

EBRD Transition Report: Better governance, better economies

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PRESS RELEASES

EBRD Transition Report: Better governance, better economies

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The findings of the latest EBRD Transition Report 2019-20, dealing with improvement in governance as a means of stepping up economic performance, are rather worrying and they show that Croatia's quality-of-governance ranking is closer to average rankings in Southeast Europe (or rather East Europe and Caucasus) than the average of the region it belongs to, i.e. Central Europe and the Baltic states.

The European Bank for Reconstruction and Development (EBRD) has issued its 2019-20 Transition Report under the title „**Better governance, better economies**”. The report focuses on the fact that the EBRD countries¹ lag behind advanced economies, and the importance of governance² for their economic growth and well-being. It looks at trends in governance at national, regional and local levels, as well as firm-level (including firms' green governance). It also assesses the countries' progress in structural reforms necessary for a sustainable market economy, whose main characteristics are: competitiveness, good governance, green economy, inclusiveness (with respect to genders, regions and age), resilience (regarding financial instability and energy) and integration (in terms of foreign trade, finance and infrastructure).

Progress in governance has slowed down

Building on the previous **Report 2017-18 Sustaining Growth**³, indicating that long periods of stable but weak economic growth can be largely explained by the poor-quality of economic and political institutions, the current report focuses on governance. Governance implies the quality of institutions which define the rules of behaviour in the society, as well as the constraints and incentives that both economic and political actors are subject to. The institutions support governance at all levels - from central government through regional and local governments to firms. They are often informal and dependent on cultural norms and practices. As a result, even in countries with similar legal

¹ EBRD (European Bank for Reconstruction and Development) was established in 1991 with the aim of accelerating transition in Central and East European countries. Over time, the bank has expanded its operations and is currently active in the following regions and countries: Central Europe and the Baltic states (Croatia, Estonia, Latvia, Lithuania, Hungary, Poland Slovak Republic and Slovenia); Southeast Europe (Albania, Bosnia and Herzegovina, Bulgaria, Cyprus, Montenegro, Greece, Kosovo, Romania and Serbia); Turkey; East Europe and Caucasus (Armenia, Azerbaijan, Belarus, Georgia, Moldavia and Ukraine); Russia; Central Asia (Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan); Southern and Middle Mediterranean (Egypt, Jordan, Lebanon, Morocco, Tunisia, West Bank and Gaza). Czech Republic was originally also among the EBRD countries, but as of 2008, it is no longer considered a transition country by the EBRD.

² There is no exact Croatian equivalent for the English term governance which encompasses all aspects of government, decision making and accountability. It is usually translated as „upravljanje“.

³ See Ott, K., (2017): EBRD Report on transition toward sustainable market economy: Croatia lags behind; *Press Release No. 98*.

frameworks, differences in implementation of laws and regulations produce very different economic outcomes.

The quality of governance in the EBRD countries in the early 1990s, lagged far behind that seen in economies with comparable per capita income levels. However, on the back of transition reforms (and, in some countries, EU-adjustments), it improved markedly during the first few transition years, but the progress has slowed down over time. Consequently, most of these countries still lag far behind developed economies when it comes to quality of governance, while they managed to substantially reduce the income lag. The most remarkable improvements were effected in the quality or economy regulation, and the slightest in the control of corruption, the rule of law and government effectiveness.

