

# Innovation, Inclusion and Integration

## From Transition to Convergence in Eastern Europe and the Former Soviet Union

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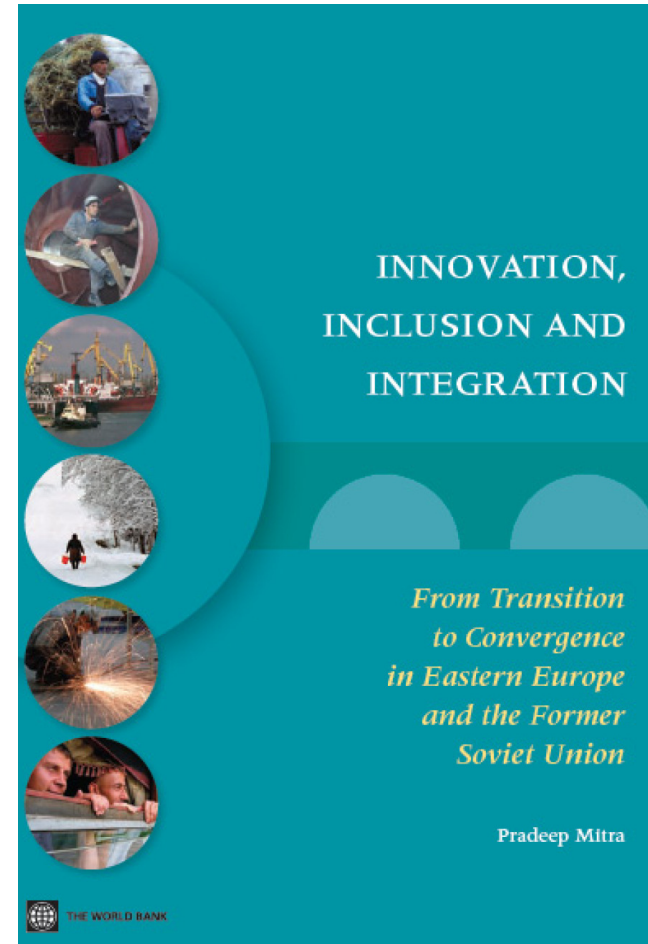
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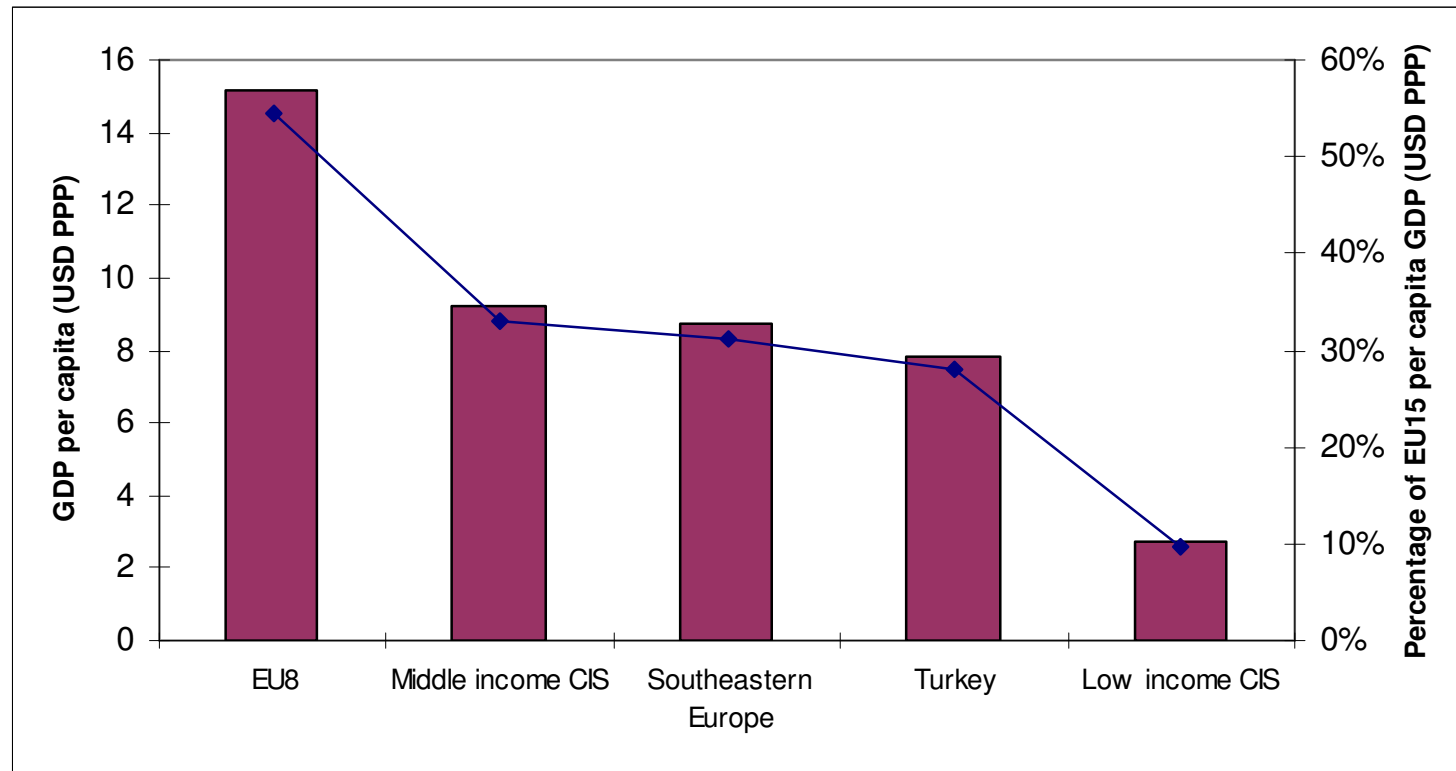
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## THE CONTEXT

*Income per capita is just over a half of the (EU-15) average for even the wealthiest subgroup of ECA countries and just over a quarter of the EU15 average for the other middle income countries*

Population-weighted GDP per capita in U.S. dollars (purchasing power parities)



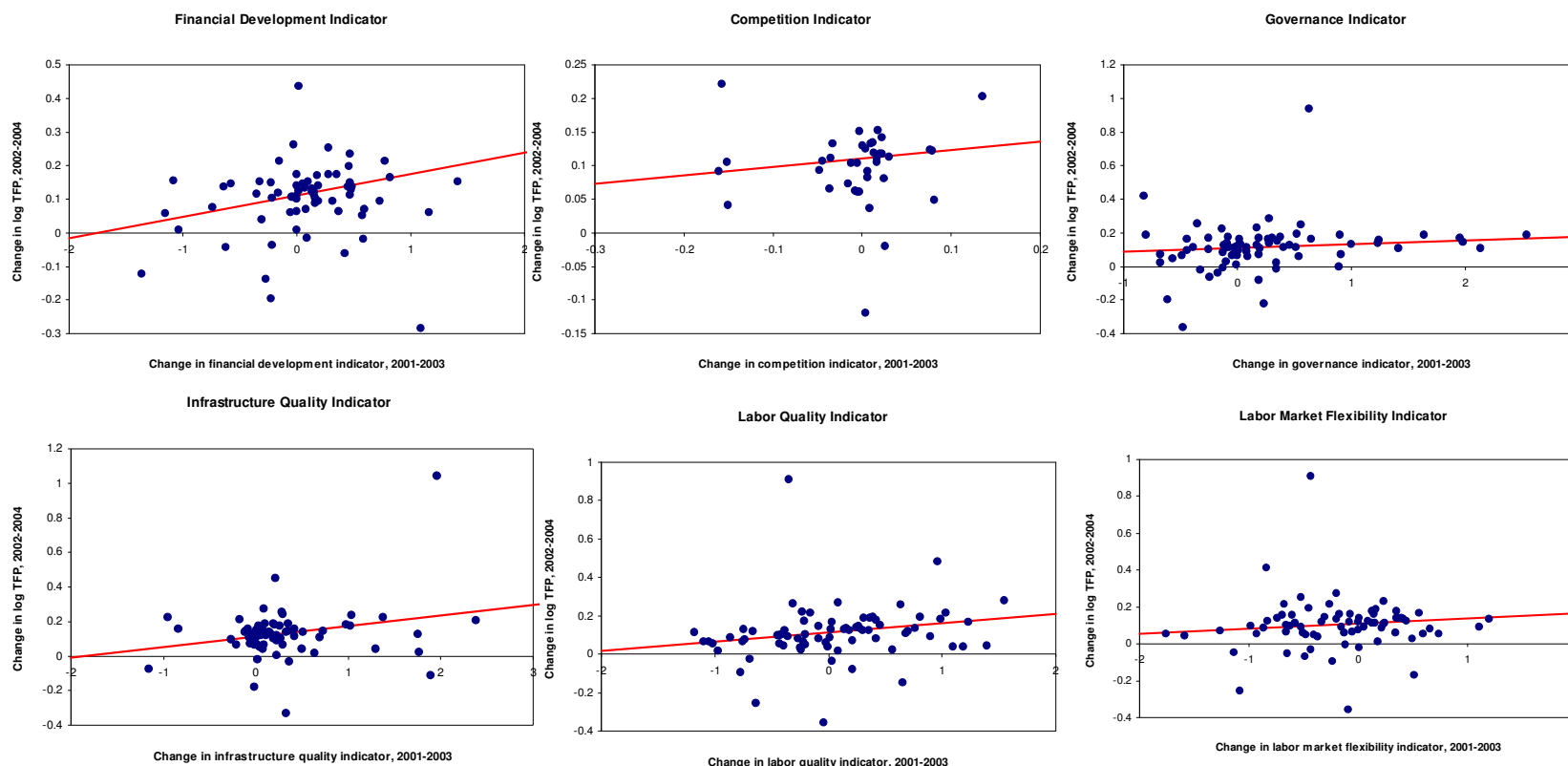
Source: World Bank World Development Indicators Database.

