report confirms some of these findings. Its analysis particularly supports the presence of a strong causal impact of democracy on the success of reform. At the same time, the report expands the analysis of economic reform in four directions.

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
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Watch the video

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

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