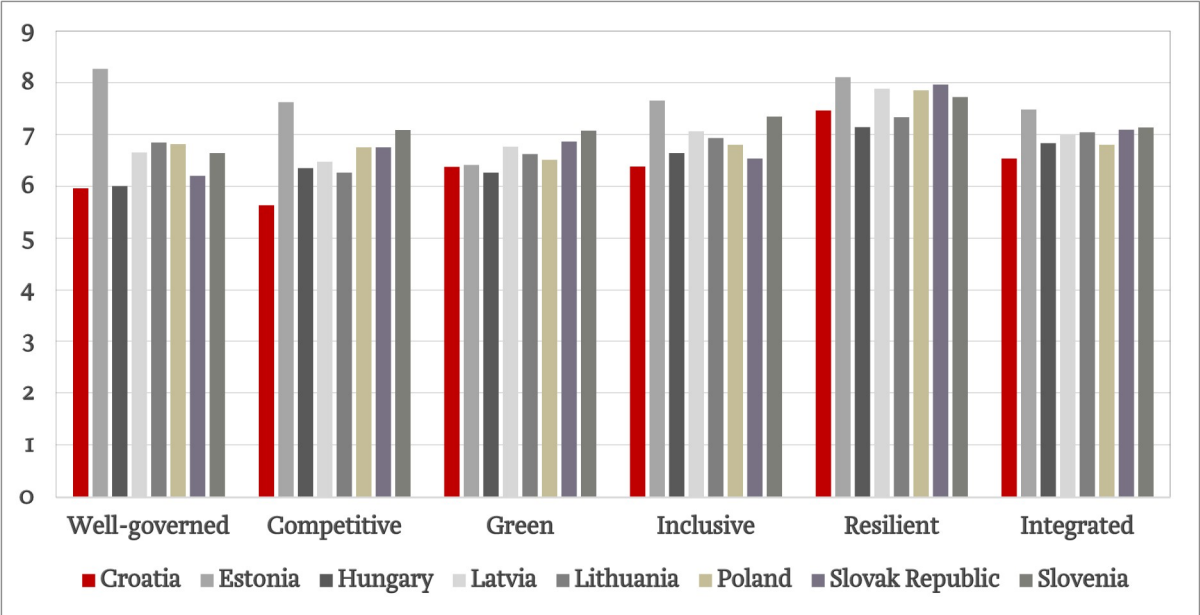
Lagging behind in governance is critical, as it results in investment cutbacks and inefficient resource allocation based on personal connections ('back-scratching'), instead of on the market principles. Given the modern economies' increasing dependence on innovation and enterprise, poor governance becomes a growing barrier to achieving the advanced economies' levels of income. Croatia, for example, would need almost 40 years to converge to the average per capita income in G-7 countries, assuming average growth rates from the period 2010-18 and a substantial improvement in governance. However, with the same growth rates, but without improvements in governance, the convergence period could even exceed 120 years.

The report suggests that in EBRD countries, even a small degree of governance convergence may lead to considerably more convergence in economic growth. Hence, improvements in governance would increase household income and life satisfaction, while discouraging emigration. However, the governance improvement effect on the quality of life and emigration decisions is much stronger than the effects of mere increases in household income. In other words, the populations that are satisfied with their institutions and that expect better social and economic outcomes in the future will be more inclined to stay in their own countries than to emigrate.

Croatia lags behind Central Europe and the Baltic states

As shown in graph 1, Croatia's position within its peer group is very poor: it is ranked the last in almost all indicators. Only Hungary lags slightly behind it in terms of green economy, and Hungary and Lithuania in terms of resilience. Croatia' ranking on competitiveness for all categories is the worst among the countries in the region.

Graph Sustainable market economy quality indicators, Central Europe and the Baltic states, 2019*



* Indicators range from 1 to 10, with 10 representing the achieved sustainable market economy standard. Source: Author, based on the Report.

Table 1 shows that, in terms of the quality of governance, Croatia ranks 14th among all the EBRD countries, lagging fairly behind the leader, Estonia, but also behind the average for its peer group (Central Europe and the Baltics). This ranking brings Croatia closer to the average for Southeast Europe, if not that for East Europe and Caucasus. The same ranking (14) and the same relationship to the group of peer countries' averages exist in terms of competitiveness, with only a slightly higher scores on inclusiveness (12) and integration (11), but markedly higher on green economy (7) and resilience (6).

