

EXECUTIVE SUMMARY

This is the first *Transition Report* to deal exclusively with the important subject of inequality and economic inclusion. It focuses on a number of key aspects of inclusive growth: the distribution of income; the impact that the transition process has had on people's well-being and happiness; equality of opportunity; and financial inclusion. The analysis in this report draws on the third round of the *Life in Transition Survey* (LiTS III), a household survey conducted by the EBRD and the World Bank in 34 countries in late 2015 and the first half of 2016. The results of that survey are compared with those of the first two rounds, which were conducted in 2006 and 2010. The report also uses the results of a unique survey of bank managers (the EBRD's *Banking Environment and Performance Survey*) and other rich sources of data.

The transition from planned to market economies was far from smooth, especially in the early years. The social, economic and physical costs of those reforms were so substantial that men and women born at the start of the transition process are on average around 1 cm shorter than those born just before or after that period. It is no wonder, then, that most people in the transition region were, until recently, less happy than people with similar income levels elsewhere in the world. Now, though, that is no longer the case: people in those formerly communist countries are, on average, just as satisfied with their lives as their counterparts in other parts of the world.

The EBRD region has not only caught up with richer countries in terms of happiness; it has also closed some of the income gap. However, not everybody has benefited equally. Only 44 per cent of all men and women in post-communist countries have enjoyed total income growth that is higher than the average for the G-7 economies. This means that more than half of all people in the transition region have not seen their earnings converge with those of people living in richer countries.

What can we do to help distribute the benefits of growth more equally? Redistributing income can help, but the key is to improve people's opportunities to succeed in life – regardless of their gender, place of birth or parental background. To achieve this, the region needs improved access to tertiary education, stronger links between secondary education and employment, better infrastructure links and more affordable childcare. Enhanced access to financial services, aided by the introduction of digital payment systems and improved information comparing the cost of different banking products, will also make it easier for rural populations, women and people in poorer countries to participate more fully in the local economy.

The last part of the report examines recent economic developments in the region. After four years of economic slow-down, average annual growth in the region fell close to zero in 2015. This largely reflects the impact that low commodity prices and the recession in Russia have had on the economies of eastern Europe, the Caucasus and Central Asia. Elsewhere in the region, moderate growth momentum has been sustained. Assessments of economic developments and structural reforms in individual countries across the region are available online at tr-ebd.com.

CONVERGENCE AND INEQUALITY



The region has achieved an impressive amount of income convergence since the start of the transition process. Furthermore, significant progress has been made in terms of reducing poverty. However, people's individual experiences of growth and convergence have differed vastly depending on their position on the income ladder.

In post-communist countries, average income growth corresponds to the experience of someone in the top 27 per cent of the income distribution. Furthermore, only 44 per cent of people in those countries have personally experienced income convergence – that is to say, long-term income growth above the average level in the G-7 economies. The shifts seen in income patterns over the last two-and-a-half decades reflect both broader globalisation trends and experiences unique to the region – a legacy of the wage decompression and deep recessions seen in the early years of the transition process, as well as the very fast shift from manufacturing and agriculture-based economies to a more service-oriented model.

Before the start of the transition process, levels of inequality in the region were very low by international standards. Although inequality has increased sharply, it remains moderate in comparison with other parts of the world. Despite this, people are overwhelmingly of the view that inequality levels are high and rising. These perceptions may, to a significant extent, be guided by the fact that wealth is strongly concentrated among the very rich – even when compared with other emerging market economies. In contrast with advanced economies and emerging markets elsewhere in the world, the richest individuals in the EBRD region derive their wealth predominantly from commodity rents and related sectors, as opposed to IT-based innovation or competitive manufacturing.

The fact that wealth is strongly concentrated among the very rich across the region calls for higher standards of governance, transparent processes for privatisation and public procurement, the disclosure of detailed information on contracts and revenue management in extractive industries, as well as consistent enforcement of competition law and efforts to diversify economies away from excessive dependence on natural resource rents. The taxation of wealth could also play a more prominent role as a source of government revenue. Meanwhile, at the bottom of the income distribution, the reduction of poverty requires targeted, well-designed social transfer programmes. Tackling broader inequality requires a combination of redistribution through taxation and public spending and measures to reduce inequality of opportunity in society (as discussed in Chapter 3).

