EXECUTIVE SUMMARY

The *Transition Report 2020-21* focuses on the role of the state, looking at the size of the state across various economies, the role of state-owned enterprises and state banks in the modern economy, and the role that the state plays in supporting the transition to a green economy. The online version of this report includes assessments of recent economic developments and structural reforms in individual economies (which are also summarised in the Structural Reform section).

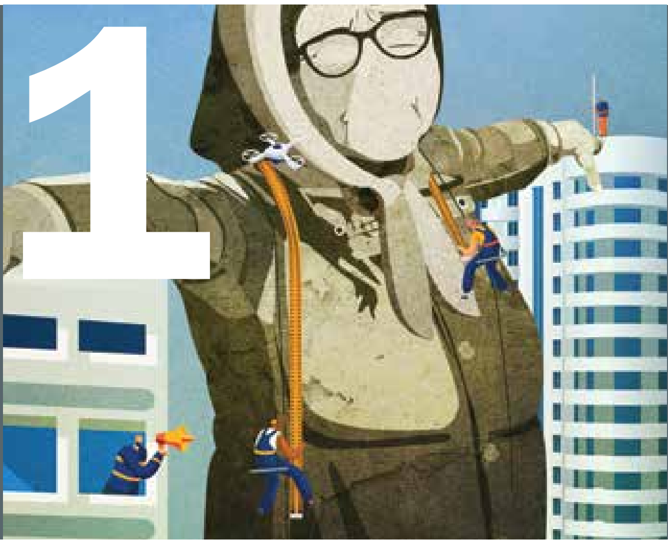
The report draws on rich sources of data, such as firm and bank-level surveys, representative household surveys (including a survey conducted by the EBRD and the ifo Institute in August 2020, which looked at the impact that the Covid-19 crisis was having on individuals in 14 economies) and a special EBRD survey examining the legal frameworks governing state-owned enterprises in the EBRD regions.

Back in the mid-19th century, government spending totalled around 8 per cent of GDP in advanced economies. Today, that figure stands at more than 40 per cent as a result of increased spending on education and healthcare and higher levels of income redistribution on account of technological change. While public-sector employment peaked in the 1980s, support for the expansion of public ownership has risen around the world as inequality has increased. Indeed, 45 per cent of people living in post-communist economies in the EBRD regions are now in favour of higher levels of state ownership. At the same time, the Covid-19 crisis has highlighted citizens' growing expectations regarding the state's ability to reduce the health and economic risks that are faced by individuals.

State ownership can help to ensure that services such as utilities or broadband are universally available and affordable. It can also help disadvantaged regions to cope with economic and technological shocks. However, weak governance and poor management at state-owned firms can result in inefficiencies and hamper productivity growth, with data showing that state enterprises are only half as likely to innovate as private firms.

Meanwhile, state banks have become increasingly important in many economies, expanding their assets almost twice as fast as private banks. They have a greater appetite for risk than their counterparts in the private sector and are able to lend to young firms without a sufficient credit history, which are often shunned by privately owned banks. However, politicians often interfere in the decisions of state lenders, resulting in inefficient allocation of funding and weak economic growth.

The state has a particularly important role to play in fostering the transition to a green economy. All of the economies in the EBRD regions have adopted environmental laws, which have focused mainly on the most polluting sectors. At the same time, however, current levels of carbon pricing are not sufficient to have a meaningful impact on climate change.



HOW BIG IS THE STATE?

The response to Covid-19 has highlighted high levels of demand for the socialisation of risks, which are partly a response to the fact that economic risks have increasingly been shifted onto people with low earnings and less tolerance of risk. The crisis has also revealed increasing expectations regarding the services that the state should provide.

While most governments have seen increases in their fiscal space, the administrative capacity to deliver on citizens' growing expectations varies considerably. The expansion of the state's role in the economy may take the form of increased government spending on goods, services and transfers, and the state may also become an increasingly important employer and provider of goods and services.

Patterns in terms of the state's expansion following major crises have varied over time and across countries on account of differences in citizens' preferences. Since the mid-19th century, state spending has risen as a share of GDP, reflecting the increasing importance of providing education, healthcare and social safety nets. While state employment has also risen over the longer term, it peaked in the 1980s and has since declined somewhat on account of privatisation and automation, despite government spending continuing to rise.

In post-communist economies, the state's share of total employment declined from around 45 per cent in the mid-1990s to 24 per cent in the mid-2010s, but remains 7 percentage points higher than the levels seen in other economies with similar characteristics. Meanwhile, government spending in post-communist economies is consistent with that of their peers at around 35 per cent of GDP.

Even as the state's share of employment has declined in recent decades, public support for state ownership of businesses and industry has grown – probably in response to rising inequality. Surveys in post-communist economies suggest that 45 per cent of people favour an increase in public ownership. Analysis also shows that women, older people, highly educated individuals and people who are more risk-averse are all more likely to work in the public sector.

https://2020.tr-ebrd.com/how-big-is-the-state

STATE-OWNED ENTERPRISES

State-owned enterprises have historically played an important role in the EBRD regions. Today, they provide almost half of all public-sector employment in those economies and are increasingly concentrated in the energy, utilities and transport sectors, where their services are often subsidised to ensure universal affordability. While private firms are able to supply such services under public service obligations with the support of compensation schemes, governments often opt for direct provision through state enterprises, particularly where administrative capacity is limited.