Note: Sub-regional aggregates are weighted by population.

EU8: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, Slovenia. Southeastern Europe: Albania, Bosnia-Herzegovina, Croatia, Macedonia, Montenegro and Serbia. Middle Income CIS: Belarus, Kazakhstan, Russia, Ukraine. Low Income CIS: Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, Uzbekistan.

# PRODUCTIVITY GROWTH

*Productivity growth is the only viable route to long-term prosperity. At the level of firms, where the core activity of restructuring took place, productivity growth within firms is positively associated with competitive markets, a deep financial sector, good governance, and superior skills and infrastructure.*



Note: The dependent variable is the change in the logarithm of total factor productivity (TFP), subtracting in each figure the effects of all other regressors.

The regressions control for firm size and for industry, location and country.

Source: World Bank (2008)



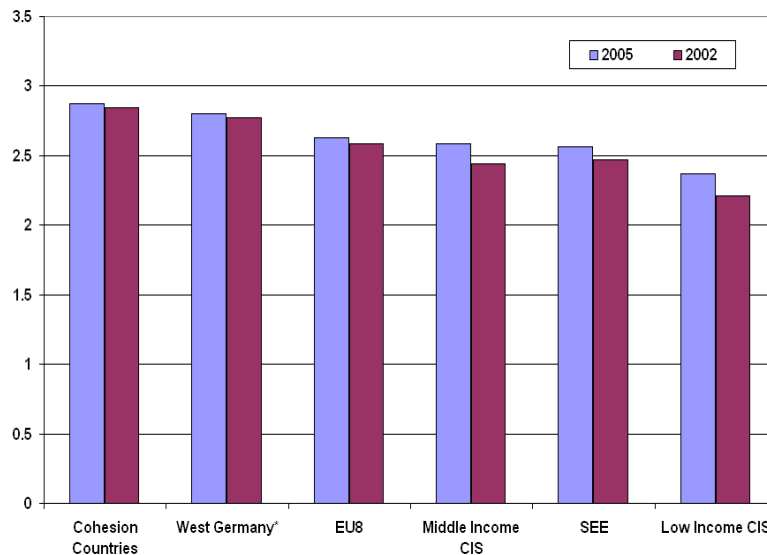
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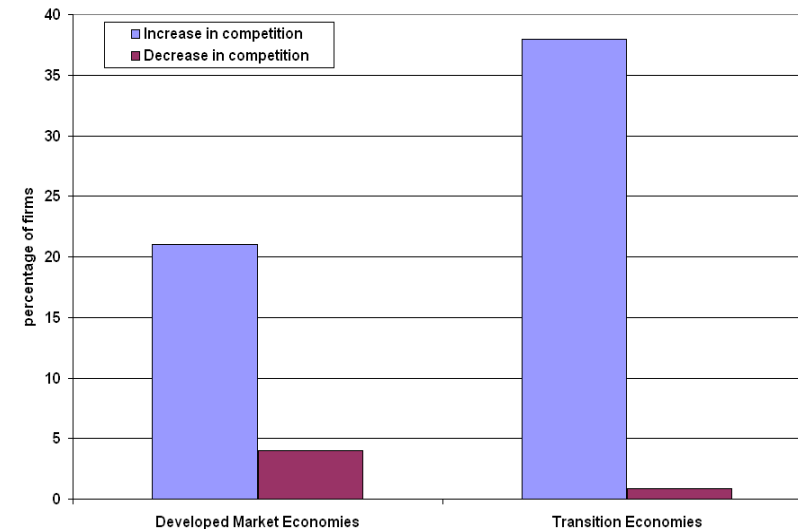
# COMPETITION

Key elements of the business environment, such as competition and finance, are maturing and converging towards those found in developed market economies. Firms in all transition country groups reported facing more competitors in 2005 compared to 2002. Of the firms facing moderate competition in 2002 (1-3 competitors), 38 percent in the transition economies stated they faced strong competition (4 or more competitors) in 2005, compared with 21 percent in the developed market economies. The fastest change in market structure occurred in the middle income CIS, followed by Southeastern Europe and the low income CIS. The EU8 countries were fairly close to the cohesion countries (Greece, Ireland, Portugal, Spain) in market structure.

Measuring Competitiveness 2002 vs. 2005



Changes in perceptions of competitiveness 2002 vs. 2005



\*Results for Germany correspond to 2004 and 2001.

Note: Firms were asked how many competitors in the national market they faced for their main product lines or services in the surveyed year and 36 months earlier. Firms were asked to select from: None (scored as '1'); between 1 and 3 ('2'); greater than 4 ('3'). Where firms reported that they did not compete in their national market we use the data for firms that report competing in their local markets. The survey conducted in West Germany did not ask firms to distinguish between their local or national markets.

Source: Mitra, Muravyev and Schaffer (2008)

Note: The blue bar illustrates the percentage of firms that reported having 1-3 competitors in the national market in 2002 as having 4 or more in 2005. The red bar illustrates the percentages of firms reporting having 1-3 competitors in 2002 as having no competitors in 2005. Where firms reported that they did not compete in their national market we use the data for firms that report competing in their local markets. The survey conducted in West Germany did not ask firms to distinguish between their local or national markets.

