EXECUTIVE SUMMARY

The *Transition Report 2019-20* is dedicated to the issue of governance. At its core, governance – which spans all aspects of authority, decision-making and accountability – is about the quality of institutions, which establish the rules of the game in a society. This report examines recent trends in governance at country level, at the level of subnational regions and municipalities, and at firm level (with particular attention being paid to firms' green governance).

The report draws on a number of rich sources of data, including the sixth round of Enterprise Surveys in the EBRD regions conducted by the EBRD, the European Investment Bank and the World Bank Group, which includes special modules looking at the green economy and management practices. The report also draws on data taken from the Gallup World Poll (a representative household survey), as well as a survey of municipal financing arrangements, the EBRD's assessments of corporate governance, detailed data on the location of bank branches across the EBRD regions, information on banks' balance sheets and emissions data for more than 1,800 industrial facilities in emerging Europe.

The economies where the EBRD invests began the 1990s with much weaker governance than advanced market economies. While the improvements in governance that those countries have achieved over the last two decades or so have been larger than those seen in other economies with comparable income levels, the "governance gap" relative to advanced economies remains sizeable. Narrowing this gap would yield a substantial growth dividend – not only at country level, but also at the level of subnational regions and individual firms. At firm level, analysis shows that improvements in corporate governance contribute to stronger productivity growth. There is, in particular, significant scope for improving firm-level governance as regards energy efficiency and green management. Financing constraints can hamper green investment and have tangible negative effects on firms' ability to reduce greenhouse gas emissions. However, for many firms the root cause of their reluctance to implement energy-saving measures is the low priority that managers assign to such investment in the first place.

As in previous years, this report also presents an assessment of developments in the area of structural reform, measuring the progress made across the EBRD regions in terms of the six key qualities of sustainable market economies.

THE GOVERNANCE DIVIDEND

Analysis of governance at economy level points to a significant governance gap in the EBRD regions in the mid-1990s, which contrasted with the regions' strong endowments in terms of human capital. Since then, many of the economies in those regions have achieved substantial improvements in the quality of economic institutions on the back of transition reforms and accession to the European Union. Overall, institution building in the EBRD regions has outpaced that seen in other emerging market economies.

At the same time, the pace of such improvements in governance has slowed markedly in recent years. Moreover, households across the EBRD regions continue to regard current levels of governance as insufficient. Such governance gaps matter, as they hinder investment and prevent the efficient allocation of resources within the economy (with resource allocation being shaped by personal connections rather than price signals).

Improving governance would yield a sizeable growth dividend. This growth dividend can be traced back to improvements in firm-level performance, with a meaningful reduction in firms' exposure to corruption being associated with an extra 1.4 percentage points a year in terms of sales growth. Moreover, in a country such as Ukraine, closing half of the governance gap relative to the G7 average will significantly boost satisfaction with life, eliminating 8 per cent of the "happiness gap" relative to the G7 (in addition to the impact of higher income per capita).

Consequently, improvements in governance will also reduce the likelihood of people reporting an intention to emigrate. In Albania, for instance, a newly acquired belief in the government's ability to fight corruption will reduce the likelihood of an individual intending to emigrate by as much as a wage increase of US$ 400 a month.

While strengthening governance at economy level is notoriously difficult, a number of countries have achieved major improvements in the quality of their economic institutions in relatively short periods of time. Their experiences can teach us important lessons about the ways in which technological improvements, external anchors and independent media can be leveraged to strengthen governance.

https://2019.tr-ebrd.com/governance-dividend

GOVERNANCE AT MUNICIPAL AND REGIONAL LEVEL

The quality of governance varies significantly within countries, resulting in large differences in the quality of municipal services (with municipal administrations in the EBRD regions typically being responsible for services such as waste collection, wastewater treatment, the water supply and pre-school education). Some of that variation stems from differences in the implementation of nationwide regulations.

Intra-country disparities in terms of quality of governance are on the rise in most countries, partly reflecting increased devolution of expenditure responsibilities to lower levels of government and the growing disparities between prosperous and struggling cities. In areas that are lagging behind, relatively poor governance, weak economic growth and outward migration by skilled workers can reinforce one another in a vicious circle.

Improving subnational governance can produce large payoffs in terms of regional growth, which can be traced back to the performance of individual firms. For instance, improving the level of governance from that observed in Romania's worst-performing region (Sud-Est) to that of its best-performing region (Sud-Muntenia) would boost regional growth by an average of 1.7 percentage points a year.

Improvements in governance at subnational level are also associated with greater well-being of residents, in addition to any impact on income levels. In terms of inter-regional competition for resources, better-governed regions attract more greenfield foreign investment projects, and those projects tend to be larger, while people living in those regions are less likely to emigrate.

Benchmarking the performance of regions and municipalities could strengthen incentives to improve governance and provide opportunities to disseminate best practices more widely. Meanwhile, case studies involving major improvements in municipal governance point to the importance of stakeholder participation in decision-making. At country level, such policies could be supported by fostering better coordination across municipalities and ensuring that municipal-level investment projects with high economic rates of return are able to secure financing.

https://2019.tr-ebrd.com/subnational-level-governance

FIRM-LEVEL GOVERNANCE

Governance at firm level is all about the rules, practices and processes that determine the relationships between shareholders, the board of directors, senior managers and other employees. Recent thinking in the area of corporate governance suggests that firms should also look beyond shareholders and take account of the broader interests of stakeholders such as customers, helping to create more sustainable and inclusive economies.