<http://2016.tr-ebrd.com/convergence-and-inequality>

THE IMPACT OF TRANSITION ON WELL-BEING



In the last 25 years, people living in formerly communist countries have seen their economic, political and social institutions undergo dramatic changes. In the early years of the reform process, they also suffered severe economic recessions. Chapter 2 of this report uses newly available data from LiTS III to analyse the impact that the early years of the transition process had on the well-being of people in those countries.

Previous studies have identified a “transition happiness gap”, with residents of post-communist countries reporting significantly lower levels of life satisfaction than their counterparts in non-transition countries with similar income levels. However, data from LiTS III show that this gap has finally closed, with residents of formerly communist countries now expressing just as much satisfaction with life as their peers in other countries.

This optimistic finding comes with three caveats, though. First of all, that “happiness convergence” is only partially explained by increases in satisfaction in those transition countries; declining life satisfaction levels in non-transition countries such as Germany and Italy have also played an important role.

Second, such happiness convergence does not mean that the acute social costs incurred at the start of the transition process were any less painful. Anthropometric measures made available by LiTS III data indicate that the early years of that process were a period of substantial deprivation, with permanent physical effects. Indeed, people born around the start of the transition process are an average of 1 cm shorter than their older and younger peers, pointing to the significant hardship that their families endured as a result of those reforms. However, data also show that those people have gone on to enjoy better lives: they are, on average, now better educated and more satisfied with life than their peers.

Third, while residents of post-communist countries have, on average, overcome the dramatic experience of transition, specific sections of society have been left behind. People born to families with lower levels of education and income have proved to be more vulnerable to the changes experienced during the transition process, and they are still lagging behind in terms of both objective and subjective well-being.

<http://2016.tr-ebrd.com/well-being>

INEQUALITY OF OPPORTUNITY



People's circumstances at birth – their gender, place of birth, ethnicity and parental background – often have a significant impact on their educational qualifications, the type of job they get and, ultimately, their earnings. Such inequality of opportunity is both inefficient and unfair. It prevents people from making the best use of their skills or realising their entrepreneurial ideas, and that can, in turn, negatively affect a country's long-term growth, leading to persistently high income and wealth inequality. A lack of opportunities can also result in a loss of confidence in the key economic and political institutions that underpin market-based economic systems, eventually resulting in reform reversals.

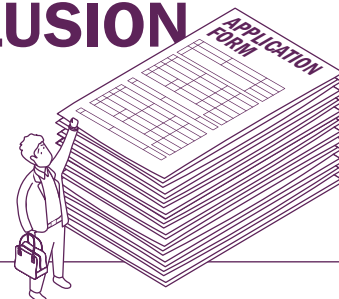
Inequality of opportunity in the EBRD region remains higher than in western European countries such as Germany, according to estimates based on LiTS III data. It accounts for an average of 20 to 50 per cent of total income inequality in many EBRD countries of operations. Parents' level of education is the key factor determining inequality of opportunity, followed by gender and place of birth. Inequality of opportunity is also strongly correlated with inequality of observed incomes: all countries with high levels of inequality of opportunity also have high levels of income inequality.

Inequality of opportunity is substantially higher in terms of getting a good job – one that provides a stable income stream of sufficient size – than it is in terms of getting a job in general. Moreover, when it comes to education, inequality of opportunity appears to have increased, since it is estimated to be significantly higher for people who started school after 1989 relative to older cohorts. High levels of inequality of opportunity in society reduce people's support for open markets and democracy. In contrast, inequality of outcomes does not have such an effect and may actually strengthen support for market economics and democracy, provided that differences in outcomes are driven by differences in effort, rather than circumstances at birth.

Economic policies can play an important role in reducing inequality of opportunity and levelling the playing field, for instance by improving access to tertiary education (through targeted scholarship programmes, for example), by strengthening links between secondary education and employment, by improving infrastructure links and by increasing the availability of affordable childcare.

<http://2016.tr-ebrd.com/inequality-of-opportunity>

FINANCIAL INCLUSION



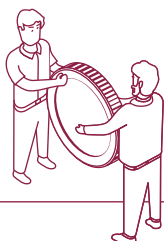
An inclusive financial system can reduce both inequality of opportunity and, ultimately, inequality of outcomes. While access to financial services is reasonably high in richer parts of the EBRD region, it is not so good in less developed economies. In those poorer countries, financial access is also distributed unevenly. In particular, many women, young people and rural populations remain disconnected from the financial system.