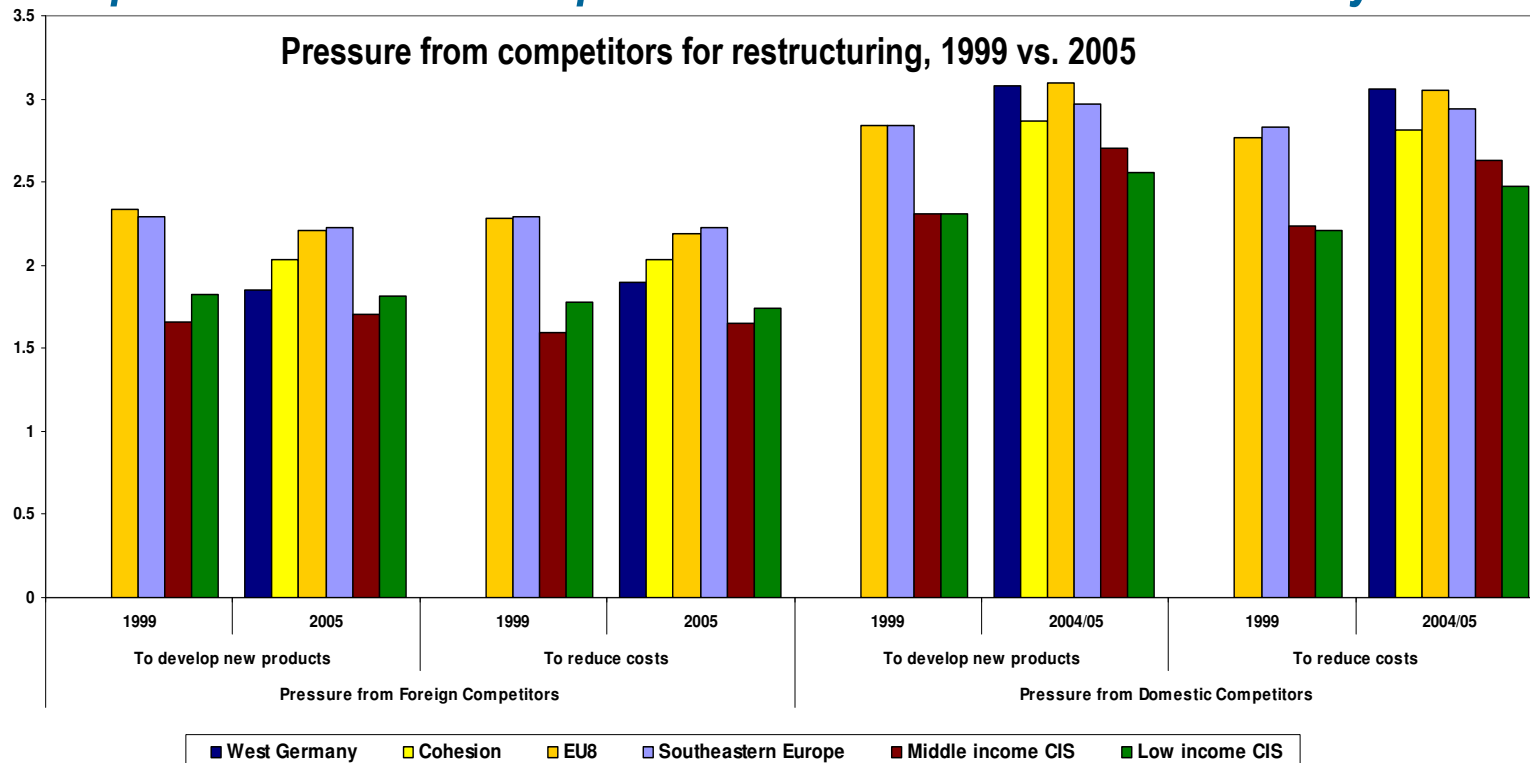


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# COMPETITION

*Pressure to develop new products and reduce costs shows some convergence with developed market economies. The EU8 are furthest along in the process, followed by Southeastern Europe and the CIS countries. Foreign competition was always present. Domestic competition was more important but firms could avoid domestic competition at the beginning of the transition by occupying market niches. However, domestic competition grew in importance as countries proceeded towards a market economy.*



Note: Firms were asked about the importance of pressure from foreign competitors in “developing new products” or “reducing costs”. Score range: 1 (Not at all important), 2 (Slightly important), 3 (Fairly important), 4 (Very important).  
Source: Mitra, Muravyev and Schaffer (2008)



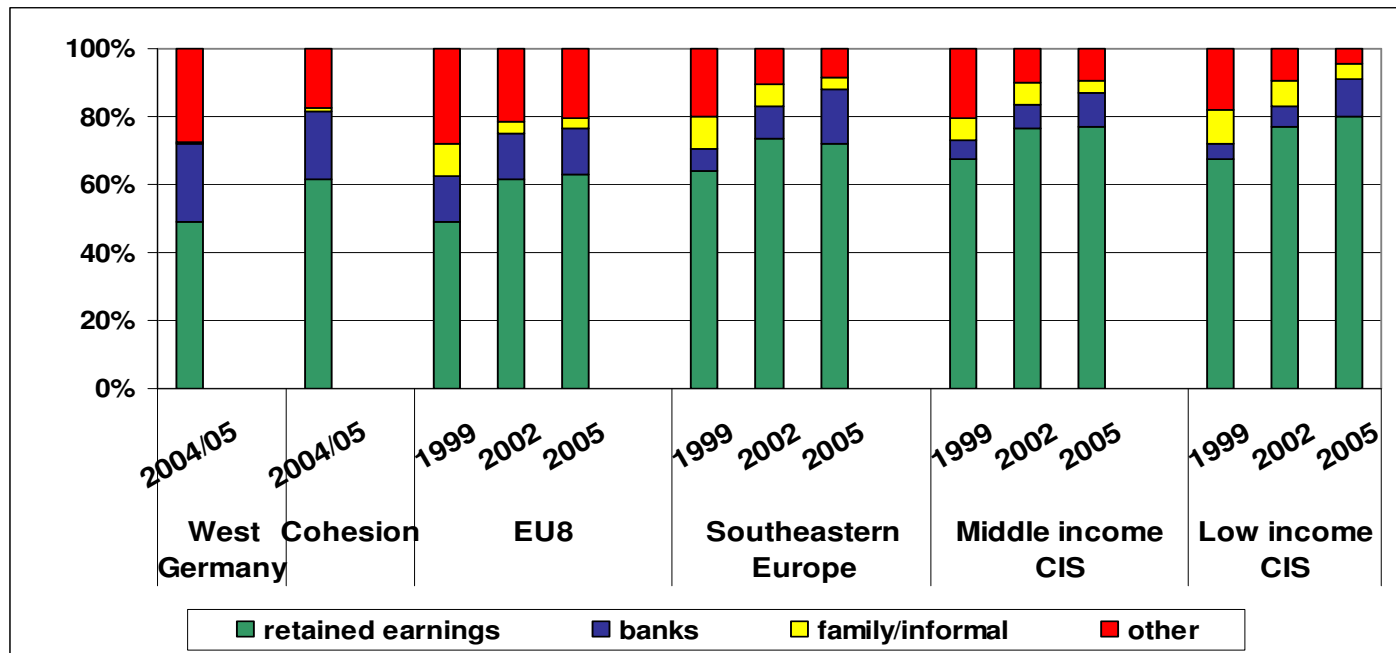
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# FINANCE

*The structure of finance for fixed investment shows a greater reliance on retained earnings over 1999-2005 in all transition country groups towards shares higher than in the developed market economies. Reliance on formal finance (banks) is generally less than in the developed market economies, although the shares for the EU8 and cohesion countries are similar. The greater reliance on retained earnings reflects a decline in loans from family, friends and money lenders – a maturing of the business and financial sectors in the transition countries, not a decline in the institutions of formal finance.*

Evolution of Financing for Fixed Investment



Note: Equity finance is small in the transition countries and is absorbed in "other"  
 Source: Mitra, Muravyev and Schaffer (2008)





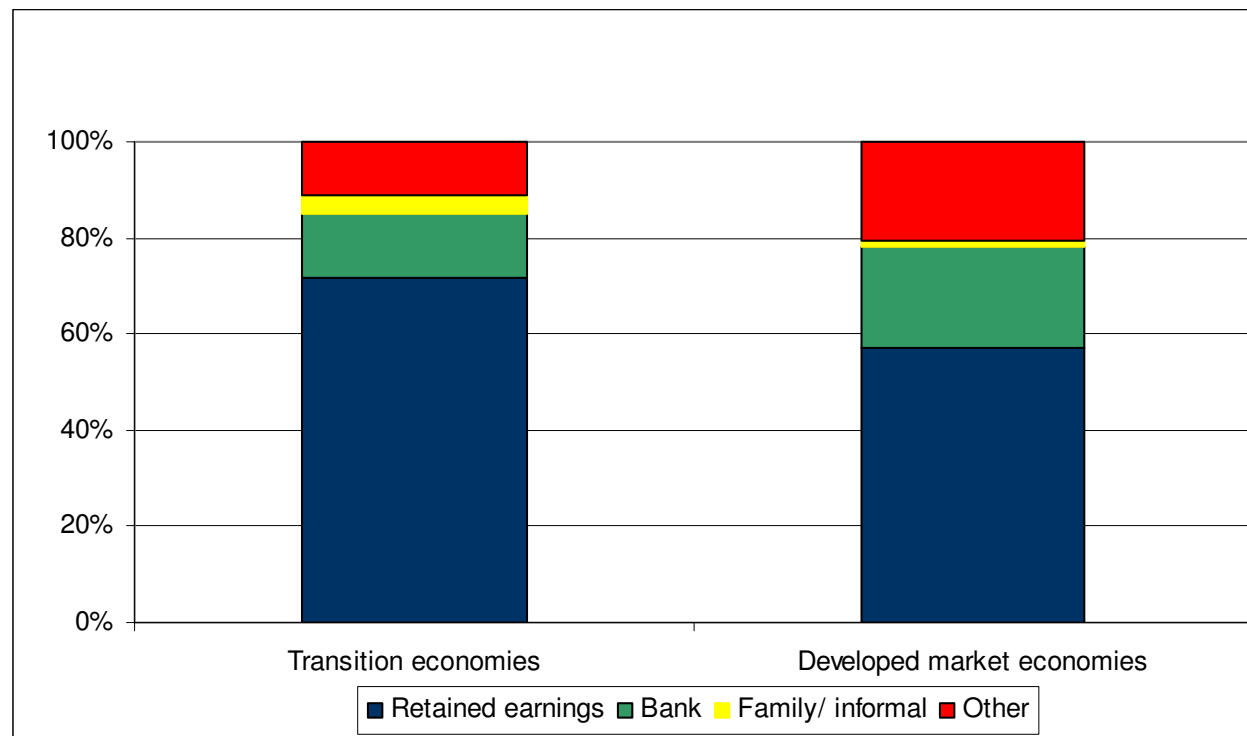
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## FINANCE

*Private firms (de novo as well as privatized) in the transition countries rely more on retained earnings, more on family and informal sources and less on bank financing and other sources in financing fixed investment compared to private firms in developed market economies.*