State enterprises can also act as automatic stabilisers, providing more stable employment during downturns and in disadvantaged regions. Employees of state firms were less likely to have their pay reduced in the early months of the Covid-19 crisis, according to a household survey conducted by the EBRD and the ifo Institute in August 2020. Similarly, levels of public sector employment are higher in regions with higher unemployment. More stable employment in the face of economic and technological shocks can help to reduce negative externalities associated with rising inequality and the erosion of social cohesion and trust. State-owned enterprises can also play an important role in winding down stranded assets in sunset industries.

However, governments often struggle to manage state-owned enterprises effectively. For instance, state-owned firms in the EBRD regions are half as likely to innovate as private-sector counterparts. Meanwhile, the goals of state ownership are often not clearly defined, with managerial responsibilities being spread across multiple government entities with conflicting interests. Management of state enterprises is often seen as an exercise in compliance, with little attention paid to strategy or risk management. Equally, state support is extensive but not transparent, reducing accountability.

As discussed in Chapter 1, the Covid-19 crisis may boost support for state ownership. This will further increase the importance of improving the governance of state-owned firms – for example, by defining the objectives of state ownership, clarifying the managerial responsibilities of government entities, separating those entities' managerial and regulatory functions, and increasing the autonomy of firms' boards.

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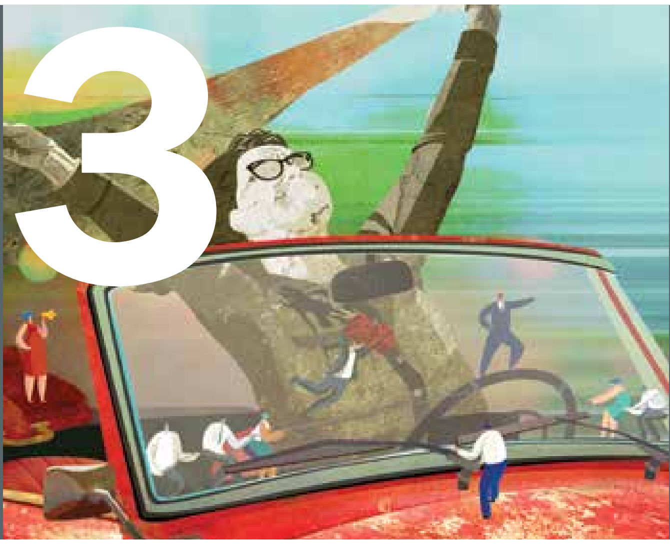

STATE BANKS ON THE RISE

State-owned banks have grown in importance across the EBRD regions since the mid-2000s, expanding their assets almost twice as fast as private banks and accounting for a growing percentage of bank branches. Today, state banks own more than half of all banking assets in a number of emerging market economies (including Belarus, China, India, Russia and Ukraine).

Private-sector banks are increasingly regarding state-owned banks as major competitors, particularly because state banks tend to have less stringent lending requirements, operate with a lower interest margin (the difference between the rates that are charged on loans and paid to depositors) and tolerate higher levels of non-performing loans. Indeed, state banks' average annual return on assets in the period 2010-19 was 1.1 percentage points lower than that of similar private banks, while their average non-performing loan ratio was 1.6 percentage points higher than that of private-sector counterparts.

State banks' greater appetite for risk can soften the impact that economic shocks have on households, small businesses and specific regions, playing a particularly important role when it comes to serving small young firms that lack collateral and/or a sufficient credit history.

While state banks can exert a stabilising influence on economic performance and support financial inclusion, this comes at a cost, with firms that choose to borrow from state-owned banks demonstrating less innovation and weaker productivity growth. This partly reflects the fact that state-owned banks may be more susceptible to political interference in lending decisions (which can result in misallocation of resources, with finance being channelled away from more productive firms towards more connected ones, thereby reducing aggregate growth). Indeed, a 5 percentage point increase in state banks' share of branches in a particular region is associated with a 10.5 per cent decline in that region's aggregate productivity.

Explicitly defining the non-commercial objectives of state banks' lending and improving their corporate governance can help to minimise the economic costs that are associated with state banks' relative inefficiency and political interference in their day-to-day decisions.

