Transition and transition impact

A review of the concept and implications for the EBRD

Report for the EBRD's Office of the Chief Economist

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Executive summary

Evaluation of transition impact of individual projects requires a rigorous conceptual framework. The existing framework developed in a paper by EBRD economists in 1997 stresses three criteria: (i) contributions to competitive market structures; (ii) contributions to institutions and policies that support markets; and (iii) contributions to market-based conduct, skills and innovation.

The EBRD approach to measuring and monitoring transition impact of EBRD projects has provided a practical and flexible framework, which has served well over the past 12 years. Yet, as the process of transition has developed, a substantial heterogeneity across the EBRD's countries of operations has emerged. There has been a growing need for an updated definition of the transition process to reflect this and the development of thinking among economists. This suggests a more nuanced approach to measuring the transition impact of individual EBRD projects.

The recent economics literature understands transition as dynamic institutional change. According to this view, analysing transition requires a focus on the institutional underpinnings of effectively functioning market economies, and the determinants of emergence of market-promoting institutions. Unless the right institutions (understood as "rules of the game") are in place, market economies will not deliver wide benefits to their citizens. This will tend to undermine the legitimacy of the transition process and slow, or even reverse, the process of institutional change.

In this sense, development of state institutions complements market development, in contrast to what was sometimes suggested 20 years ago. Another contrast with the conventional wisdom of 20 years ago is that the endpoint of transition is much less clearly defined now than it was then: there are multiple versions of capitalism, and the historical and institutional contexts of individual countries necessarily affect their destinations. This has been brought into sharp relief during the current financial crisis.

In general, the EBRD model of supporting transition impact through project-specific loans has been very successful. Moreover, the three core principles of lending, namely, sound banking, additionality and transition impact, continue to provide a sound framework for structuring project lending. The EBRD has benefited from the focus that has been achieved through the way that transition impact has been factored into its lending strategy. The EBRD has also succeeded in embedding its mission of promoting transition into its corporate culture.

However, while the basic framework for monitoring and conceptualising transition is sound, it does not fully reflect current thinking about dynamic institutional change and its impact on economic development. Hence, there is scope for further work on rethinking the conceptual basis of the core transition indicators as a framework for monitoring broad goals towards supporting the emergence of a sustainable and effective market economy. Transition impact assessment should include explicit measurement of the institutional preconditions for development, legitimacy and resilience of market supporting institutions.

This has a number of implications.

1. On the issue of the EBRD's contribution to a sustainable path towards a market economy, the current process for evaluating transition impact appears biased against repeat projects. Indeed, a case can be made that in sectors where projects can positively reinforce each other it is through repeat projects that a critical mass can be achieved which could increase a sustained transition impact of EBRD lending. Renewed emphasis on the additionality requirement will be needed to ensure that repeat projects do not crowd out private sector investment.

2. On the issue of the diversity of paths of transition countries, while aggregate lending flows indicate that the EBRD does focus its attention to countries where transition needs are greatest, it is clear that existing Transition Indicators compiled by the EBRD at the country level are not effectively integrated into the process of assessing transition impact at the project level. There is potential for greater clarity in joining the macroeconomic and project-centred assessments of transition impact.

3. On the issue of sustainability, one should remember that transition is at best an intermediate goal and that it is important to remain focused on the ultimate ends towards which transition is oriented. Introducing concerns such as social cohesion, occupational safety and gender balance, for example, would foster broader development goals and help to promote sustainable market economies. This would require developing an appropriate measurement framework to assess progress in these dimensions. There are now many data sources available that can be used in assessing the EBRD's wider impact on transition.

4. Similarly, in order to achieve sustainable transition impact, there is a case for considering an extension of EBRD lending into areas such as education, healthcare, (social) housing, environment, and innovation and knowledge. Part of this could be achieved through greater lending to public-private partnerships even where the facilities are ultimately managed in the public sector. However, there is a need for caution. Such a move makes sense only if the appropriate expertise is acquired. Such a move is also feasible within a broad private-sector focus – especially if the EBRD moves only into those new sectors where there is a market demand.

Foreword

> The meaning of transition has changed in some fundamental ways after 20 years.

The EBRD has been actively engaged in its countries of operations for nearly 20 years, guided by its mandate to aid transition towards open, market-oriented economies, to promote private and entrepreneurial initiative and to assist in structural and sectoral economic reforms, including de-monopolisation, decentralisation and privatisation.

The EBRD's Office of the Chief Economist (OCE), which over the years has developed the intellectual underpinnings of the transition concept and its application to countries, sectors and projects, is reviewing the transition concept and its relevance to the changed context after 20 years of demonstrable progress. Transition priorities are evolving in response to a set of important developments and observations.

- The **meaning of transition** has changed in some fundamental ways after 20 years. Although the original purpose of the Bank – to foster transition to open, market-oriented economies and democratic systems of government – remains valid and relevant, there has been some rethinking on the start and end points of the process. Most importantly, what has emerged over time is the recognition of a need to rethink the appropriate role of the state and to refocus attention on the qualitative rather than the quantitative dimension of transition – that is, not just markets, but well-functioning markets; not just regulation, but effective regulation.
- Although much of the region has made substantial progress in market creation and privatisation, there is **wide variation across the transition countries** and across sectors. Some of the most basic aspects of transition – for example, economic restructuring, large-scale privatisation and trade reorientation – have not occurred in some of the less advanced countries in the region. There is no unique endpoint for transition, either at the sectoral or the country level, as countries will differ based on their political and economic culture and in how they perceive the optimal division of labour between the state and the market, how to redistribute wealth and meet social needs, how to organise production in certain strategic or politically sensitive sectors, and so on.
- The **impact of the global financial crisis** on the region has been severe and will be lasting, at least in part of the region. There have been some setbacks in the transition process, for example with actual or potential re-nationalisation of banks and some major corporates and a greater role for the state in economic affairs. While most of the countries in the region are likely to remain on (or return to) the path towards building well-functioning, market-based economies, the crisis has revealed the fragility of some past transition achievements and the weaknesses of the dominant growth models that were adopted.
- **Energy efficiency and climate change** are important issues which intersect with, and can be an important part of, the transition process. Excessive energy use and harmful emissions are the result of a systemic market failure to internalise the costs of environmental damage caused by industrial projects. The region will need to shift more emphatically to a low-carbon growth path, which has implications for the Bank's operations within its existing mandate and for the current methodology for assessing the impact that projects have on transition.
- **Formation of knowledge-based industries** is an essential part of the transition process and can underpin sustainable growth. So far, the transition countries have

not succeeded in translating their relatively good stock of human capital and infrastructure into globally successful innovation. To promote this further, it is necessary to strengthen the institutional framework, foster competition and increase productivity to levels experienced in well-functioning market economies and to allow greater responsiveness to changing market conditions.

The OCE review is fundamentally about holding up to internal and external scrutiny its methodology for assessing and measuring transition and the transition impact of Bank projects.

For this reason, OCE engaged three prominent academic economists with extensive policy experience to critically examine the Bank's core concepts and OCE's methods, bringing to the task a deep knowledge of the ways in which thinking in the economics profession on development has shifted over the years. The experts were chosen not so much for their knowledge of transition as such or of the region, but for their general qualifications, their standing in the profession and ability to place the Bank's mandate and modes of operation into a larger context. In the process of preparing the report the external experts have interacted closely with OCE and discussed extensively with other Bank staff and Board directors.

This Report, which concisely fulfils its mandate, is broadly reassuring. It praises the Bank for remaining focused and for embedding its mission of promoting transition into its corporate culture. While acknowledging that the basic methodology for assessing transition impact is sound, the Report also convincingly argues that the methodology should evolve and adapt to changed conditions and should better reflect current economic thinking, primarily about dynamic institutional change and the role of the state in economic development.