The structure of finance for fixed investment in private firms in transition economies and developed market economies, 2005



Source: Mitra, Muravyev and Schaffer (2008)



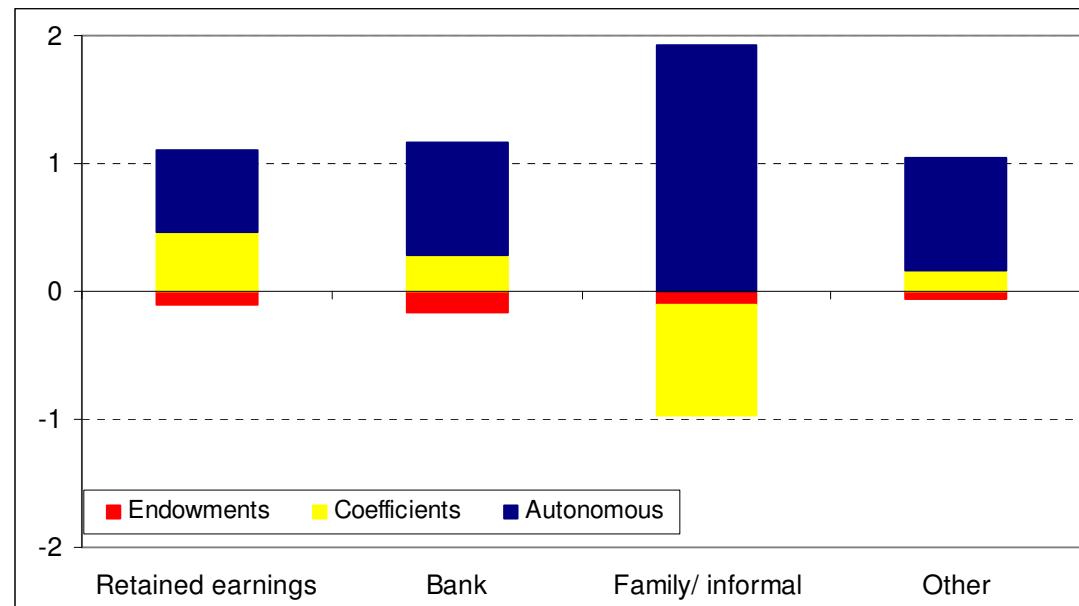
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## FINANCE

*Differences in the structure of finance for fixed investment do not arise primarily on account of differences in observed firm characteristics (size, sector, location, export orientation, majority ownership), called “endowments”. Nor primarily on account of differences between developed market economies and transition economies in the underlying relationship linking those characteristics to the structure of finance, called “coefficients”. They are due more to “autonomous” factors having to do with the maturation of the business and financial sectors in the transition economies.*

Decomposition of the difference in structures of finance between private firms in transition economies and developed market economies



Notes: Endowments: difference due to observed firm characteristics (size, sector, location, export orientation, majority ownership). Coefficients: difference due to the relationship linking firm characteristics to the structure of finance. Autonomous: residual difference in the structure of finance.

Source: Mitra, Muravyev and Schaffer (2008)

## CONVERGENCE

- When it comes to competition, whether measured by the number of competitors an enterprise faces in its product or service lines in the domestic market, or with regard to the importance of pressure from competitors for restructuring, the transition countries are following in the footsteps of the developed market economies.
- The structure of finance for fixed investment reflects a process of maturation of the business and financial sectors in the transition economies.
- In general, the EU8 are farthest along in the process of convergence of the business environment, followed by Southeastern European economies, with the CIS countries being some distance behind.



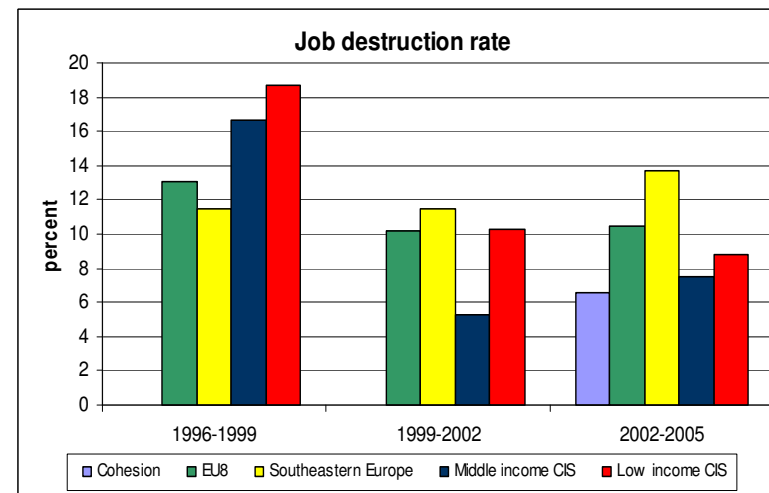
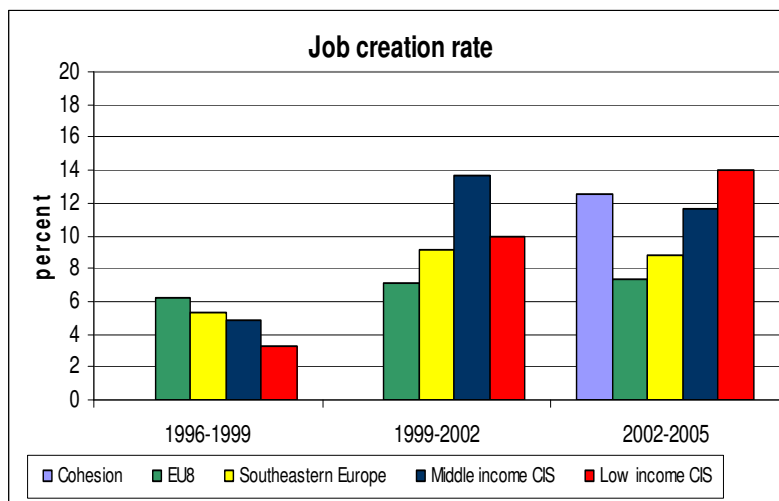
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# EMPLOYMENT

*Job destruction rates (JD) were higher during early transition and either stayed broadly the same or fell; job creation rates (JC) were lower during early transition and either stayed broadly the same or rose. Aggregate job growth (JC less JD) was negative during 1996-99, but less so in the EU8 and Southeastern Europe. But the situation reversed by 2002-2005, with job creation considerably higher and job destruction considerably lower in the CIS than in the EU8 and Southeastern Europe. Indeed, job destruction was lower and job creation was higher in the cohesion countries as well compared to the EU8 and Southeastern Europe.*

Job Creation and Job Destruction, by Country Group



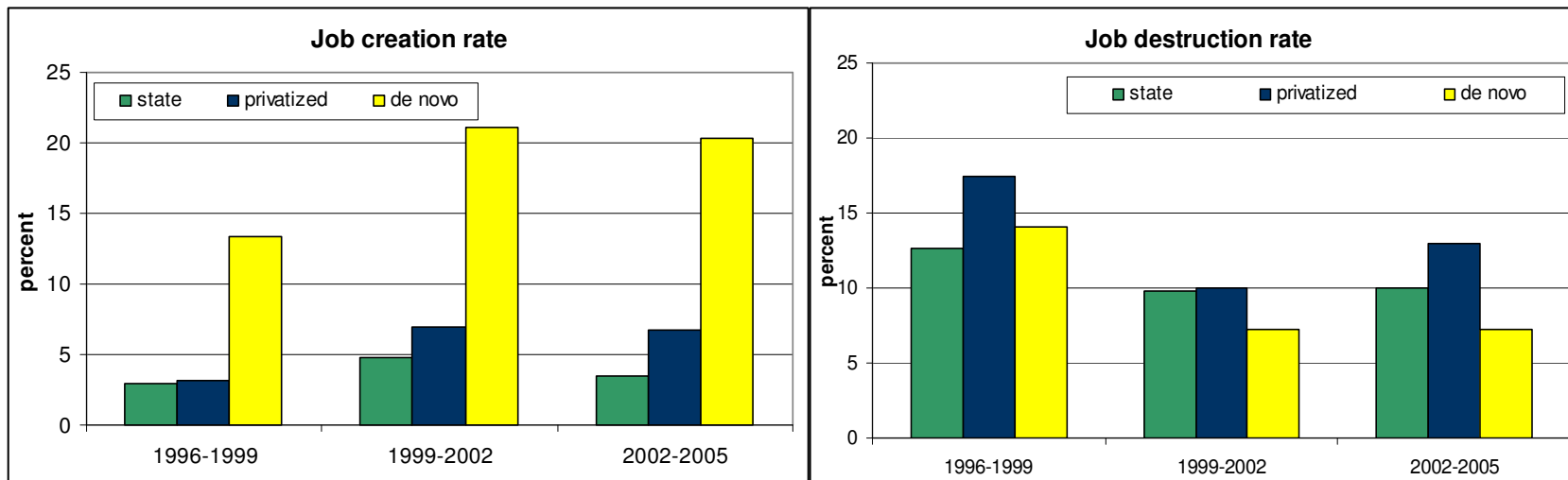
Source: Mitra, Muravyev and Schaffer (2008)



## EMPLOYMENT

Aggregate job growth was consistently the highest in de novo firms – around 15-20 percentage points higher than in state-owned and privatized firms. The pattern of positive net job growth in new firms and downsizing in traditional firms is found in all country groups even a decade-and-a-half since the start of the transition.