The reasons for such exclusion vary depending on the circumstances of the household or individual in question, with many young people being discouraged by onerous documentation requirements, while older people are often deterred by long distances to the nearest bank branch. While gender gaps in terms of access to bank accounts have nearly been eliminated in richer parts of the EBRD region, they persist in poorer countries across all age groups. There are also significant differences between rural and urban areas of poorer countries in terms of access to bank accounts, with rural women having the worst access. While foreign banks' entry into local markets has improved competition – and thus access to financial services – in many countries, evidence suggests that these gains have been uneven, with less educated and lower-income households continuing to have less access to such services. Many of these households do not normally apply for loans – and when they do, they receive fewer loan offers than their peers.

Governments can stimulate the use of bank accounts and encourage more people to connect to the formal financial system by introducing digital payments for wages and transfers. At the same time, banks can design financial products that better meet the needs of excluded groups, such as “no-frills” accounts and mobile banking, as well as tailoring documentation requirements to the realities of younger and poorer individuals. Focusing efforts on improving access to finance in rural communities, where the social benefits of financial inclusion are considered to be high, can help to foster the economic integration of this important segment of society, which is currently underserved in the region. Meanwhile, participation in credit markets can be encouraged by establishing credit registries, fostering the expansion of branch networks (and thus competition) in underserved areas, publicising the interest rates available in the local area using official comparison websites and promoting financial literacy campaigns.

<http://2016.tr-ebrd.com/financial-inclusion>

MACROECONOMIC OVERVIEW



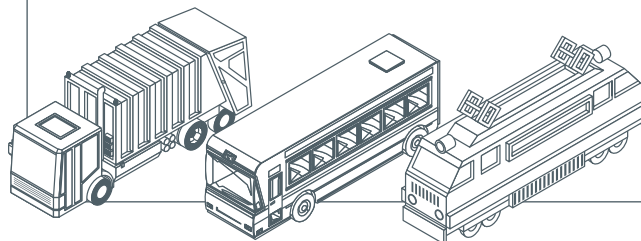
Following four consecutive years of deceleration, the average annual growth rate in the region fell further to stand at 0.5 per cent in 2015, down from 1.9 per cent in 2014. Growth is expected to pick up modestly in 2016 and 2017. Low commodity prices and the continued recession in Russia are weighing on the economic performance of both Central Asia and eastern Europe and the Caucasus. At the same time, decreases in the cost of energy imports are benefiting the economies of central and south-eastern Europe, as well as in Turkey, where growth momentum has been sustained. Those economies have also benefited from accommodative policies in the eurozone. At the same time, monetary tightening in the United States of America has led to a decline in capital flows to the EBRD region.

Declining revenue from tourism, partly owing to security concerns, has negatively affected the outlook for Turkey and countries in the southern and eastern Mediterranean region. Meanwhile, Ukraine's economy, which contracted by almost 10 per cent in 2015, is expected to return to positive growth in 2016 and 2017 as structural reforms are gradually implemented. The UK's vote to leave the European Union is expected to have only a limited direct impact on countries where the EBRD invests.

The economic outlook for the EBRD region is subject to major risks relating to geopolitical tensions in and around the region and a general weakening of investor confidence with regard to emerging markets in general.

<http://2016.tr-ebd.com/outlook>

STRUCTURAL REFORM



Political and economic challenges persist across the region, and governments are continuing to respond with a variety of approaches. On balance, policy responses remain positive, with many countries pursuing ambitious reform objectives.

New analysis focusing on the development of small and medium-sized enterprises shows that providing non-bank financing to such firms and helping them to acquire better business skills are particular hurdles for many countries in the EBRD region. Updates to regional inclusion gap scores point to some improvements in the area of inclusion, particularly in more advanced economies, but also some stagnation and backtracking. This highlights the remaining challenges of building more inclusive societies, especially in eastern and south-eastern Europe, Central Asia and the southern and eastern Mediterranean region.

<http://2016.tr-ebd.com/reforms>