As well as giving an overview of the objectives for change, the Report also provides some useful guidelines and suggestions. However, in line with the mandate, it is not prescriptive.

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Introduction

About 20 years ago, the post-communist countries of central and eastern Europe (CEE) began a major political and economic transformation. To assist this process, OECD countries established a new international financial institution, the European Bank for Reconstruction and Development (EBRD). The purpose of the Bank was "to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the CEE countries committed to and applying the principles of multiparty democracy, pluralism and market economics."[1] At that point, the general endpoint of that transformation was clear: a democratic political system and a market economy.

Especially as the Articles of Agreement also stipulated that the EBRD's main mode of operation should be financing individual projects working predominately with the private sector, it was necessary to monitor progress, have a tangible process of measurement and find ways of bringing this in to the EBRD's operations. The landmark document in this process is a paper by Nicholas Stern and Hans Peter Lankes in 1997. They argued for three main criteria for assessing transition impact: (i) contributions to competitive market structures; (ii) contributions to institutions and policies that support markets; and (iii) contributions to market-based conduct, skills and innovation.

The Stern-Lankes approach to measuring and monitoring the transition impact of EBRD projects has provided a practicable and flexible framework, which has served well in the past ten or more years. Yet, recently, as transition has progressed, there has emerged a substantial heterogeneity across the EBRD countries of operations. Also there has been a growing need for an updated definition of the transition process, and therefore for a more nuanced approach to measuring the transition impact of individual EBRD projects.

As part of the process of reflection on these issues, the EBRD's Office of the Chief Economist (OCE) commissioned this paper. The authors were invited to interview key members of staff and, based on recent research in the economics of institutions, develop an operational definition of transition that could help the EBRD pursue its mission in the changing environment.

A review of the intellectual basis of the mandate of the EBRD is timely for two reasons. First, there are now twenty years of transition experience to draw on. Second, thinking in the wider economics profession has developed over this period – in large measure influenced by the transition experience, but also in response to wider economic developments.

The aim of this paper is to foster a fresh debate on how the EBRD monitors its impact on transition and how it incorporates this into its lending strategy. While focusing on transition has proved useful to the EBRD, the notion of transition is somewhat passé. Transition was, and is, part of a wider process of dynamic institutional development in which economies develop a balance between state and market that enhances the well-being of citizens. Such considerations lead naturally to an eclectic mix of public and private responsibilities in the economic sphere. It is important to recognize that there are areas where increasing the role of the market is contentious and that there are multiple solutions to providing an effective market economy that serves the needs of citizens.

Within this wider context, there is a role for EBRD lending to promote broader social ends than those currently encapsulated in transition

1. Article 1 of the Agreement Establishing the EBRD.

impact and measured through well-defined transition indicators. It is appropriate to have a debate about the content of these goals and how they are monitored. There are now many more data sources available for this than in the past. As part of this, it is relevant to give thought to the way that impact is achieved and whether a program of lending in an area is justified to achieve a larger and more lasting impact.

This report is being written at a time of considerable global economic turmoil, which is severely affecting the EBRD's client countries. This turmoil will doubtless lead to a re-evaluation of the experience of the past twenty years, in particular the consequences of liberalization, globalization and financial development. While acknowledging that the current global economic circumstances put more weight on crisis management in the EBRD's priorities, this paper is focused on its *raison d'être* over a longer time-horizon.

The remainder of the paper is organized as follows. Part 1 provides a review of the relevant literature on the role of market supporting institutions in a successful market economy. Part 2 describes the present system of project evaluation as well as making proposals for specific improvements. Part 3 discusses broader potential avenues for the future development at the EBRD. Part 4 concludes with recommendations.

Part 1: Structural and Institutional Transformation

1.1 The Role of Market Supporting Institutions

For many years, mainstream economics largely took for granted the institutions needed for a market economy to flourish. This contrasted with the classical economists such as Smith and Marx, who were preoccupied with how property rights and legal systems underpinned markets. Much mainstream economics was largely sympathetic to the potential for central planning to do as well, or better, than markets even in the production of purely private goods. But a post-war consensus emerged that saw a sharp divide in responsibility between the state and the market based on whether a good was private or public. For the production and distribution of private goods, competitive markets should (by and large) work well. However, for goods with wider social benefits (so-called public goods) state provision was the presumed solution. Alongside this division of responsibility lay a richly developed theory of market failure and a set of recipes for fixing such failures through regulatory means.

Over time, however, economists have become increasingly dissatisfied with the way that decision making is conceived in this framework. The underpinning institutions for competitive markets to flourish cannot be taken for granted. Equally, the state as an institution has to have appropriate incentives to deliver its mandate. These concerns underpin the modern institutional approach to discussions of the appropriate role for states and markets.[2]

In light of this, two distinct fault lines can be seen which shape many of the modern debates about the boundary between state and market.

The first fault line emerges around the competence of the state as an institution to allocate resources. One of the virtues of the market is the fact that knowledge is decentralized and fosters creativity and innovation at ground level. But every modern state also recognizes that some economic activity requires a degree of central coordination. Many activities have external effects such as their environmental impact for which a central strategic hand is needed. There is also broad acceptance that efficiency benefits from the market can be worth sacrificing in the social sphere to achieve greater social cohesion.

The second fault line stresses the role of competing interests. The supporting case for state intervention often turned on the motivation of planners as benevolent maximizers of a uniquely agreed concept of the social good. It is hard to see what realistic set of institutions of governance would guarantee this. Moreover, the notion that there can be a single vision of the social good is questionable. A key role of political institutions is to find ways of resolving conflicting views about how society should be governed. Markets in this world are also an expression of diversity, allowing individuals to be empowered by exercising choice over what they consume – this is the libertarian case for markets. But market economies also generate powerful interests that try to influence the state in malign ways. Producers will often use that influence to lobby for protection against competition. The key governance problem is to devise a system of government which allows the benefits of the market to flourish while holding such interests at bay. Private market economies that do not resolve these issues generate popular resentment, which can undermine the efforts to privatize market

2. See, for example, Dixit (2004) and Djankov et al (2003).

activity. Indeed the traditional Marxist critique of the market economy was born out of a view that unfettered markets lead to social injustice.

Against this background, the modern economics literature now thinks hard about the role of market supporting institutions – those public institutions that stand behind markets and make them work. Thinking is heavily influenced by political economy issues – understanding that problems of governance combine economic and political concerns. It is not enough to wish that the state be effective – it is important to understand the institutional structures that make it so.[3]

This approach leads easily to a shopping list of important market supporting institutions which help to ensure that markets can serve to promote broad notions of social good. Effective markets require: a functioning legal system to enforce contractual obligations; regulation to deal with external effects and concerns about social cohesion; property rights protection – for both physical and intellectual property; and competition policy. Without these in place, the case for allocating resources through markets is more questionable.

It is now understood that the best way to provide these is through building effective state institutions. Note that by "state", we also include the idea of giving a role in the public sphere to a number of potential "watchdogs", namely the press, consumer representatives, labour and business unions and NGOs more generally. These institutions can favour a sustainable market economy by fostering accountability and a proper balance of power within society. (Of course, imbalances that generate status quo biases when reforms are needed should be avoided.)

The focus on institutions emphasises the role of rules, i.e. processes that deliver outcomes. In modern parlance, the notion of an institution is frequently defined as "the rules of the game"[4]. Sustained change comes from redefining these rules and exploiting the incentives that they create.[5]

To see why institutions matter crucially, consider the concrete example of building a competition authority to assess when market power is being abused by private firms. There are four main functions: (i) a referral function in which any firm that is suspected of abusing its power is referred to the authority; (ii) an investigative function in which the claim is subjected to evaluation; (iii) an adjudicative function in which the firm is given the opportunity to defend itself and to have the evidence heard; and (iv) an enforcement authority which considers remedy and makes sure that it is implemented. Of course, underpinning this there need to be statutes in law that make abuse of market power illegal in the first place. However, without the necessary competence of the institutional structures at these four stages, the formal legal structures can be irrelevant. A good law that is poorly institutionalized may be worthless.[6] The credibility of the state in regulating markets is built over time by showing that the structures are effective, i.e. are not subject to corruption and delay and are staffed by competent regulators who take their jobs seriously. These are major investments in state capacity that can sometimes take years or even decades to build. However, without them the textbook case for markets is easily undermined.