Job Creation and Job Destruction in the Transition Economies, by Ownership

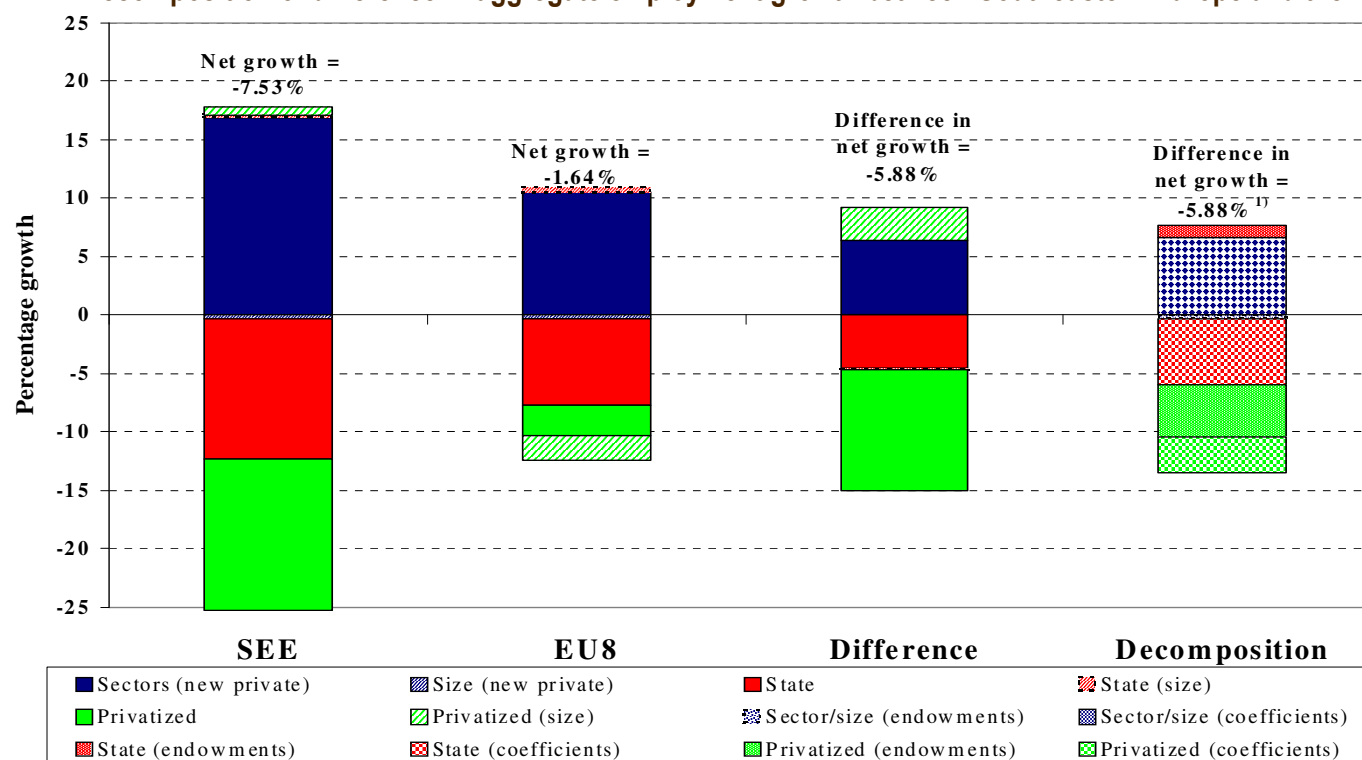


Source: Mitra, Muravyev and Schaffer (2008)

## EMPLOYMENT (SEE vs. EU8)

Labor market outcomes have reflected firm behavior. Net job growth was weaker in SEE (-7.53%) than in the EU8 (-1.64%) over 2002-2005. Job growth in de novo firms was over one-and-a-half times as strong as in the EU8 (blue in first and second columns), but this was more than completely offset by downsizing, which was over twice as large in state-owned and privatized firms in SEE (red and green respectively exert a drag in the third column). The employment story is one of convergence. The boom in the new private sector is further advanced but slowing in the EU8 countries, because there are presumably fewer market niches left for de novo firms to occupy than in Southeastern Europe due to the EU8's greater progress in the transition. And the downsizing of state-owned and privatized firms is further advanced in the EU8 but slowing, as there is less of the transition legacy to be extinguished.

Decomposition of difference in aggregate employment growth between Southeastern Europe and the EU8



<sup>1)</sup> The fourth column decomposes the difference in net growth into the effects of (i) growth in sectors and decline in state-owned and privatized firms (coefficients) and (ii) levels of employment in sectors/ownership categories (endowments)

Source: Mitra, Muravyev and Schaffer (2008)

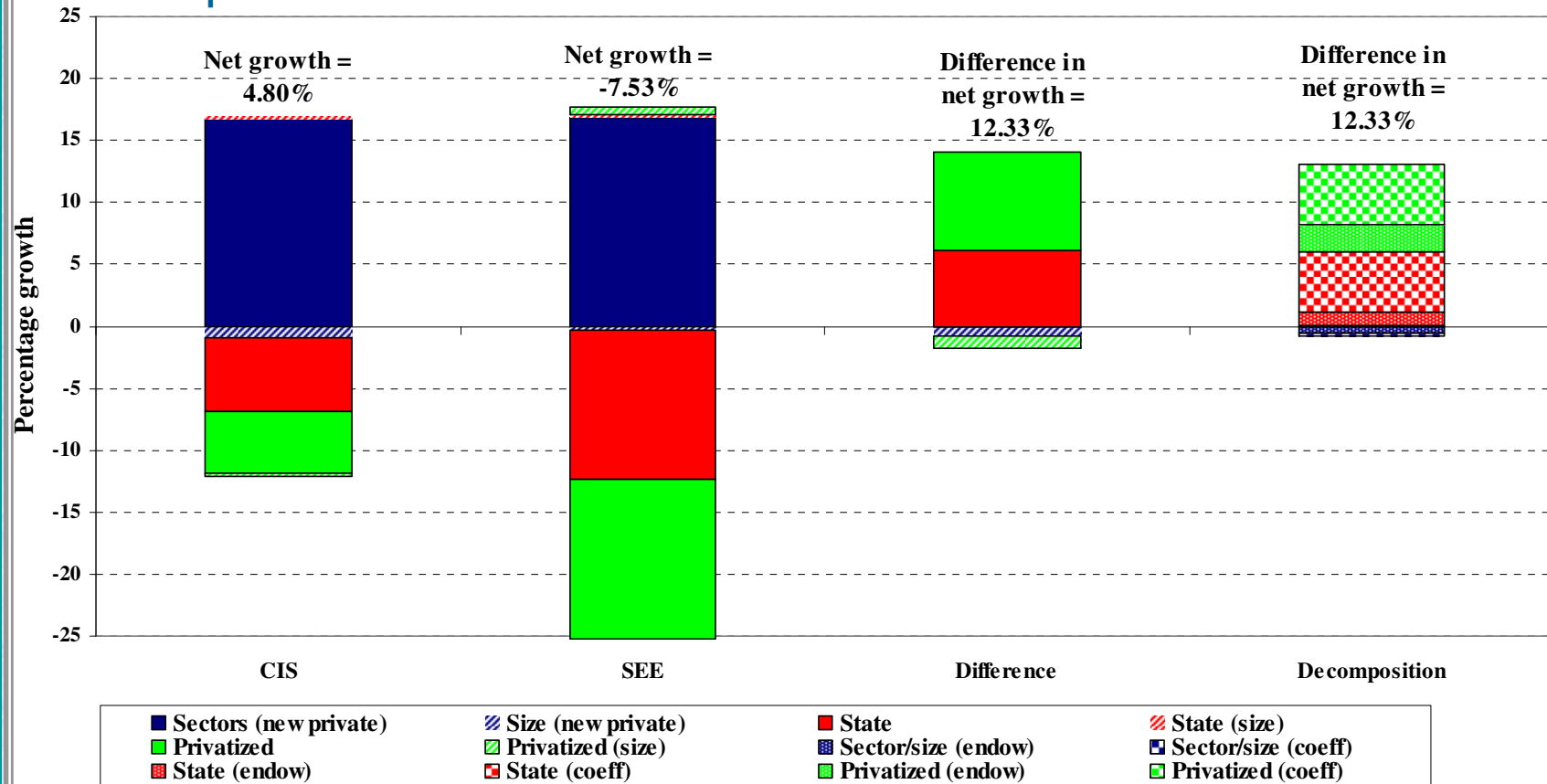


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## EMPLOYMENT (CIS vs. SEE)

Net job growth was stronger in the CIS (4.80%) than in SEE (-7.53%) over 2002-2005. Job growth in de novo firms was equally strong in both country groups (blue in first and second columns) but downsizing in state-owned and privatized firms in the CIS was less than half as strong as in SEE (red and green in first and second columns). This illustrates a failure of convergence, since the CIS, having made less progress in the transition than SEE, would be expected to have more of the transition legacy left to be extinguished. The result is likely due to less competition in the CIS.