The various aspects of firm-level governance are closely related, as confirmed by the most recent round of Enterprise Surveys, which included special modules on the quality of management and the use of senior managers' time. In particular, those surveys examined firms' business practices as regards operations, monitoring, targets and incentives. The chapter finds that in countries that score more highly in terms of the EBRD's Corporate Governance Sector Assessment, firms tend to have better management practices.

Differences in firm-level performance are, to a significant extent, driven by differences in firm-level governance. Improving corporate governance and management practices enables firms to combine human capital, physical capital and material inputs more efficiently. Across the EBRD regions, affiliates of multinational companies and listed companies tend to be better managed than family-owned firms. Furthermore, professional managers at family-owned firms tend to make better use of their time than managers who are members of the family. At the same time, weak governance at national level hampers owners' ability to delegate the running of their firms to professionals. Indeed, only 17 per cent of family-owned firms in the EBRD regions are run by professional managers.

Businesses that face strong competition in product markets tend to be better managed, with competition encouraging shareholders and managers to adopt sound governance practices. Less onerous labour market regulations also appear to be conducive to firms adopting better management practices. At the same time, businesses can also learn about better governance practices from interaction with their peers and from managers who have experience of working for other companies or in other sectors.

https://2019.tr-ebrd.com/firm-level-governance

FIRMS' GREEN GOVERNANCE

Greenhouse gas emissions in the EBRD regions have fallen substantially since the 1990s. However, if the regions' economies are to fulfil their commitments under the Paris Agreement, firms will need to continue to improve their green credentials. The green economy module included in the latest round of Enterprise Surveys indicates that only a small number of firms in the EBRD regions and comparator economies exhibit high-quality green management practices, with the majority of firms continuing to perform poorly in this regard.

This chapter shows that credit constraints hamper all investment by firms, including investment with environmental benefits. Indeed, industrial facilities in areas where firms are more credit-constrained emit around 5 per cent more greenhouse gases than similar facilities in areas without binding credit constraints. However, financial constraints are not the key determinant here, with the question of whether firms undertake green investment projects depending primarily on the strength of their existing green management practices.

While many firms are, in principle, keen to reduce their environmental impact, managers often prioritise other types of investment in the face of financial and time constraints, even in situations where green investment projects would produce positive returns. In line with this interpretation, green management scores at the 10 per cent of firms that have recently been exposed to extreme weather events are, on average, significantly higher than those of other firms. Similarly, companies tend to invest more in green projects when they face external pollution or pressure from customers.

Thus, improving the availability of credit is just one element of the broad policy mix that is necessary to improve firms' green credentials. Governments may also have to compel firms to produce in a more energy efficient manner using environmental standards or other regulations, or via subsidies that are contingent on the use of specific green technologies. Targeted green credit lines can also encourage firms to prioritise green investment. In addition, voluntary environmental standards may help to harness the power of public pressure and consumer awareness in order to further reduce firms' environmental footprints.

https://2019.tr-ebrd.com/firms-green-governance

MACROECONOMIC OVERVIEW

Growth in the EBRD regions has been slowing since the middle of 2018. This deceleration has been driven by a very sharp slowdown in Turkey and weaker export growth across the EBRD regions, mirroring the global slowdown in trade. Economic growth is expected to moderate further in 2019, in line with less favourable external conditions, before picking up somewhat in 2020 as the recovery in Turkey takes hold.

GDP per capita at purchasing power parity is still less than 60 per cent of G7 levels in three-quarters of the EBRD regions' economies. Indeed, in some countries it remains less than one-tenth of the G7 average. If countries were to reap the benefits of improved governance, convergence with G7 income levels could be achieved about 26 years earlier than is currently expected on the basis of average growth rates for the period 2010-18, given the governance dividend that is estimated in Chapters 1 and 2. In other words, that governance dividend could potentially result in the rate of income convergence returning to something close to pre-crisis levels.

https://2019.tr-ebrd.com/overview

STRUCTURAL REFORM

This final section of the report presents updated transition scores for all of the economies where the EBRD invests and discusses major reform initiatives across the EBRD regions.

Changes to competitiveness scores largely reflect gradual improvements in the business environment, for instance, in Azerbaijan, Georgia, Morocco and Turkey. Meanwhile, Albania, Armenia, Hungary and Uzbekistan have all embarked on major reforms of their tax regimes, and new mechanisms supporting access to finance for small and medium-sized enterprises have been introduced in Belarus, Georgia, Ukraine and Uzbekistan. Several countries (including Cyprus, Greece, Ukraine and Uzbekistan) have also made further efforts to restructure state-owned enterprises and banks. In contrast, Romania's business environment has deteriorated, resulting in a modest decline in that country's competitiveness score.

A number of countries (including Azerbaijan, Cyprus, Georgia and Kazakhstan) have recently embarked on judicial reforms and introduced alternative dispute resolution mechanisms.

Green scores have been revised upwards in several countries (including Egypt, Ukraine and Uzbekistan) on the back of progress with the introduction of carbon-pricing mechanisms. In addition, Montenegro, North Macedonia and Russia have now ratified the Paris Agreement on climate change. In the area of inclusion, various countries (including Russia, Tunisia and Uzbekistan) have adopted new laws and regulations aimed at strengthening gender equality in the workplace.

Changes to resilience scores have been driven largely by declines in levels of non-performing loans (with Cyprus and Greece making particular progress in this area), as well as improvements to the regulatory environment and standards of governance in the financial sector.

A number of countries (including Albania, Greece, Kazakhstan, the Kyrgyz Republic, Serbia, Ukraine and Uzbekistan) have adopted measures aimed at reducing barriers to cross-border trade and improving air connectivity, which have been reflected in their respective integration scores.

https://2019.tr-ebrd.com/reform