What has been described for the case of competition policy is also true, mutatis mutandis, for other policies crucially needed to foster a sustainable market economy, like consumer protection, worker protection, investor protection or financial regulation in particular.

The above considerations confirm that the preconditions for an effective market economy have to be delivered by the state. Hence, development of appropriate institutional structures for markets should progress

3. There is now a rich literature on these issues by economists – see Besley (2006) and Persson and Tabellini (2000) for reviews of aspects of the modern political economy literature.

4. See North (1990).

5. See Acemoglu et al (2001) and Engerman and Sokoloff (2002) for arguments along these lines using an historical perspective across the world.

6. For example, Bhattacharya and Daouk (2002) and Bhattacharya et al (2008), who show that if the law against insider trading is available but not enforced, the outcome may even be worse for the capital markets than having no insider trading law at all.

hand-in-hand with changes in state institutions. This approach gives a central role to political economy – understanding incentives in the public as well as the private sphere. This framework applies at any level of development and to any country. Recent events have shown that even established democracies/market economies always have to adapt to challenges, and building effective institutions is the way to guarantee this in the long term.

Although there are broad principles including accountability, legitimacy (effective authority), transparency and competency that underpin effective institutions, it is hard to argue that there is a unique level of optimal institutions. This is likely to result in a certain degree of institutional pluralism with the specifics of institutions being influenced by the unique cultural, historical and economic circumstances of each country. The one-size-fits-all solution cannot be justified on practical or theoretical grounds.

This point is amply illustrated by the history of the states that now comprise the European Union (EU). While the EU has pursued harmonization in a number of spheres, the institutional diversity is still remarkable. While all are democratic, the exact rules and constitutional procedures remain diverse. Many forms of regulation also vary widely. There is close to no convergence in the social spheres with different models for running health, education and law and order. Perhaps even more striking is how far this still applies to the States of the U.S.A. despite their long-historical ties to a single federation. For example, states use different systems for selecting their judges, have different levels and coverage in minimum wages, run different systems of worker protection against injury and have different systems of insurance regulation.

Viewed in this context, the end point of transition is murkier than it might seem on the basis of a simplistic view of states and markets. The content of an idea like transition becomes less clear beyond a point.

But that does not make transition an empty concept. Indeed for the first phase of the exit from communism it had some clear implications. This was particularly clear-cut in the privatization sphere. The arguments for decentralized private production applied unambiguously in the production of a wide range of private goods. By placing them in the private sphere, there were clear governance benefits too, limiting the potential for industries to act as special interests. However, without appropriate regulatory oversight, it is evident that such interests can thrive equally well when firms are private.

Even from the start there were contested spheres, prime examples of which are public utilities such as power generation and provision of public transportation services. These are particularly important in the EBRD client countries due to the potential environmental impact. But whether ownership should be private or public to achieve the best outcome is far from clear a priori. The consensus view now downplays the role of ownership relative to other factors. The crucial point is the environment in which firms operate and the incentives that this creates. It is now thought that setting up transparent, competent and efficient institutions to ensure that these industries are run in the public interest matters more than who owns the assets.

One important issue is the extent to which effective market economies require democracy. It is hard to reach a definitive view on this.[7]

There is, unsurprisingly, a strong correlation between prosperity and democracy, as there are reasons to believe that democracies do tend to have features which are likely to make them economically more successful in the long run. These include a greater institutionalized ability (through regular elections) to replace failed leaders and to turn around failed policy strategies. Democracies tend also to be more transparent so that

7. See, for example, Persson and Tabellini (2008).

public institutions are subject to greater scrutiny and those that run them are more likely to be held to account by their citizens. The between-country correlation between democracy and the level of corruption is strong which, although not amenable to a causal interpretation, is reflective of some general differences in governance.

As far as supporting effective markets is concerned, the link with democracy is however indirect and, reflecting this, the experience is heterogeneous. On the whole, being democratic is positively correlated with a range of measures of regulation and protection of private property. However, there are plenty of examples of successful autocracies and unsuccessful democracies. In issues of governance, it is important to dig beneath the broad labels like autocracy and democracy and look at specific institutional structures. In practice it is extremely difficult to measure this in systematic ways. Measuring specific institutional differences such as the form of the electoral system or checks and balances is a useful start. But it is much more difficult to measure informal institutions and cultural norms which could be equally important in shaping how formal institutions work.

Summing up, this brief discussion emphasises that three things matter to a successful market economy:

- The competence/efficiency of producers.
- The balance of interests between producers and wider social goals.
- The institutionalization of solutions to regulatory issues.

1.2 Complementarities Between Market Development and Institutions

While thinking among economists has progressed on these issues, a key question for this paper is how to operationalize these ideas in the EBRD's lending strategy. The EBRD's mandate to lend in a way that supports transition effectively already acknowledges the importance of complementarities between market development and wider goals.

Three questions flow from this. First, how should transition goals be framed conceptually? Second, how can progress be made on measuring progress towards these goals? Third, how can this be brought into a lending strategy?

The above discussion emphasised that a core intellectual theme to organize this thinking is in terms of how to support effective institutional change that can strengthen the operation of markets and to ensure that these markets best achieve broader social benefits. This means sufficient competition, effective regulatory oversight, as well as wide acceptance that the market mechanism is the best way to allocate the goods in question. Markets for health and education, for example, are controversial because there are questions about the social acceptability of the outcome when prices play a role in these spheres.

Institutional change that accompanies market reform and improves the working of the market is at the heart of the idea that states and markets are complements. For transition to a market economy to achieve tangible social benefits, markets must be effectively regulated and there must be legitimacy to the distributional outcomes. To say that market development supports transition in a wider sense flows from the idea that it can contribute to achieving wider social goals. And transition impact is best measured in relation to those goals.

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Institutional change that accompanies market reform and improves the working of the market is at the heart of the idea that states and markets are complements.

The EBRD’s core business is lending to projects, and it is committed to factoring in transition impact in its project lending criteria. Its basic approach to address this is based on three principles: sound banking, transition impact and additionality. These are intimately linked.

For EBRD lending to have any transition impact, it must be that the projects supported have catalytic power, i.e. lead to the support of projects which would not otherwise be funded. Thus, additionality is a necessary condition for the EBRD to have transition impact.

In terms of economic principles, the notion of transition impact is equivalent to arguing that the pure private return to lending must be supplemented by a suitable concept of social return with the divergence being the impact on transition. Given the requirement that all projects meet sound banking principles, this makes economic sense under the assumption that transition countries remain capital constrained, i.e. there are more potential projects that meet sound banking principles than could be funded out of normal capital inflows.

This last assumption appears entirely plausible for the initial period of transition and for the current situation. However, it is more questionable during the period immediately preceding the credit crunch. But for the foreseeable future, the role of the EBRD in achieving additionality is beyond question.

Individual projects are marginal to achieving transition – almost no given project can be expected to make a significant difference on its own. However, collectively, projects can have a macro-economic impact and hence support transition. But to have that impact, it is necessary that the same consistent and coherent principles of transition impact are applied for all individual projects. It is also important that, at any point in time, these reflect the highest priorities of each country. The recent literature implies that these priorities do not have to be similar in all transition economies. There may also be scope for promoting complementarities – if some sectors of the economy under perform, then they could be supported through projects.