<sup>1)</sup> The fourth column decomposes the difference in net growth into the effects of (i) growth in sectors and decline in state-owned and privatized firms (coefficients) and (ii) levels of employment in sectors/ownership categories (endowments)

Source: Mitra, Muravyev and Schaffer (2008)

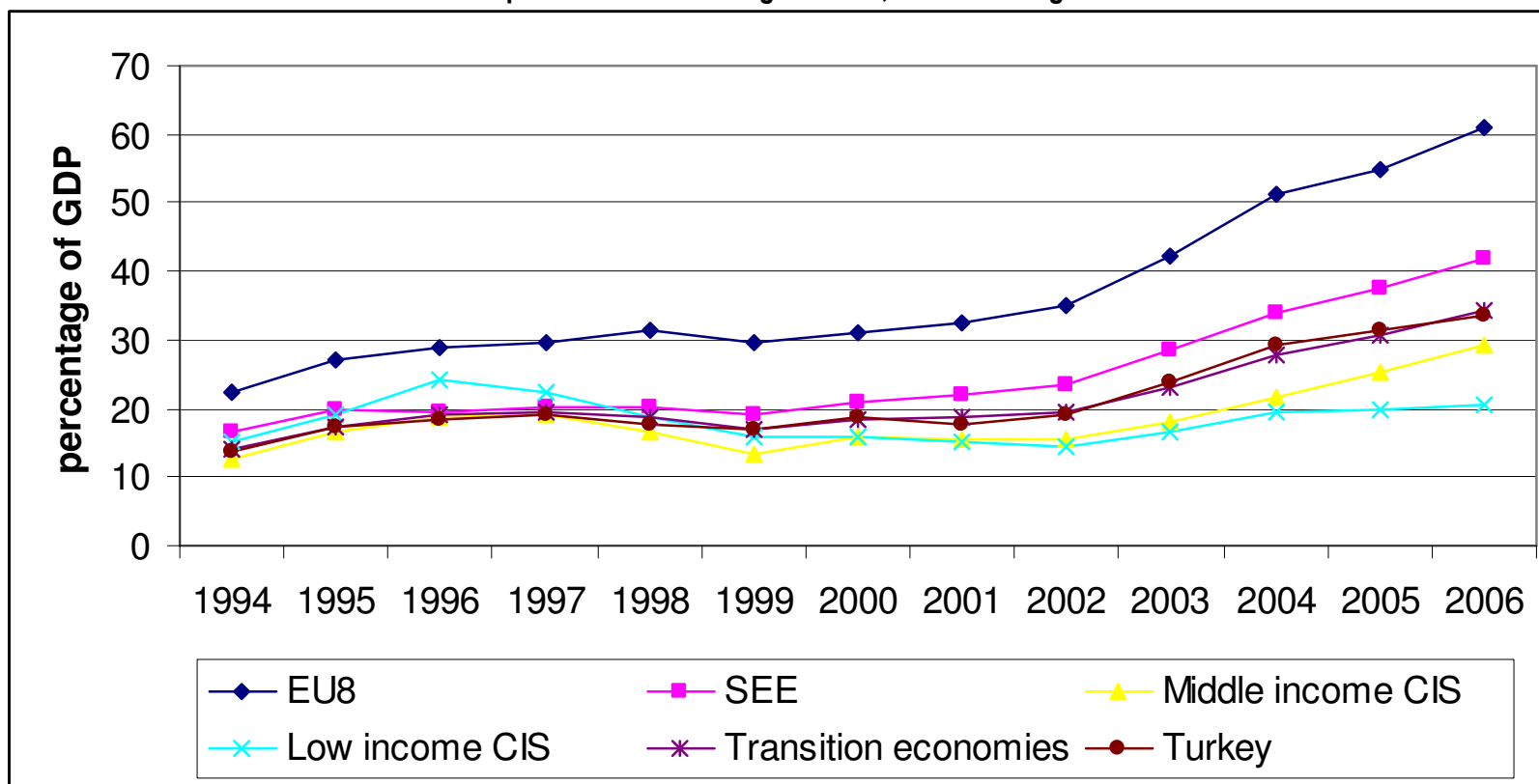
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# INTEGRATION

*The region's international trade collapsed at the onset of the transition. But it grew rapidly thereafter: merchandise exports and imports as a share of GDP accounted for nearly 35 percent in 2006, ranging from 20 percent in the low income CIS countries to more than 60 percent in the EU8, with SEE in between at 40 percent. By 2003 the transition countries as a whole did not systematically trade any more or less than countries anywhere else.*

Merchandise Trade Openness as Percentage of GDP, in Purchasing Power Parities



Source: World Bank staff estimates, updating World Bank (2005b).



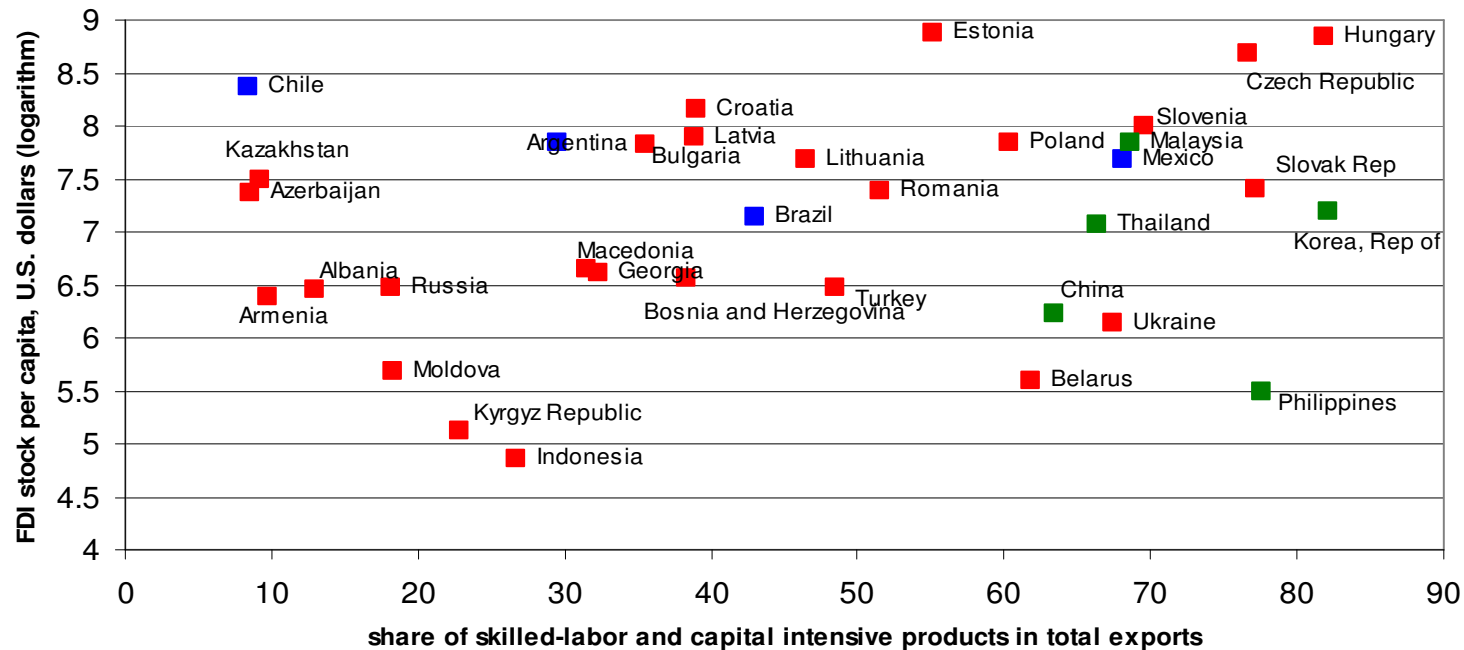
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## INTEGRATION

The more pronounced convergence of the business environment in the EU8 compared to the CIS, noted earlier, is evident in patterns of integration as well, which vary greatly across countries. Countries with larger stocks of FDI per capita (mostly Central Europe and Estonia) export a higher share of capital-intensive and skilled labor-intensive products; others (mostly the CIS) export a higher share of natural resources and unskilled labor-intensive products. Note however that Ukraine and Belarus have received comparatively modest FDI per capita but export mainly capital-intensive and skilled labor-intensive products.

