INNOVATION IN TRANSITION

Last year's *Transition Report*, entitled Stuck in Transition?, examined the causes of the slow-down in income convergence between transition countries and more advanced market economies. It focused on country-level characteristics that continue to hamper economic development in large parts of the transition region – weak economic and political institutions, slow structural reforms, limited productivity growth and the daunting challenge of improving human capital and working towards equal opportunity. The report was a general reality check and, to some extent, a wake-up call.

Innovation in Transition – the title of this year's *Transition Report* – tackles a similar set of issues from a completely different perspective. The report focuses, in considerable detail, on the individual firm in transition. Adopting this micro perspective is crucial to achieving a deeper understanding of why countries can become "stuck" in transition. More importantly, it also reveals the effect that individual firms can have on economy-wide productivity and the specific steps that can be taken to help boost productivity and reinvigorate economic growth. The challenge for policy-makers is discovering how to facilitate and encourage change at the firm level without intervening in decisions that are best left to firm owners and management.

We use the word "innovation", with some hesitation, to describe what happens in individual firms. Innovation has associations with high tech and R&D, but innovation is something much broader and encompasses the introduction of any new products, services or production processes. This definition of innovation is particularly important in emerging economies because many productivity improvements, and ultimately economic growth, will come from imitation and adapting globally available technologies to local markets. Some of these changes will happen when new firms with novel ideas enter the market and when unproductive firms cease to produce, freeing up resources that can be used to realise better ideas. The economy also gains when efficient and fast-growing firms expand their market share while inefficient ones wither. Yet, most productivity improvements stem from within firms, particularly in emerging and developing economies.

The overriding question that the *Transition Report 2014* aims to answer is why certain firms in the region innovate and grow while others become stuck in terms of their development. To answer this question, the report draws on a unique enterprise survey conducted across the region by the EBRD and the World Bank over the past three years – the fifth round of the Business Environment and Enterprise Performance Survey (BEEPS) – together with the Middle East and North Africa Enterprise Surveys (MENA ES) carried out by the World Bank, the EBRD and the European Investment Bank. The latest round of BEEPS includes, for the first time, a special module on firms' innovation activities. This collates information about the new products and processes that firms have introduced in the recent past. The survey enables these activities to be related to a firm's management practices, its performance and the business environment in which it operates.

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The analysis also benefits from another major survey conducted by the EBRD in 2012, the second round of the Banking Environment and Performance Survey (BEPS II). The survey used face-to-face interviews with the CEOs of over 600 banks in the region to collect detailed information on their operations and business models. BEPS II also collected data on the locations of over 137,000 branches operated by these banks. This has provided a unique opportunity to gain additional insights into how firms and banks interact throughout the transition region and how these interactions may drive innovation in firms.

Through the analysis of these rich data it is possible to establish that firm innovation in the transition region entails much more than "frontier" innovation in the form of research and development (R&D) and the creation (and patenting) of products and services that are new to the global market. In many transition countries, firms innovate mainly by adopting existing products and technologies and adapting them to local circumstances.

Reaping these relatively easy returns remains an important driver of firm productivity across many transition countries and one that, unfortunately, is often overlooked by local policy-makers. As a result, innovative firms – much more so than non-innovative ones – continue to suffer from business constraints. These limitations take the form of widespread corruption, a lack of skilled labour, excessive customs and trade regulations and scarce funding options.

In countries still far removed from the technological frontier, policy-makers should focus more on improving the country's capacity to absorb and benefit from technologies developed elsewhere. This requires, in particular, better primary and secondary education, better access to bank credit and an environment in which entrepreneurs are encouraged to improve the way they manage their firms.

As firms gradually close the gap between themselves and the global technological frontier and as the structure of the economy changes, economic institutions and policies supporting this change should also evolve. As an economy approaches the global frontier, the contributions made by innovative start-ups play an increasingly important role compared to improvements made within existing firms. The policy focus then needs to shift from facilitating investment and the transfer of technologies to nurturing creativity, providing highly specialised human capital and creating space for the entry of young, innovative firms as well as allowing the exit of firms that do not succeed. This requires that we pay more attention to flexible labour markets, better competition policies, good universities and sufficient access to venture capital and private equity for young start-up firms. It is the failure to successfully achieve such structural transformation that has left so many countries stuck in the "middle-income trap".

While governments cannot directly make firms improve their performance, they can help them do so. They can achieve this by ensuring that economies are sufficiently open to trade and investment, by helping firms to learn about more efficient ways of doing business, by enabling workers to acquire the right skills and raising the general level of education and by safeguarding competition that rewards firms that transform themselves and puts pressure on laggards to improve. Importantly, as firms transform themselves, the structure of the economy and the economic institutions must also evolve. Government policies should adapt too; there is no one-size-fits-all innovation policy.

As experience has shown, blindly copying the institutions of advanced economies is not the solution – the main challenge is establishing how to tailor institutions and policies to the needs of a particular country. Countries must engage in what Dani Rodrik and others have described as "self-discovery". For such a process to result in the right policies, the private sector must be involved, probably even in a leading role. To prevent manipulation by special-interest groups the process must be transparent and independently governed.

As governments succeed in tackling the institutional challenges and are able to local build capacity they can become involved in more risky activities. These include targeting sector-specific technology or skills gaps and finding interesting ways of enhancing sector-specific skills with cross-cutting enabling technologies. Such so-called "smart specialisation" requires a basic implementation capacity in countries and an adequate quality of human capital, but it has the potential to create added value.

The overall message of this year's *Transition Report* is a hopeful one. Last year's report argued that change at the regional level within a country can eventually help to reform institutions and increase income. Likewise, as explained in this year's edition, changes at the firm level can collectively transform an entire economy. Regardless of a country's level of economic development or its progress along the transition path, individual firms can make a difference.

In all countries, no matter how difficult the business environment is or how weak the economic institutions may be, there are firms that enjoy high levels of productivity, on a par with those of their peers in advanced markets. The main difficulty for countries is the large number of less-productive firms. Managers in these firms can make decisions that have a profound impact on the productivity of their businesses. Governments can make it easier for them to implement these decisions and can increase the pool of talent from which they can draw. As firms move along their transition path, so will the countries in which they are based.

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