Suppose, for example, that there is a series of projects in the power sector. If these are all structured on the basis of best practice in terms of governance and environmental benefits, then their collective impact can be larger than the impact of any project in isolation.

For example, such projects can establish a norm for the sector that is adhered to by other firms. It can also lead to demonstration effects in which other firms emulate best practice. There may also be political benefits – the voice of vested interests that argue that good governance and environmental soundness cannot be achieved will be diminished. So projects that are not individually large in economic terms can have wider impacts. It is the cumulative effect reaped from such changes that can make a difference.

This may have implications for a lending strategy. It will become important to see whether projects in an area need to be joined together to achieve a wider impact rather than having isolated projects across an economy. Below, we will discuss in more detail the pros and cons of a programmatic lending strategy in the context of achieving wider transition impact.

In anticipation of that, it is worth thinking about how critical mass in projects can change market supporting institutions in theory. There are many possible policy routes towards this and we will give a few illustrative examples.[8]

First, promoting competitive markets has the benefit of reducing the potential for significant large firms to exercise political power. This supports the Stern-Lankes focus on the importance of market competition and the fact that competition policy is a key part of the Transition Indicators. It is more likely that a competition authority will be captured in a

8. See Roland (2000) for further ideas.

world where economic power is more concentrated. So focusing project lending on where there is a significant competitive benefit remains an important goal and is more likely to be successful where this is an explicit strategic priority.

Second, limiting the ability of politicians to interfere in the workings of private firms is also an important way of supporting an effective market economy. This can, for example, distort competition to the extent that firms now face a soft budget constraint. This is recognized in the EBRD's governance and enterprise restructuring transition indicator. This may become a particularly difficult issue in the current economic climate as popular support for specific industries gathers strength. It is already clear from the experience of the EU that there is major pressure for public support, for example to the car industry.

Third, public procurement practices that favour specific firms may also have a corrosive effect on competitive markets. Thus, measures that make sure that such processes are open and transparent are important. This is partly reflected in the EBRD's price liberalization transition indicator.

Fourth, how far decentralized government is able to better promote less arbitrary state interference in markets has been widely debated. It can be argued that federalism can be market preserving because of its beneficial effects in disciplining governments.[9] Competition could also improve infrastructure provision as local governments "compete" to attract firms into a locality. Thus, support for local government infrastructure projects can be thought of as having this indirect benefit in affecting inter-governmental competition. In general terms, the Transition Indicators put weight on infrastructure reform as a key supporting investment for markets.

Fifth, the goal of supporting institutions in EBRD countries moving towards EU accession is a useful focal point for many market supporting investments. Given the institutional constraints that are placed by the EU as part of single market principles, there is a need for clear ground rules between businesses and the state. Of particular importance are the EU state aid rules which severely limit state intervention to support specific firms except on an open and transparent basis and according to specific principles. The EU is also playing an increasing role in competition policy and areas of business regulation.

Although the existing Transition Indicators do provide a useful framework to reflect how an effective market supporting environment is emerging, there is certainly scope for revisiting their formulation in light of the discussion in this section.

9. See Qian and Weingast (1997).

Part 2: The Role of the EBRD in Transition

2.1 Principles

The Bank's mandate is to promote transition towards a market economy mainly by financing individual projects, working predominantly with the private sector.[10] The EBRD differs from other international financial institutions (IFIs) in several respects. First, it has a limited geographical remit (recently, however, it has been expanded to include Mongolia and Turkey). Second, it has a clearly defined mandate of promoting transition towards open market-oriented economies. This implies, at least in principle, a limited lifetime: once the transition is accomplished, the Bank should cease to exist.[11] In this sense, the EBRD is different, for example, from the International Finance Corporation (IFC). The EBRD's mandate of promoting transition is quite narrowly defined while the IFC's mandate is "reducing poverty and improving peoples' lives".[12]

Third, the Establishing Agreement is also very specific on how the EBRD should achieve this goal. According to the Agreement, the Bank should promote transition through lending to individual projects, predominantly in the private sector.

The EBRD's purpose. (From Article 1 of the Establishing Agreement.)

In contributing to economic progress and reconstruction, the purpose of the Bank shall be to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the countries of CEE committed to and applying the principles of multiparty democracy, pluralism and market economics.

The fact that the EBRD's mission of promoting transition is rather narrow has clear advantages for accountability of the Bank's operations. However, as we emphasised in Part 1, transition per se is not a final goal and should be seen as part of a wider remit to support markets in order to improve people's lives.

Interpreting transition in this instrumental way largely diffuses the need to define the mandate more broadly. For example, it might be suggested that the EBRD should adopt broader goals such as poverty reduction, increased well-being, gender equality, social cohesion or environmental sustainability. A further issue is whether the EBRD should finance projects that promote those broad goals in its region that are not related to transition.

We will revisit these issues in Part 3 of this paper. The EBRD has, so far, focused on transition goals only. And in recognition of this, it has decided to "graduate" countries that have completed the transformation to the market economy. That said, the current crisis shows these (actual or expected) graduations may have been premature. Even though many post-communist countries have built market institutions, there remain questions of whether these institutions are fully entrenched.

Looking in a broader perspective, therefore, we believe that the EBRD's original mandate is still valid because it is consistent with pursuing broader goals. As we have already discussed social cohesion and broad-based increases in living standards are vital for a well-functioning and sustainable market economy. Without these foundations, there is always a risk of reversal of past progress.

10. The EBRD has an explicit pro-democratic mandate which makes it unusual among the international financial institutions. In practice, the EBRD does work in countries that are far from multiparty democracies. Yet, the democracy and pluralism mandate does impose binding constraints on the EBRD's operations: in such countries, the EBRD cannot partner with governments.

11. The recent addition of Turkey to the Bank's remit somewhat dilutes the clear definition of the Bank's mandate. Although Turkey shares many similarities with post-communist countries, it is not a transition country. The very precedent of extending the Bank's remit also casts doubts on whether the shareholders of the Bank accept the concept of its finite lifetime.

12. Among the international financial institutions, the EBRD is most similar to the European Investment Bank (EIB). Like the EIB, the EBRD focuses on relatively clear priorities and has a well-defined mode of operations. The main differences are that the EIB's priority is the development of the EU, and its main mode of operation is to support long-term infrastructure projects.

2.2 Operationalizing the Mandate

In order to operationalize its mandate, the EBRD has built a sophisticated system of measurement and monitoring of intermediate goals. The underlying purpose of this system is to evaluate each project's contribution towards the overall mission. This is crucial as the EBRD is a demand-driven rather than a programmatic institution. Instead of designing programs itself, the Bank works with individual projects originated by potential customers.

The EBRD uses three criteria to assess projects: (i) sound banking, (ii) additionality and (iii) transition impact and, as argued above, these three dimensions of lending make conceptual sense in terms of a framework that sees the core mandate of the EBRD as supporting transition towards an effective market economy.

However, a key issue is how readily these criteria can be translated into an operational imperative. We will discuss each in turn.

Sound banking is conceptually straightforward. The Bank measures a project's returns in terms of (risk-adjusted) interest rates and makes sure the Bank lends at market rates. As an IFI, the Bank is well-capitalized and can afford long-term lending in countries where long-term markets are not developed (often non-existent). Hence, it can charge market rates and its services are still in high demand.

Additionality means that the Bank's financing does not crowd out private capital and adds to the stock of projects that are funded in the economies of its client countries. Additionality is a binary variable and is also relatively easy to measure. The litmus test is the answer to the question: "would the project take place without funding from the EBRD?" Given the Bank's multiple conditionalities (especially those related to transition impact), its demand-driven approach more or less automatically takes care of the additionality issue. Indeed, if there is a non-EBRD solution, the clients would prefer not to involve the EBRD because its loan rates are not subsidized and it asks for conditions related to the transition impact.