FDI Stock per Capita and Share of Skilled-Labor and Capital-Intensive Exports in 2006



Source: UN COMTRADE and IMF International Financial Statistics Database, updating analysis in World Bank (2005b).

Note: FDI stock per capita is for 10 years or more over the period.





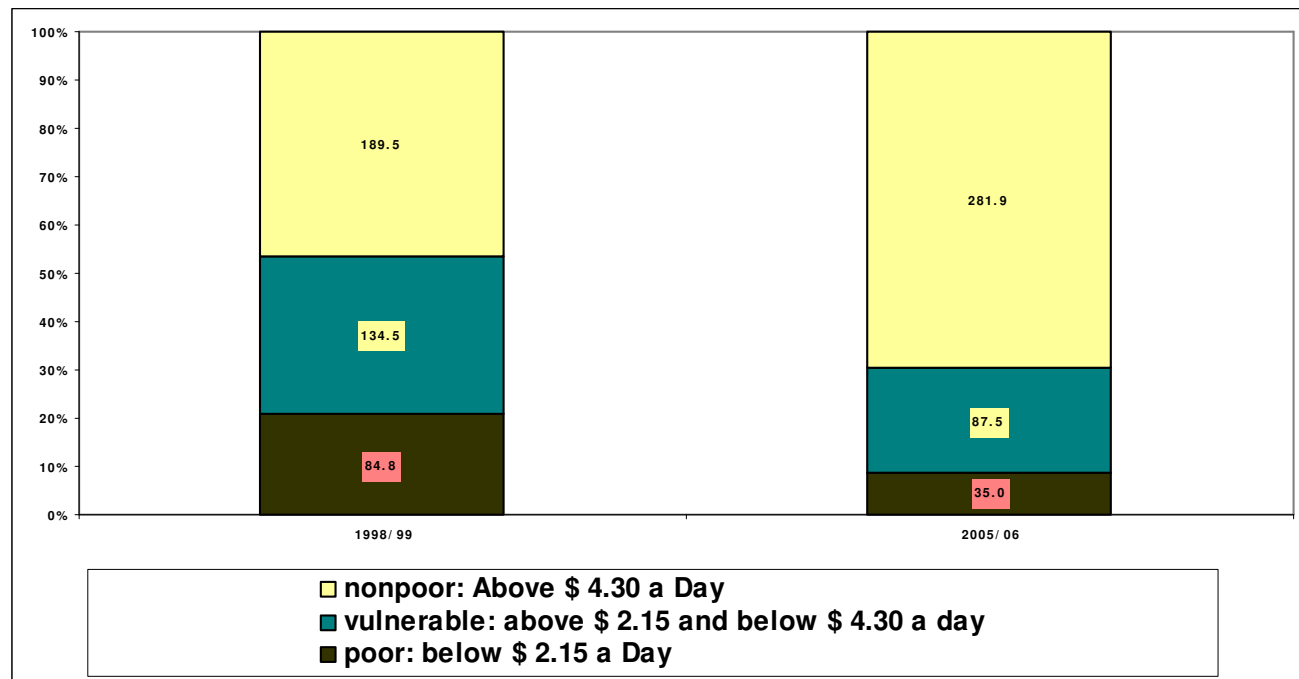
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# POVERTY

*Productivity growth, which allowed broad-based increases in real wages, together with public transfers to households fed by rising fiscal revenue, moved 50 million people -- of a total of 400 million -- out of absolute poverty (\$2.15 PPP a day) in the transition countries between 1998-99 and 2005-06.*

Poverty in Transition Countries, 1998/99–2005/06



Source: ECA Household Survey archive, updating analysis in World Bank (2005a)



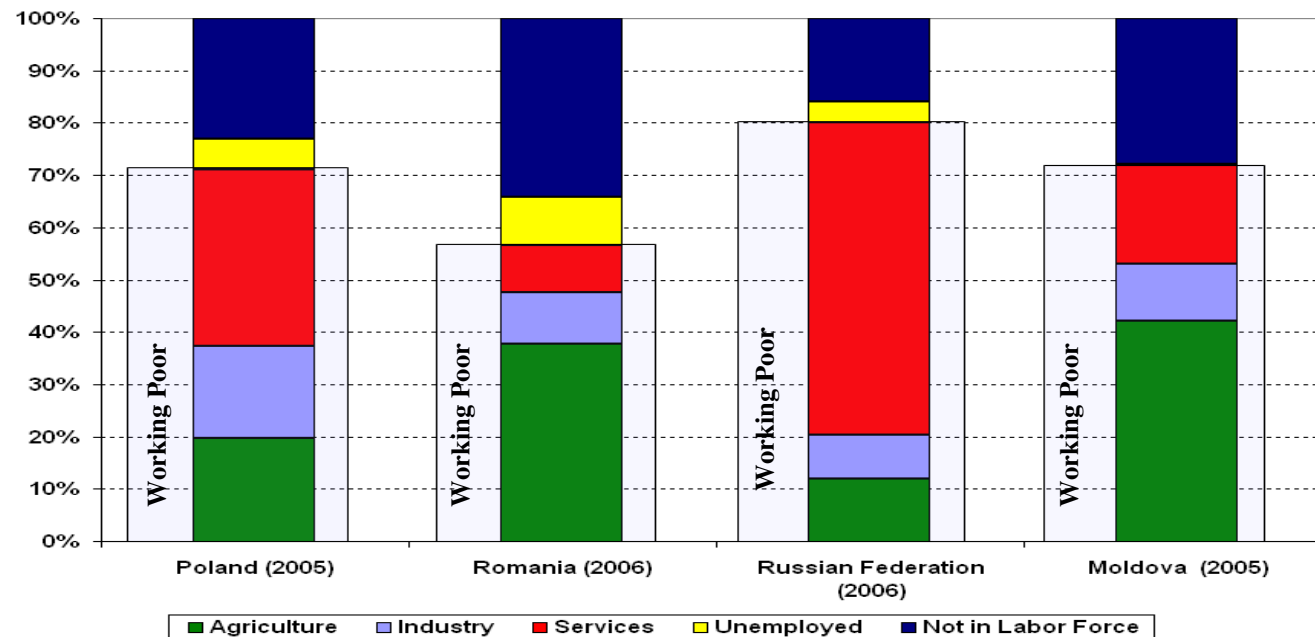
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## POVERTY

*The working poor are the majority of the poor everywhere, suggesting that productivity growth will remain a dominant concern of policy makers. However, the risk of the employed falling into poverty is lower than that of the unemployed. The unemployed poor make up a small proportion of the poor. But the risk of the unemployed falling into poverty is not only above that of the employed but usually above that of the inactive (those not in the labor force). The inactive poor are a significant proportion of the poor in many countries. Other things being equal, those excluded from the labor force are significantly more dissatisfied with their lives.*

Poverty Profile by Employment Status of the Household Head in Selected Transition Countries 2005/2006



Note: In Poland \$4.30 a day, at 2000 U.S. dollars in purchasing power parities, is used as a poverty line, for other countries in this chart, \$2.15, also at 2000 U.S. dollars in purchasing power parities, is used.