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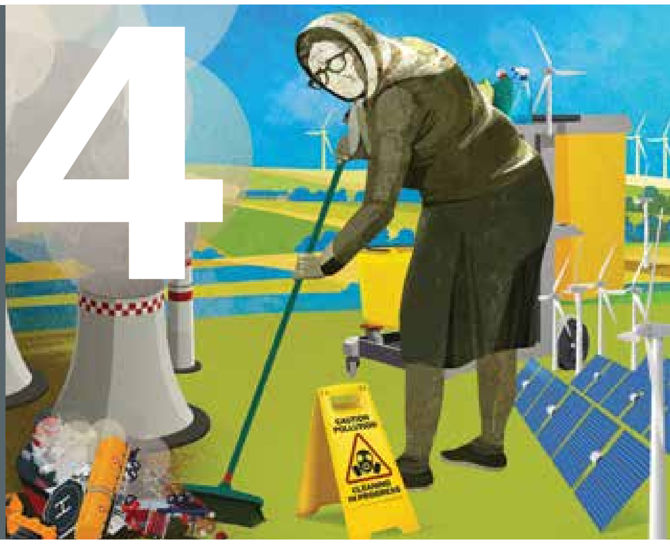

THE STATE AND THE GREEN ECONOMY

Economies in the EBRD regions have made significant progress in reducing greenhouse gas emissions relative to the levels seen in the 1990s. However, the emission targets set by those economies under the Paris Agreement are not yet sufficiently ambitious, given the reductions that are needed to keep global temperature rises well below 2°C relative to pre-industrial levels.

All countries have adopted green laws and policies that can help reduce CO_2 emissions relative to output. However, the enforcement of such measures is key, and that is where the EBRD regions are lagging behind. Green policies and laws in those regions have reduced CO_2 emissions by 12 per cent over the period 1997-2016 relative to the levels that would otherwise have been seen. That is encouraging, but much more is needed to accelerate the shift to a green economy.

In the short term, countries must build the transition to a green economy into their post-Covid-19 recovery plans. Happily, many of the government investment projects that are necessary for that transition are also effective ways of boosting the economy. Such measures must prioritise industries and firms that have a zero-carbon future, without propping up zombie firms that will struggle in the green economy.

In the medium term, the state must address the market and policy failures that are impeding the transition to a green economy. The key here is to get prices right, which means removing fossil fuel subsidies, putting a higher price on carbon and applying that higher price to more emission sources. Additional incentives, subsidies and regulation are also needed to encourage resource efficiency, leverage the network effects of green investment and ensure access to capital for firms with green investment plans.

In the longer term, the state must facilitate the "creative destruction" that this transition process will unleash, while supporting workers and communities that are adversely affected. Environmental policies must be integrated into a broader industrial strategy fostering clean growth, in order to encourage private-sector investment in the green economy.

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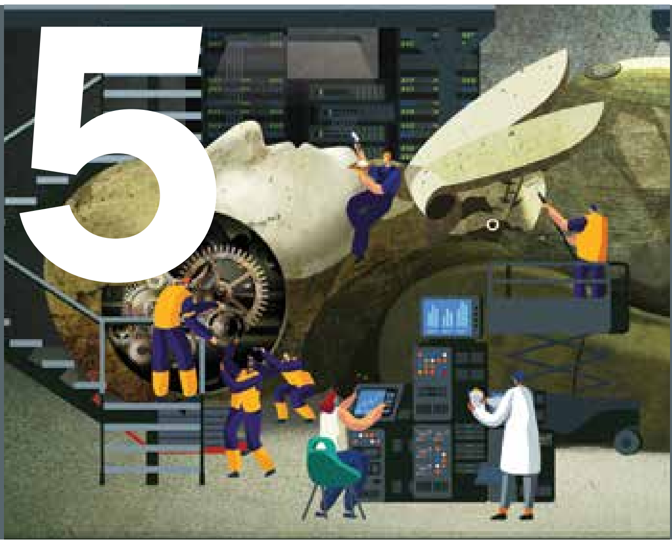

STRUCTURAL REFORM

This section of the report presents updated transition scores for individual economies, assessing developments over the last year, as well as changes over the period 2016-20. It focuses on six key qualities of a sustainable market economy, looking at whether economies are competitive, well-governed, green, inclusive, resilient and integrated.

Successfully implementing structural reforms is more difficult during economic downturns, when policymakers' focus shifts from addressing longer-term issues to tackling immediate challenges. At the same time, however, the economic and social fallout from the Covid-19 pandemic has emphasised the need for further structural reforms across the EBRD regions to ensure that economies recover quickly and become more resilient to external shocks.

Governments across the EBRD regions have implemented a wide range of measures in response to the pandemic. Those actions, which have been unprecedented in terms of their scope and the speed of their implementation, have ranged from the provision of liquidity to the banking system and moratoriums on loan repayment to various tax breaks for businesses and cash transfers to households.

Many countries have continued to carry out structural reforms over the last year, with reform measures including the strengthening of governance frameworks for state-owned enterprises, anti-corruption measures, the digitisation of government services, the expansion of technical and vocational education and training programmes, and the enhancement of frameworks governing public-private partnerships. Many of those reforms were initiated before the pandemic, but in most cases their implementation has continued despite the challenging environment. However, some reforms have been delayed, with Kazakhstan, Romania and Ukraine, for instance, all postponing the privatisation of major assets.

Over the last year, increases in transition scores have been observed primarily in eastern Europe and the Caucasus, south-eastern Europe and Central Asia. At the same time, declines have tended to be moderate, have been concentrated in scores for green transition and governance, and have been seen primarily in central Europe and the Baltic states and south-eastern Europe.

https://2020.tr-ebrd.com/reform