Transition Impact poses the main challenge in terms of measurement and monitoring. To address this challenge, the Bank has developed a broad range of procedures.

The concept of transition impact is ingrained in the EBRD's corporate culture – not only in the Office of the Chief Economist (OCE), the Compliance Department, or the Evaluation Department (which is in charge of the ex interim and ex post evaluation of projects), but also among the bankers who initiate the projects.

The transition impact scores enter the bankers' incentives in both formal and informal ways. The Bank is unique in its internal discipline of measuring progress towards transition goals and the assessment of transition impact of individual projects. The bankers screen out projects that have no chance of being awarded high transition impact scores. While there are certain drawbacks of the measurement and evaluation system, the extent to which the measurement discipline drives major processes within the EBRD is nonetheless impressive.

The transition impact measurement system automatically adjusts the EBRD's operations towards its mission. In particular, the EBRD does not even have to decide to graduate a country (or a specific sector in a country). The transition impact measurement system provides incentives to shift lending to projects with higher transition impact.[13] Hence, a country where such projects are rare will have fewer projects and will graduate *de facto*.

The measurement system also has direct implications for the Bank's organisational structure and sectoral specialization. The Bank has developed and focused on some specific core strengths.

While the development of core competences is important, there is a concern that the EBRD has locked itself into its existing specializations. This would make extending its business towards new areas, for example supporting projects that build towards a knowledge-based economy, more difficult.

13. As discussed above, sound banking and additionality are straightforward to check in practice.

To do so would likely require a substantial effort, including training needs specific to new areas.

2.3 Measuring Transition Impact

The measurement system includes three major elements.

The first element is related to the assessment of transition impact of individual projects. These assessments are done using the Stern-Lankes methodology by OCE on the scale of "excellent/good/satisfactory/…/negative." The Bank can occasionally undertake projects that have a transition impact score of "satisfactory" or lower, but the overall share of such projects cannot exceed 20%. Transition impact is measured along three major dimensions: contributions to market structure (including greater competition and the demonstration effect); contributions to market-supporting institutions and policies (including private ownership, reform policies and rule of law); and contributions to market-based conduct, skills and innovation (transfer and development of market-promoting skills and technologies, including corporate governance).

Stern-Lankes transition impact criteria. (From Stern and Lankes, 1997

- *Contributions to competitive market structures*
- *Contributions to institutions and policies that support markets*
- *Contributions to market-based conduct, skills and innovation*

The transition impact measurement system for projects is also linked to country-wide and sector-wide measures. Every three years the EBRD produces a *Country Strategy* for each country of operations (which is then annually updated). This Country Strategy identifies sectors and instruments on which the EBRD should focus to maximize transition impact. The Country Strategies are based on the "transition gaps analysis" and the "transition priorities" which follow from these transition gaps.

The second major element of measurement/ assessment system is the project evaluation carried out by a separate department within the EBRD, the Evaluation Department. This department picks a representative selection of projects and measures their progress against benchmarks that are set ex ante. Evaluation is conducted both during the life of the project and ex post. Some projects are evaluated on self-reported performance by the bankers in charge; but others are evaluated based on field trips. It is important to emphasize that the ex ante benchmarks are set by project economists and are also directly related to the transition impact analysis.

The third element is the set of the country-wide "Transition Indicators". These are compiled by OCE every year for every country and are published in the Transition Report. The methodology was developed in 1994 and has remained largely unchanged since then. There are nine indicators (three on enterprise privatization and restructuring, three on markets and trade, two on financial institutions, and one on infrastructure). Each dimension is evaluated on the scale of 1 (transition has not started yet) to 4+ (transition complete). The Transition Indicators are probably the most externally visible set of variables produced by the EBRD. They are widely used in policy debates – both related and unrelated to EBRD operations – and are the most widely used measure by academics of transition countries' reform progress.

While the Transition Indicators are the Bank's best-known product externally, there is little explicit use of them within the Bank. There is no formal link between them and the other transition impact measures – either the project-level transition impact scores or the gaps-priorities-strategies measures. Moreover, there seems to be no operational link in practice either. The Transition Indicators are occasionally used in formulating transition gaps and transition priorities, but this process is not systematic.

It may seem puzzling that the Transition Indicators and the other project-related measures of transition impact are not formally linked. But it is a natural implication of the absence of the aggregate impact assessment process at the EBRD. The EBRD does measure the transition impact of a given project but does not estimate its aggregate contribution towards transition. Certainly, it is hard, if not impossible, to bridge the gap between an individual project's transition impact score and the change in aggregate transition indicators of the whole countries. Yet, the EBRD's whole operation is based on the idea that individual projects do have transition impact in aggregate. Otherwise, it is hard to argue for having built a lending institution which is both demand-driven and project-based. Rather, the shareholders would be better off with a traditional development bank which designed top-down programs of lending in order to achieve specific transition goals in a given country.

2.4 EBRD Lending and the Transition Indicators

As we have discussed, the EBRD is committed to having a portfolio of project-level transition impact scores based on country-level Transition Indicators. Assuming that these are measured correctly, we should observe the following broad picture in terms of allocation of EBRD lending across countries over time. First, the EBRD should have a larger presence in countries with lower Transition Indicators. Second, in a given country, an increase in the EBRD's lending should result in an improvement in Transition Indicators.

Is this pattern consistent with reality? At the first glance, it is.

The EBRD has succeeded in bringing the countries of CEE – "advanced transition countries", in the Bank's internal parlance – to the highest levels of Transition Indicators; after this, the Bank has focused on the "early transition countries" where the Transition Indicators were lower. Right before the global crisis of 2008, most EBRD business was concentrated in the former Soviet Union while the advanced CEE economies had virtually "graduated".

These patterns in the evolution of EBRD lending across countries and over time imply that, even though project-level transition impact scores and country-level indicators of transition progress are not linked formally, the Bank's operations are indeed consistent with its core mission to support transition through its lending strategy.[14] Moreover, there is no evidence that the Bank has jumped on the "EU Accession Bandwagon" and tried to take credit for the progress in transition related to the implementation of the *Acquis Communautaire*. On the contrary, throughout the 1990s and 2000s, the Bank's lending in the accession countries was decreasing, while at the same time it was expanded to the other regions, as indicated by Figures 1 and 2 that summarize lending allocation across geographical regions. (There are two figures because of a change in the geographical classification system in 2001.)

Moreover, the left-hand graph of Figure 3 illustrates the negative correlation between the average value of the Transition Indicators and the average logarithm of the ratio of the EBRD's lending to the country's GDP. The right-hand graph illustrates the positive correlation between the change in average Transition Indicators over 1994-2008 period and the change in Transition Indicators over the same period. While it is hard to interpret these graphs in causal terms, these correlations are consistent with the conjectures above.

At this level of analysis, one can therefore conclude that, in its geographical focus, the EBRD did stick to its transition mission over the last twenty years.

14. The hypotheses can also be tested formally. Using the data on EBRD lending to a given country in a given year, we have tested the hypotheses above and did find that (i) there is a negative correlation between the level of the TIs and the level of EBRD lending relative to the country's GDP in a given year; (ii) controlling for country and year fixed effects, the change in the EBRD's annual lending is positively correlated to the country's change in the TIs in a given year (the results of the statistical analysis are available upon request). Not surprisingly, the EBRD's business volume has a stronger correlation with the large-scale and the small-scale privatization as well as the regulation of the financial and the telecoms sectors – rather than with the other Transition Indicators.