Source: ECA Household Survey Analysis, updating World Bank (2005a)



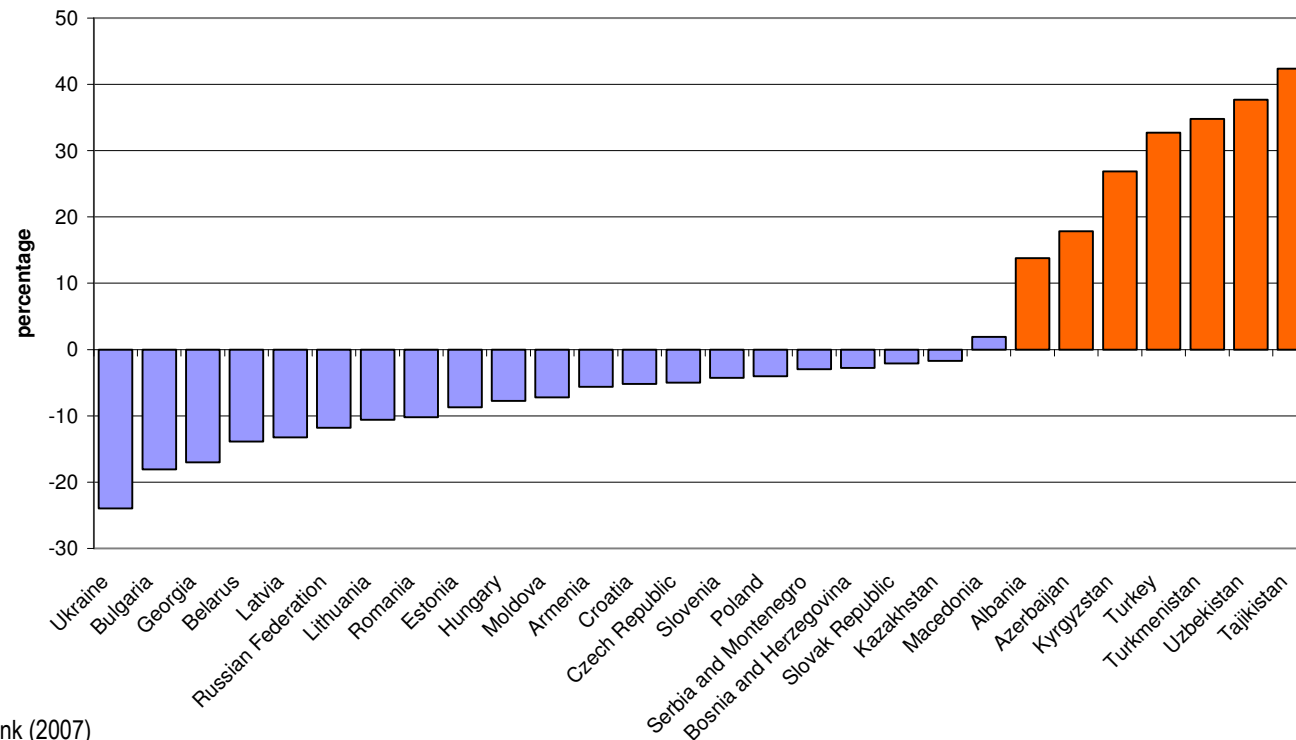
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## AGING

*As if twin political and economic transition have not been challenging enough, many transition countries now face a third transition of aging populations. Demographic projections suggest that by 2025 the average Slovene will be 47 years old, giving the country one of the oldest populations in the world. One in five Bulgarians will be over 65. Ukraine's population will shrink by a fifth and Russia's by more than a tenth.*

Population Change in Europe and Central Asia, 2000–25



Source: World Bank (2007)



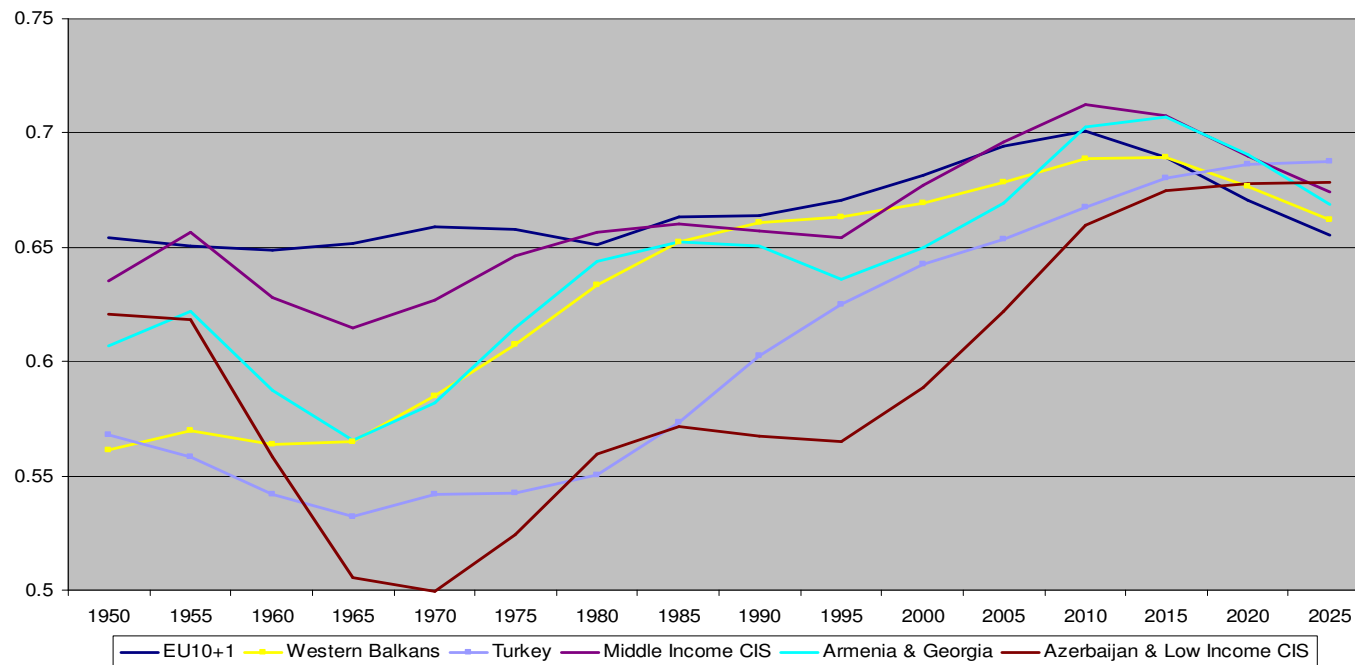
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# AGING

*The share of working age population (ages 15-64) to total population is expected to decline rapidly after 2015 in all subgroups of countries except Turkey and (Azerbaijan and the low income CIS). Other things being equal, this has the potential to slow economic growth<sup>1)</sup>.*

Working Age Population to Total Population, 1950-2025



Source: UN Population Prospects (2004). World Bank Staff Estimates.

<sup>1)</sup>This is because growth in  $\frac{GDP}{POP} = (\text{growth in } \frac{GDP}{EMP}) + (\text{growth in } \frac{EMP}{WORKING\ AGE\ POP}) + (\text{growth in } \frac{WORKING\ AGE\ POP}{POP})$ , where POP is the total population, EMP is the employed population and WORKING AGE POP is the working age population.



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# AGING

## *A policy package to address the demographic challenge <sup>1)</sup>*

- **Productivity growth driven by reforms of the business environment (competition, finance, governance, skills, infrastructure)**
- **Labor Market Reform**
  - lower tax wedge on labor where fiscal considerations permit
  - make employment protection legislation less stringent
  - allow more flexible labor contracts
- Pension reform**
  - raise and equalize retirement ages for men and women
  - index pensions to inflation
- **Health reform**
  - complete health sector reform to address legacy-of-transition issues
  - promote healthier old age both to keep individuals productive and lower health expenditures
  - reform financing and delivery of long-term care, especially new delivery arrangements
  - strengthen informal care-giving
- **Immigration to fill labor shortages**

<sup>1)</sup> See World Bank (2007)

# Conclusions

## Innovation

- Productivity growth within firms, where the core activity of restructuring takes place, requires a supportive business environment that delivers competition, a deep financial sector, good governance and superior skills and infrastructure.
- Key aspects of the business environment in the transition countries, e.g. competition and market structure, as well as finance and the structure of lending to firms, are maturing and converging towards those in developed market economies. This augurs well for the sustainability of productivity growth. Convergence is most pronounced in the EU8 and some of the Southeastern European countries. The CIS are followers but are some distance behind.

## Inclusion

- Sluggish employment growth has reflected the interplay between (i) job growth in new private firms that were able to occupy market niches nonexistent under central planning; and (ii) downsizing in state-owned and privatized firms, with the latter typically being more dominant. Both factors become less important the further a country progresses towards a market economy. Indeed the evolution of employment may now be driven less by such legacy factors and more by factors such as the availability of labor for skills demanded by employers, at least in the countries farthest advanced in the transition, viz., the new member states of the EU.



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## Conclusions (continued)

- Continued productivity growth within a reforming business environment and rising public transfers fed by rising fiscal revenue can reduce income poverty, even if employment prospects and labor force participation do not improve. But those excluded from employment report being more dissatisfied with their lives, so building inclusive societies by addressing the constraints to job creation must complement productivity growth.

### Integration

- Domestic and external factors worked in harmony as the EU8 and parts of Southeastern Europe used the anchor of prospective EU accession to lock in the reforms of policies and institutions necessary for rapid productivity growth and deeper integration into the world economy. Today, all countries in Southeastern Europe have concluded Stabilization and Association Agreements, a first step on the road to EU accession. The extent to which countries without such prospects can use outside mechanisms (such as the European Neighborhood Policy, WTO accession, subregional trade agreements) to enhance the credibility of a reforming government and lock in the necessary institutions however remains to be seen.

### The Third Transition

- The challenge posed to economic growth by aging populations in a large swath of transition countries is serious and systemic. Offsetting it will require renewed emphasis on both innovation and inclusion, supplemented by international labor migration—itsself a facet of integration.

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