In the part dealing with country assessments, EBRD indicates positive economic growth trends in Croatia, raising the country's credit rating to investment grade and plans for joining the eurozone. However, it also lists key priorities Croatia should focus on in 2020 which include:

- Stepping up reforms aimed at preparing the country for joining ERM II and the banking union. Despite improvements in macroeconomic performance, *the authorities should speed up key structural reforms, focusing in particular on improving public-sector governance.*
- Introducing sustainable and permanent measures to address acute skilled labour shortages. Several sectors, especially tourism, have long been experiencing a lack of qualified staff. Increased quotas for foreign workers can be a short-term solution to that problem, but long-term solutions are called for, including a *further reduction in labour market rigidities.*
- Business environment reforms should continue to be prioritised. Despite improvements, bureaucratic processes remain an obstacle to doing business. Moreover, state-owned enterprises remain dominant in some sectors, and their *privatisation, including through initial public offerings, would attract investors and increase the competitiveness of the economy.*

Recommendations to Croatia, coming from various sources, such as EBRD, IMF and the European Commission, are more or less repeated year after year. Progress is slow, or even absent in some sectors, and comparisons with comparable countries are far from encouraging. This report, for example, even points to a deterioration in the quality of governance and integration indicators in 2019 relative to 2018. Therefore, both the current Croatian government and those who will succeed it after the next parliamentary elections should carefully consider the recommendations made to Croatia, but also general recommendations for improving governance, especially at the level of central government, which relate to the following:

- *Public administration reform* - a professional civil service with transparent, merit-based recruitment and remuneration procedures is the crucial element of the strengthening of institutions.
- *Streamlining cumbersome regulations* - primarily the tax system and law, since unnecessary complexity tends to breed the abuse of office and authority by civil servants.
- *Employment of modern technologies* - that can dramatically increase transparency of public data, especially as regards public procurement, tax administration and public disclosure.
- *Ensuring press freedom* - as the measures aimed at increasing transparency and fighting corruption proved to be more effective in the presence of greater press freedom. But of course, press freedom is also dependent on the quality and strength of a country's democratic institutions.
- *Promoting international cooperation in the fight against corruption* - plays an important role, particularly as it makes it more difficult for corrupt officials to park unexplained wealth abroad.

If there is no political will to finally solve the problems of non-transparent public sector and incompetent public administration breeding clientelism, nepotism and bribery, Croatia will continue to be stuck among countries where there is discontent and apathy and from which people emigrate to better governed and economically more advanced countries.