Figure 1: Annual business volume in EUR million 1991-2000

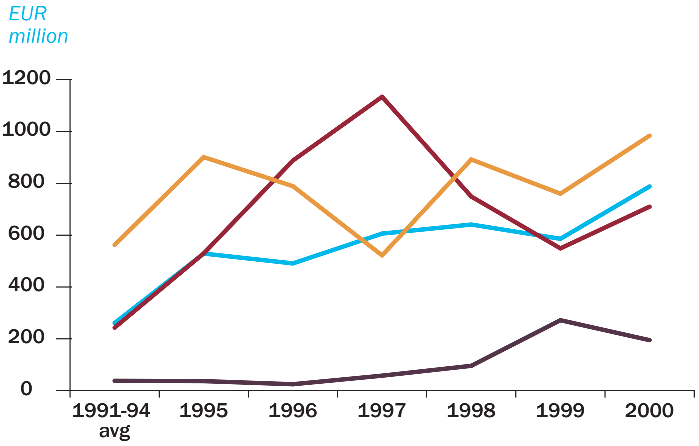


Figure 2: Annual business volume in EUR million 2001-2008

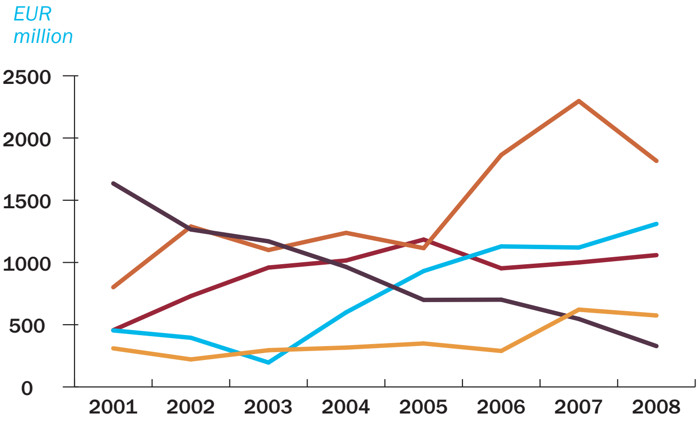
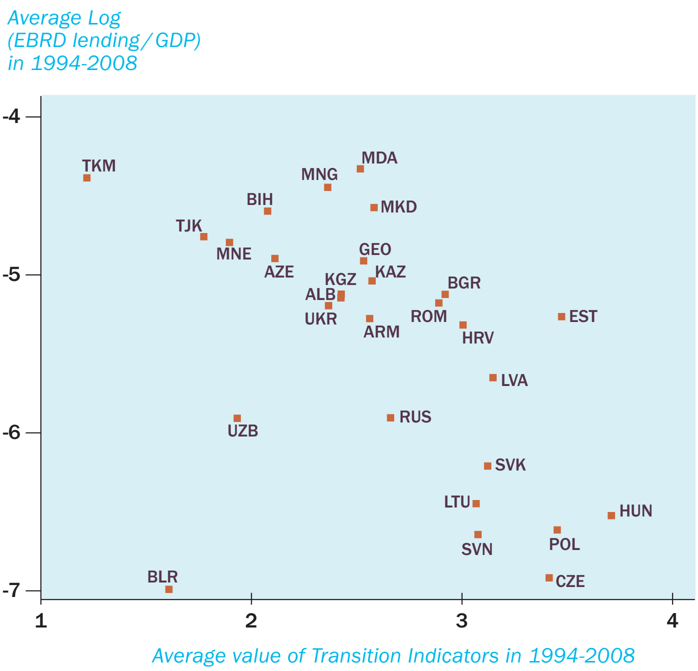
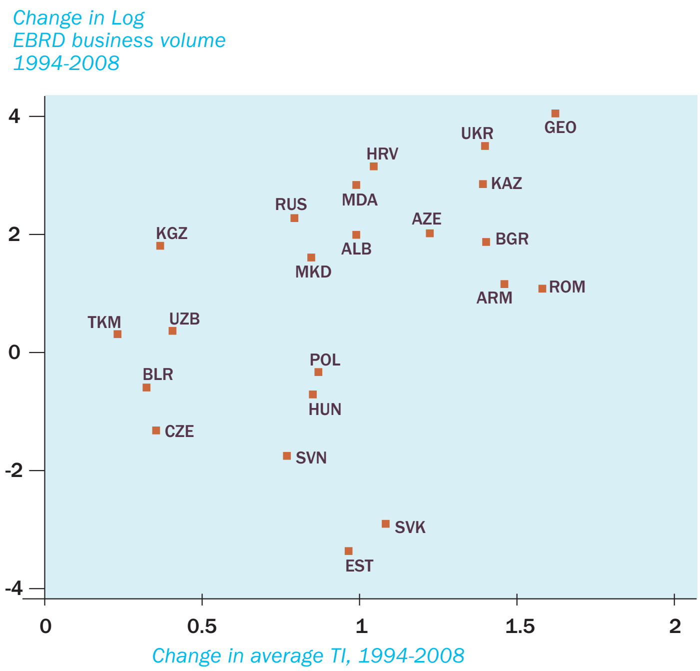


Figure 3: Transition Indicators (TI) and the EBRD business volume





> The EBRD has not been taking advantage of easier business conditions in advanced transition countries, but has extended its presence in countries where its impact on transition would be higher.

2.5 Measuring Improvements in a Wider Context

As mentioned in Part 1, economists now pay a lot of attention to how institutions evolve to support markets. This has led to the collection of many data series to measure this, most of which were not available when the EBRD's Transition Indicators were first conceived. Some of these are based on micro-economic survey data while others, like the Transition Indicators, are macro-economic.

One important data source is the World Bank's "Doing Business" report.[15] This work is motivated by the need to monitor the rules and impediments to starting and running private businesses on a consistent basis around the world. Measures are produced that include specific indices of the ease of starting new businesses, employing workers, registering property, getting credit, complying with taxes, closing businesses, and enforcing contracts. The list is currently being extended to include infrastructure provision and conditions relating to construction permits. The focus of the project is to assess mainly the de jure picture for different countries. While initially the project was mainly cross-sectional in nature, assessing differences at a point in time, there is an increasing focus on reforms over time.

There has been much debate about how well the Doing Business indicators really do measure important features of the economic environment. There is a host of correlation-based evidence. However, it is difficult from this to establish whether there is a causal link between the rankings on the index and the effectiveness of the state. However, this attempt at quantification has certainly raised the level of the debate by providing a series of objectively measurable indicators as a starting point. The project is also extremely open and transparent about its methodology.

We recommend analyzing the Doing Business indicators carefully and even creating an additional series within the Transition Indicators that would measure the quality of the state institutions along the lines of the Doing Business methodology. It is possible that there would be scope for the EBRD to work directly with IFC, which now runs the Doing Business project.

The Sustainable Energy Index (developed within OCE) could also potentially play a role in bringing environmental issues more systematically into the monitoring process. We think it is important that the EBRD continues to produce and develop this index on an experimental basis with a view to phasing it in to complement the existing Transition Indicators.

Another potential avenue for progress is to make greater use of micro data sets: in particular the Business Environment and Enterprise Performance Survey (BEEPS) and Life in Transition Survey (LiTS). These new datasets usually provide country-level measures, but some of them are so large that they can also produce sector-level implications. Interestingly, although most of them have been produced by the EBRD itself, they have not been formally integrated into its project assessment so far. Let us consider them in detail and formulate which could be used and how.

BEEPS and LiTS are conducted every three years.[16] These surveys provide two new dimensions to assessing transition progress. First, they complement the Transition Indicators and other measures in capturing vital dimensions of market supporting institutions and other components of sustainable and functioning markets including: the quality of state institutions, availability and adequacy of skills and infrastructure, the degree of social cohesion

15. See www.doingbusiness.org

16. BEEPS in 1999, 2002, 2005, 2008, and LiTS in 2006, 2009.

and support of further transition and reforms. Second, unlike the Transition Indicators, they capture *the real situation on the ground* rather than the "law on the books".

