FOREWORD

The title of this year's report – *"Better Governance, Better Economies"* – summarises its message well. Good governance matters. It matters at the level of countries, subnational regions and firms, and it also matters for people's well-being. That is why the EBRD's transition concept emphasises the importance of strong governance as one of the six key qualities of a well-functioning market economy, in addition to looking at whether economies are competitive, green, inclusive, resilient and integrated.

Governance is a concept that eludes easy definition. In its working definition of the term, the Institute on Governance says that governance "determines who has power, who makes decisions, how other players make their voice heard and how account is rendered". Governance can be thought of as the rules of the game, determining the constraints and incentives that economic and political actors are subject to. Governance dictates the manner in which people organise themselves, whether at the level of small groups or entire societies.

Poor governance is detrimental for three reasons. First, it creates uncertainty. When the rules of the game lack clarity, outcomes become unpredictable. Thus, uncertainty discourages investment, be it inflows of foreign direct investment, firm-level decisions about the expansion of operations or entrepreneurs' decisions on whether or not to set up new businesses. People dislike uncertainty in their daily lives, regarding it as a cause of stress, and uncertainty regarding governance discourages people from investing in their futures.

Second, poor governance damages competitiveness. Corruption, the twin brother of poor governance, necessitates additional payments, increasing the cost of running a business, gaining an education or accessing medical services. While the nominal cost of living or running a business in a given location may be low, the effective cost – once bribes and delays have been taken into account – may cause firms to fail or prompt residents to leave.

Third, poor governance creates an uneven playing field. It gives advantages to firms and individuals with links to ruling elites, while disadvantaging others, leading to inequality of outcomes, inequality of opportunities and inefficient allocation of resources. It also gives rise to a general sense of injustice and disillusionment with politics.

This year's *Transition Report* documents patterns and trends in governance at country, region and firm level, showing that governance matters for economic growth, the perceived quality of life and the natural environment.

The first part of the report focuses on governance at country level. It shows that although the EBRD regions have achieved substantial improvements in governance since the 1990s, those gains have tended to slow in recent years and the "governance gap" relative to advanced economies remains virtually unchanged. There are, however, notable exceptions to this trend. Georgia, for instance, has closed almost 70 per cent of its governance gap relative to the G7 average since 1996, while Estonia has closed around 90 per cent of its gap.

A persistent governance gap will be very costly over time. The analysis presented in this report suggests that closing half of the gap between the quality of economic institutions in the EBRD regions and the G7 average would boost income growth per capita by an average of around 0.9 percentage point a year across the EBRD regions as a whole. Moreover, governance deficits may be particularly detrimental for upper-middle-income economies, where innovation and entrepreneurship matter more for growth than cheap labour, economies of scale and imported technology. This is because innovation and entrepreneurship are particularly sensitive to the quality of governance.

Governance also matters at the level of individuals. People in the EBRD regions are much more likely to report an intention to emigrate within the next year if they regard the quality of governance as poor. In a country such as Albania, for instance, a newly acquired belief in the government's desire and ability to tackle corruption will have the same effect in terms of reducing the likelihood of an individual intending to emigrate as a wage increase of about US$ 400 a month.

This report also looks at governance at regional level, showing that intra-country differences in the quality of governance are large relative to cross-country differences. In Hungary, for instance, the quality of governance in the country's worst-performing region is comparable to the average level seen in Romania, while the country's best-performing region is comparable to the worst-performing region in Spain. Moreover, countries with lower average levels of governance tend to exhibit larger regional disparities. Worryingly, such regional disparities also seem to be increasing over time, which is likely to exacerbate regional differences in income.

The report then goes on to consider developments at firm level, focusing on corporate governance. The EBRD

conducts regular assessments looking at the quality of corporate governance in the economies where it invests. The last such assessment, which was carried out in 2016-17, found significant variation across the EBRD regions in terms of the quality of legislation and practices in this area. Common weaknesses include inadequate non-financial disclosure by listed companies, a lack of clarity regarding the responsibilities and composition of boards of directors and the role of independent directors, and a lack of diversity at board level. Analysis of firm-level surveys shows that the quality of management tends to vary more across firms within individual countries than it does across countries.

The final part of the report focuses on the issue of green governance, showing that firms and countries differ significantly in terms of the quality of green management practices: the ways in which firms set targets for energy consumption, structure their operations to achieve those targets and monitor their progress. In most of the economies where the EBRD invests, there is a lack of green leaders and the majority of firms perform poorly in terms of their green credentials. Foreign-owned firms and exporters (which, as the report shows, tend to have better overall management practices) also tend to perform better in terms of green management, investing more in order to reduce pollution and save energy. Although green investment can be hampered by financing constraints, many firms shy away from such investment for the simple reason that it is regarded as a low priority by managers.

The overall message that emerges from this report is that there is a significant economic and social dividend to be reaped from improvements in governance at country, region and firm level. Securing that dividend will require resolve, vision and leadership on the part of national governments, regional leaders, managers and entrepreneurs alike.

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