Table 1. Sustainable market economy quality indicators, EBRD countries, 2019*

| | Well-governed | Competitive | Green | Inclusive | Resilient | Integrated |
|--|---------------|-------------|-------|-----------|-----------|------------|
| Estonia | 8.27 | 7.63 | 6.42 | 7.66 | 8.11 | 7.49 |
| Cyprus | 7.07 | 6.68 | 6.32 | 6.66 | 5.60 | 7.68 |
| Lithuania | 6.85 | 6.27 | 6.63 | 6.94 | 7.34 | 7.05 |
| Poland | 6.82 | 6.76 | 6.52 | 6.81 | 7.86 | 6.81 |
| Central Europe and the Baltic states average | 6.68 | 6.62 | 6.62 | 6.93 | 7.69 | 7.00 |
| Latvia | 6.66 | 6.48 | 6.77 | 7.07 | 7.89 | 7.00 |
| Slovenia | 6.65 | 7.09 | 7.08 | 7.35 | 7.73 | 7.14 |
| Georgia | 6.40 | 4.98 | 5.32 | 5.14 | 6.19 | 6.35 |
| Jordan | 6.23 | 4.18 | 5.85 | 4.36 | 6.18 | 5.81 |
| Slovakia | 6.21 | 6.76 | 6.87 | 6.54 | 7.97 | 7.10 |
| Turkey | 6.18 | 5.42 | 5.28 | 5.01 | 7.02 | 5.70 |
| Montenegro | 6.11 | 5.44 | 5.41 | 5.98 | 6.44 | 6.15 |
| Romania | 6.04 | 6.01 | 6.14 | 5.74 | 7.11 | 6.75 |
| Hungary | 6.01 | 6.36 | 6.27 | 6.65 | 7.15 | 6.84 |
| Croatia | 5.97 | 5.64 | 6.38 | 6.39 | 7.47 | 6.54 |
| Russia | 5.90 | 5.83 | 5.09 | 6.83 | 6.42 | 5.00 |
| Bulgaria | 5.79 | 5.71 | 6.04 | 6.24 | 6.91 | 6.85 |
| Azerbaijan | 5.79 | 4.39 | 5.35 | 4.94 | 3.97 | 5.59 |
| Armenia | 5.78 | 4.97 | 5.72 | 5.97 | 6.40 | 5.45 |
| Kazakhstan | 5.67 | 5.26 | 5.36 | 6.46 | 5.95 | 4.91 |
| Republic of North Macedonia | 5.57 | 6.02 | 5.16 | 5.90 | 5.93 | 5.75 |
| Southeast Europe average | 5.55 | 5.56 | 5.42 | 5.90 | 6.12 | 6.10 |
| Serbia | 5.52 | 5.36 | 5.79 | 6.16 | 5.86 | 5.99 |
| EBRD countries' average | 5.46 | 5.09 | 5.53 | 5.68 | 5.97 | 5.64 |
| Eastern Europe and the Caucasus average | 5.45 | 4.77 | 5.53 | 5.75 | 5.37 | 5.42 |
| Morocco | 5.34 | 4.49 | 5.87 | 3.17 | 5.73 | 4.88 |
| Greece | 5.22 | 5.78 | 6.13 | 6.24 | 7.04 | 6.41 |
| Belarus | 5.15 | 5.17 | 6.22 | 6.63 | 4.16 | 5.43 |
| Albania | 5.11 | 5.14 | 4.49 | 5.31 | 5.22 | 5.66 |
| Mongolia | 5.11 | 4.22 | 5.36 | 5.19 | 5.37 | 4.53 |
| Tunisia | 4.88 | 3.93 | 4.92 | 3.82 | 5.10 | 4.33 |
| Egypt | 4.83 | 3.08 | 5.19 | 3.51 | 5.60 | 4.43 |
| Southern and eastern Mediterranean average | 4.83 | 3.82 | 5.17 | 3.91 | 5.34 | 4.80 |
| Moldavia | 4.81 | 4.36 | 4.68 | 5.58 | 5.82 | 4.94 |
| Ukraine | 4.78 | 4.77 | 5.87 | 6.21 | 5.67 | 4.75 |
| Kosovo | 4.56 | 4.78 | 3.47 | 5.28 | 5.18 | 4.67 |
| Bosnia and Herzegovina | 4.53 | 4.68 | 5.20 | 5.48 | 5.91 | 5.08 |
| Uzbekistan | 4.45 | 3.39 | 4.41 | 5.41 | 3.96 | 3.93 |
| Central Asia average | 4.21 | 3.83 | 4.76 | 5.36 | 4.55 | 4.30 |
| Kyrgyz Republic | 4.12 | 4.04 | 4.48 | 4.62 | 5.12 | 4.92 |
| West Bank and Gaza | 3.88 | 2.87 | 4.07 | 3.84 | 4.95 | 4.65 |
| Lebanon | 3.84 | 4.36 | 5.10 | 4.73 | 4.48 | 4.70 |
| Tajikistan | 3.63 | 3.25 | 4.84 | 5.05 | 3.68 | 3.51 |
| Turkmenistan | 2.28 | 2.81 | 4.09 | 5.41 | 3.21 | 3.97 |

* Countries and regions are ordered according to the 'good governance' indicator (column 1). Indicators range from 1 to 10, with 10 representing the achieved sustainable market economy standard.

Source: Author, based on the Report.