There is a good case for including measures from BEEPS and LiTS in the transition impact assessment methodology. They could be used at the project level, for designing the Country Strategies and for the assessment of the Transition Gaps. The additional advantage of BEEPS and LiTS data is that they allow for country-sector level measurement, not just country level. BEEPS is now run for non-transition countries as well, providing a useful point of comparison for benchmarking purposes. (Hopefully, this will also be the case with LiTS albeit not until 2012.)

One issue that merits consideration is whether the EBRD should run these surveys annually. While there are obvious merits to this (subject to resource cost concerns), we do not believe that it is a necessary pre-condition for them to play a larger role in EBRD strategy and operations. Since they are micro surveys they are expensive. But the institutions and social structure that they monitor probably do not change particularly quickly, making annual monitoring inessential. Moreover, Country Strategies are developed only once every three years.

The EBRD is also developing a new microeconomic survey of management skills.[17] While this is a useful innovation, it will take a while before it can become a part of the regular assessment system.

In addition to BEEPS and LiTS, there are a number of somewhat similar surveys that could be considered as complements. For example, the World Bank runs the Living Standard Measurement Survey (LSMS) that includes many relevant questions. However, LSMS (as well as other similar surveys) can only be used by the EBRD if run regularly in all transition countries. We do not think this is realistic; nor is this crucial, given the success of LiTS.

2.6 Bringing New Measures into Transition Impact at the Project Level

There are good reasons to believe that the current system of assessing the transition impact of projects is functioning generally well. The internal discipline of transition impact measurement and the EBRD's mission-driven corporate culture reinforce each other. This is an achievement that should not be underestimated. As the economic literature on mission-driven institutions suggests,[18] the co-existence of non-profit mandates and for-profit incentives is very delicate. The EBRD is an institution that has both; hence, it is quite remarkable that it has both been profitable and has been generally promoting its original mandate. Indeed, as shown in the graphs and correlations in section 2.4, the EBRD has not been taking advantage of easier business conditions in advanced transition countries, but has extended its presence in countries where its impact on transition would be higher. This indicates that the Transition Indicators are relevant to aggregate EBRD lending flows, even if they seem somehow 'orthogonal' to project-level transition impact measurement.

While there is a case to be made for the idea that these two approaches – country-wide Transition Indicators and project-level transition impact measurement – are an independent check on each other, there is also a case for bringing them closer together and to monitor more carefully the links between them.

This raises the question of how Transition Indicators (or other suitably constructed macro-measures) might ideally enter the

17. Skills are not covered in detail by BEEPS and LiTS. To measure skills, the EBRD can design yet a separate study or it can rely on OECD's international comparisons, e.g. PISA and similar projects. The EBRD would have to make sure that PISA is administered in all EBRD countries.

18. See for example Besley and Ghatak (2005).

impact assessment at the project level. Transition Indicators are meant to measure the overall attainment of a functioning market economy. In this sense, there is some logic to having any project assessment officer formally assess to what extent the project is likely to improve specific Transition Indicators.[19] The Evaluation Department could then regularly revisit the correlation between predicted and the actual change in Transition Indicators.

However, we do not regard it to be fruitful to engage in formal quantitative analysis of a project's impact on Transition Indicators. This would be an impossible task and arguably incompatible with the EBRD's mission. Nonetheless, rigorous qualitative retrospective evaluation can certainly be done.

Operationally, the easiest way to better connect transition impact measurement and Transition Indicators is to make the latter better linked with the measurement system for formulating Transition Gaps and Country Strategies. The ultimate goal would then be to have a more integrated approach between the troika "Transition Indicators/Transition Gaps and Country Strategies/transition impact measurement".

"There is some logic to having any project assessment officer formally assess to what extent the project is likely to improve specific Transition Indicators."

19. While, for an academic economist, it is virtually inconceivable that such assessments are feasible, there is little doubt that EBRD officers can do such assessments very well. At least, the Stern-Lankes project assessment concept (that also may seem abstract) is fully operationalized within the Bank.

Part 3: Possible Future Paths for the EBRD

This section uses the discussion from the previous two sections to assess what broad changes, if any, to the EBRD's mission are justified. It also discusses the lessons from, and possible changes to, the transition impact measurement system in the light of the previous discussion and the lessons from the last eighteen years of transition.

The issues summarized in Part 1 have two important implications for the EBRD's strategy in fostering transition:

1. A sound private economy does require market supporting institutions, including an effective state. This means that, for example, "more widespread private ownership" is only good for transition if instruments like regulation and competition policy are strong. That way, markets are likely to deliver real benefits to consumers.
2. While initially there was a lot of optimism about the "victory of the market", reversals are possible. It is therefore crucial to focus on factors that create resilience and sustainability in markets.

These arguments could be used to justify the EBRD widening its mission in ways that we discuss below. However, there is an important caveat. Even though the concept of transition has changed, and the endpoint is not as clear-cut as before, it is important that the EBRD does not move to a point where "anything goes". We strongly believe in the major premise of the Stern-Lankes analysis. Transition is about building "well-functioning and sustainable markets".

The need for an organizational focus is amply documented in the economics and political science literature on effective organizations.[20] It is a good idea, for accountability purposes, to go from a broad objective ("transition private-sector project funding") to a more precise, measurable mission, which is what Stern and Lankes offered. The question is whether their criteria need adapting, given how our understanding of transition has evolved and the progress that has been made since.

One can be more or less radical in the broadening of the EBRD's mission. Below, we discuss ways in which it could be done:

1. Stressing critical mass, or resilience, could imply dropping the idea of decreasing returns, whereby a second project or the renewal of the first project in a given sector/area is less valued than the first. This can and should be done without turning the EBRD into a more classical development bank.
2. Resilience may also call for more spending on education, health or innovation, a strategy that the EBRD could pursue. This of course requires acquiring the relevant competencies if they are currently missing. It also has implications for the definition of the appropriate interaction of the EBRD with the public sector.
3. Resilience/sustainability may also call for including measures related to the social cohesion and support of well-functioning and sustainable markets. If projects reduce inequality of opportunity and promote popular support and legitimacy of market supporting institutions, they should be explicitly rewarded for this in terms of the transition impact score.

20. See Wilson (1989). Also see Dewatripont et al (1999) for the modeling of Wilson's ideas.

3.1 Building a Resilient Market Economy: a Programmatic Approach?

A case can be made for a more programmatic approach to lending in which individual projects are not evaluated in isolation. Structural and institutional change may better be effected through a critical mass of projects, and consideration should therefore be given to whether returns to a sequence of related projects could be increasing. There should thus be efforts to consider how projects work together to achieve wider goals. This would require adapting the internal evaluation process away from proceeding on a strictly project-by-project basis.

One illustration of the potential role for this kind of approach is provided by the current global crisis. Lending to one bank may not make much sense if the banking system is collapsing. Recapitalizing the whole banking system (e.g. jointly with the national government and other actors like the IMF) is then a more defensible strategy. This could only be accomplished by viewing lending in a strategic and programmatic way. The potential role for such an approach is further reinforced given the instability of financial markets at the present time. It calls into question the intellectual underpinnings of the previous emphasis on promoting foreign banks. It also raises the spectre of effective nationalization of previously private banks.

Another reason to think in more systemic terms follows from the political economy literature: privatization is not sustainable if it is not legitimate. Therefore, one should keep in mind that more widespread private ownership is leading to incentives for wealth-creating entrepreneurship and growth when the private property rights are accepted by society. As stressed in Part 1, yet another lesson from political economy research is the importance of vested interests and the critical mass necessary to withstand their pressure. Consideration might therefore be given to widening the notion of transition impact towards a broader goal emphasising how projects support structural and institutional change rather than the narrower concept of "transition". However, to be effective, this would require an adaptation of the strict project-by-project approach to take this into account to redefine the demonstration effect.

So what would this more programmatic approach imply for the EBRD's behaviour? It would certainly imply dropping the idea that a second project in the same line of business is not as worthwhile as the first one. The same logic would also affect decisions to renew a given project. But we acknowledge the limits that should be applied when heading in this direction. First, it is essential to take into account the fact that repeat business, or similar business, may be more easily acquired. Second, it is important to keep pushing the EBRD to make a difference and to think innovatively about new areas of business.

These observations interact in an important way with the additionality criterion. We stressed in Part 2 above that this criterion is most often not binding now. Revamping additionality may in fact be a natural way to keep discipline within a programmatic lending strategy while not discriminating against systemically valuable repeat projects. It may indeed be the angle through which one can argue for (or against) the existence of critical mass effects while keeping a project focus. Introducing a discussion of the risks of reversals, or the value of critical mass effects in specific sectors, in this additionality perspective may be a relatively safe way to keep the EBRD's focus and avoid mission creep, which is obviously an important concern.

Our bottom line judgement is that taking irreversibility or critical mass effects on board could in fact strengthen the EBRD's mission, by making its concept of transition more credible and better suited to today's circumstances. In this sense, if anything, it would also make the distinction between the EBRD and other IFIs, like IFC or EIB, stronger. This is particularly relevant given that recent events, like the arrival of Turkey as a client country, that have weakened the EBRD's specificity.

3.2 Collaboration with the Public Sector and Broader Objectives

In Part 1, we observed that broader goals are a core part of the transition mandate. Development of markets is only instrumentally related to achieving broader social goals. Moreover, the resilience or durability of transition is connected with the achievement of these broader goals such as social cohesion, to take an EU term.

Effective state intervention may be just as important to achieving a resilient market economy as private capital itself. In the 1930s, the last period of great global economic turmoil, Keynes was concerned about the sustainability of capitalism and saw the role of the state as providing a critical factor to support its legitimacy.

So if the goal of the EBRD is to support transition to a self-sustained market economy, there is a question of whether lending to support private production is the only means to achieving this end. Were the EBRD to embark in the direction of lending more to public projects, this would be a substantial change in its focus.

We will consider two relevant questions: (i) in which areas could the EBRD move and (ii) if it does move, then how should it do it?

A case could be made that there are significant transition benefits in venturing into areas like:

- Education.
- Healthcare.
- (Social) housing.
- Occupational safety.
- Gender balance.
- Environment.
- Innovation and knowledge.

Indeed, these various dimensions are all related to the broad concept of sustainable development, i.e. development which reduces the probability of reversals on the path to a successful market economy, by strengthening the safety net, by providing decent working conditions and opportunities to citizens, and by preparing them better to meet the challenges of a modern global world. Note also that the last two dimensions, environment and innovation/knowledge, are really transversal, affecting all sectors of activity. In particular, innovation should not be seen as just applying to hi-tech sectors. Recent work shows that the best performer in this respect, i.e. the US, achieves higher productivity through its superior performance in the *use* (rather than the *production*) of information technology, in a wide variety of sectors, like retail trade, banking, and manufacturing.[21]

There is a case for the EBRD to think more in terms of final as well as intermediate goals. Indeed, transition and structural transformation make sense only as intermediate inputs into the wider social goals including: poverty reduction, increased well-being, gender equality, social cohesion, and environmental sustainability. These are the goals EBRD stakeholders care about in the end, and it is important to be able to argue that its focus on successful transition is an effective way to achieve these goals.

21. See Bloom et al. (2007).

Venturing into the above areas would make the connection between intermediate and final goals more concrete.

Doing this is, however, not without significant dangers. Chief among these is the dilution of the EBRD's concrete mission and focus. In this respect, it is important to stress two main caveats.

The first danger is the one of venturing into territory where the EBRD lacks expertise. It is clear that such expertise can be built over time. Yet, there is a case for moving cautiously. Nonetheless, the EBRD has a good starting point having developed the capacity to deal competently with closely related areas of lending.

The second danger is a blurring of the EBRD's private-sector focus, which has helped define its mission successfully in the past.

From this point of view, we believe that it is a good idea to maintain a focus on private lending and to keep the organizational mandate around transition impact, understood as consolidation of a well-functioning market economy.

The focus on private-sector lending should not go too far. One could, for example, venture into public-private partnerships. Helping to finance schools or hospitals built by private firms seems worthwhile whether they are ultimately run by the public or private sector. Funding such public-private partnerships would appear perfectly consistent with the EBRD's core transition mandate.

Here, there is some scope for borrowing from EU practices and doctrine. Rather than focusing on private versus public ownership, more emphasis can be put on market conformity, for example on good and open procurement, and on limiting state aid to what is needed to fulfil universal service obligations and to what can be defended by appealing to explicitly defined market failures. From this, it would be possible to develop a methodology for making explicit the trade-off between the correction of market failures and the potential distortions of competition.[22]

22. See European Commission (2005).

Part 4: Conclusions and Recommendations

This section briefly summarizes our conclusions and recommendations. Whenever appropriate, we refer to specific sections of the paper for details.

1. Supporting transition impact through project specific loans has allowed the EBRD to be an effective force for promoting transition. The three core principles of lending – additionality, sound banking and transition impact – continue to provide a sound framework for organizing project lending. The EBRD has benefited from the focus that has been achieved through the way that transition impact has been factored into its lending strategy. We were impressed how this is ingrained in the corporate culture of the EBRD and provides coherence to its activities.
2. The basic framework for monitoring and conceptualizing transition, while basically sound, is not fully reflective of current thinking about dynamic institutional change and its impact on economic development. While in the early stages of transition the priorities for transition were relatively clear, this has become less so further along the path. In particular, the current framework seems less robust on how transition impact is to be assessed in more contentious areas like public utilities. (Part 1 and Parts 2.2 and 2.4)
3. There is scope for further work on rethinking the conceptual basis of the core transition indicators as a framework for monitoring broad goals towards supporting the emergence of a sustainable and effective market economy. Moreover, there are many other sources of data such as BEEPS and LiTS which do not seem to be used at all in assessing the EBRD's wider impact on transition. (Part 2.5)
4. We recommend that the EBRD launches a small project to collate available measures of performance, those created by the EBRD and other organizations. This could be used as a means of assessing how such measures could be put alongside existing transition indicators and used in the EBRD's monitoring of transition progress. (Part 2.5)
5. Existing Transition Indicators seem poorly integrated into the process of assessing transition impact at the project level. There is potential for greater clarity in joining together the macro-economic and project centred assessments of transition impact. (Parts 2.5 and 2.6)
6. Transition impact should include explicit measurement of the institutional preconditions for development, legitimacy and resilience of market supporting institutions. Transition is at best an intermediate goal and it is important to remain focused on the ultimate ends towards which transition is oriented. (Parts 2.5, 2.6, and 3.1)
7. The current process for evaluating transition impact appears biased against repeat projects. However, a case can be made that it is through repeat projects that a critical mass can be achieved which would increase the transition impact of EBRD lending. Achieving such critical mass effects through project-based lending will require the additionality requirement for EBRD lending to be more binding. (Part 3.1)
8. More debate is needed on how far ultimate goals for transition economies should affect the way that the EBRD thinks about its priorities. Introducing concerns like social cohesion, occupational safety and

gender balance, for example, would foster broader development goals and help promote sustainable market economies. However, this would require developing an appropriate measurement framework to assess progress in these dimensions. How this would then influence project-based lending remains to be articulated. (Part 3.2)

9. In order to achieve greater transition impact, there is a case for considering an extension of EBRD lending into areas like education, healthcare, (social) housing, environment, and innovation and knowledge. Part of this could be achieved through greater lending to public-private partnerships even where the facilities are ultimately managed in the public sector. However, there is a need for caution. Such a move makes sense only if the appropriate expertise is acquired. However, we believe that such a move is also feasible within a broad private-sector focus. (Part 3.2)

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