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Central and Eastern Europe Prosperity Report

2016

FIRST EDITION

This report was authored by Paul Caruana Galizia and Fei Xue

Foreword

Freedom for the captive nations of the Soviet Empire was the clarion call of the cold war. But dissidents and their allies argued that once we gained freedom we needed justice too: redress for the crimes of the past, a law-governed system which bound both rulers and ruled, and an international order which upheld the rights of smaller and weaker countries.

In retrospect, we should have highlighted a third goal: trust. As this report rightly notes, the greatest damage of the five totalitarian decades was not physical but psychological. Under the Communist system, you survived by narrowing your circle of trust tightly. Even that did not work fully: the secret police were quite capable of pitting husband against wife, child against parent, teacher against student.

This hidden legacy still dogs many of the countries in the region. If you cannot trust other people it is hard to do business with them. If you do not trust institutions, then selfish, zero-sum behaviour becomes the norm. Though superficial economic statistics may tell a story of material convergence, without stronger social capital it will be decades before we truly heal the wounds of the past.

The gloomiest implication of this report is that a dangerous vicious circle may be developing. If young people from the CEE region feel that its development is hobbled by the low-trust legacy of past and move to the more prosperous economies of northern and western Europe, then the CEE countries may never achieve the critical mass they need to make real changes. Having failed to rebuild trust during the easy years of global prosperity and a benign international order, it may now be too late.

That, I suspect, is too pessimistic. For a start, the greatest destroyer of trust—totalitarian rule—has gone. The generations whose outlook was most badly warped by the climate of fear and lies are ageing, moving out of the workforce. Those that come in their place have different experiences and higher expectations.

Secondly, not everyone wants to leave and the climate is far from hopeless. Unlike in Russia, the ruling elites in the CEE countries are not immune from political competition. They lose elections and lose court cases. In some cases, they are the object of mass demonstrations. They do not use force to stay in power. International standards still apply, both in formal requirements and as informal benchmarks.

Thirdly the diasporas can, as during Communism, be reservoirs of hope, energy, and experience for those wanting to make changes back home. Europe is heavily networked in both physical terms and in cyber-space. The role of the Ukrainian diaspora in supporting the Maidan protests in Kiev deserves note here.

Fourth, although some of the problems seem dauntingly large, there is plenty of low-hanging fruit. The spectacular progress shown by countries such as Estonia and Georgia in dealing with bureaucracy, ostentatious corruption, and obstacles to business highlights what can be done elsewhere.

The report rightly differentiates between two kinds of trust: between individuals and between individuals and institutions. Cultivating the second of these looks harder but is easier in practice. It involves transparency, accountability, and responsiveness. People will join a queue once they see that queuing works. They will stop wasting money on bribes, and time in cultivating personal contacts, when they see that a bureaucracy treats everyone equally and fairly. The internet is a big help here, especially in promoting e-government. A future report could usefully examine the effect of this, as promoted in Estonia and other countries.

Finally, it is important to avoid an orientalist perspective in which the CEE countries are seen only as pupils of a wise and omnipotent West. These countries may be (mostly) poorer than the old democracies, they are (mostly) more scared of Russia, and (mostly) have lower levels of social trust. But on other indicators they score dramatically well. The OECDs PISA scores for education, for example, regularly put Estonia and the Czech Republic ahead of their "western" peers. In terms of their strategic and security cultures, the frontline states of Europe are far ahead of most NATO and EU countries. Yes, they still have a lot of catching up to do on some fronts. But so do we.

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Executive Summary

The *Legatum Prosperity Index*™ is a framework that assesses countries on the promotion of their citizens' flourishing, reflecting both economic and social progress across nine pillars of prosperity, ranging from Governance and Business Environment to Social Capital, and 104 variables. This makes the Index an authoritative measure of human progress, offering a unique insight into how prosperity is forming and changing across the world.

The Prosperity Index captures the richness of a truly prosperous life and with it seeks to re-define the way we measure national success. It shows how quality education and healthcare, effective governance, as well as strong social bonds, are crucial to a thriving society and flourishing nation.

A nation's prosperity has traditionally been measured by macroeconomic indicators of wealth such as average income per person, GDP per capita. In moving to "GDP and beyond" to cover both wealth and wellbeing, and not just one or the other, the Prosperity Index is not discarding the importance of wealth creation.

Indeed, it is no surprise to find that countries with low prosperity scores tend to have low average incomes and vice-versa. However, prosperity is as much about wellbeing as it is about wealth. There are numerous factors that together determine the life chances and opportunities made available to a nation's citizens.

That is why we go beyond prosperity rankings and look at how well countries deliver prosperity in relation to their wealth levels. Using GDP per capita, the level of prosperity delivered by a country can be compared with the level of prosperity expected given that country's wealth. By doing this, we can identify the countries who are doing the most with what resources they have. We can describe countries that are delivering more prosperity than would be expected given their wealth as having a 'prosperity surplus' and those delivering less, a 'prosperity deficit'.

This inaugural 2016 *Central and Eastern European Prosperity Report* underscores the importance of looking beyond wealth. It shows that while Central and Eastern Europe's (CEE) average income remains far behind that of Western Europe, its prosperity has converged at a much faster rate.

Through improvements across the nine sub-indices of prosperity, the region's prosperity is now at 87 percent of the Western European average compared to 47 percent for income.

Central and Eastern Europe achieved much of its prosperity convergence in a buoyant global economic environment. Reintegrating into the global economy, the region realised large gains from trade. Those countries that joined the European Union acquired institutional credibility, and received large net capital inflows. Their citizens moved west across the European Union in search of work, reducing the wage gap between Western and Central and Eastern Europe.

Now, in a global environment that is less favourable to economic growth, and a European environment increasingly hostile to integration, the region's prosperity depends increasingly on its own ability to deliver more prosperity relative to its income – to generate a prosperity surplus for its citizens.

One of this study's central findings is that the ability of Central and Eastern European countries to deliver a prosperity surplus is limited by the region's defining and damaging characteristic: one of the world's largest social capital deficits. This deficit, a legacy of communism, means that the bonds and trust between citizens and citizens and institutions are substantially weaker than those elsewhere in the world. These weaknesses have serious implications for the region's performance across its components of prosperity.

When trust between citizens and between citizens and institutions is low, we see an increase in public sector corruption. Citizens do not trust that their fellow citizens are playing by the rules (paying tax, for example) and do not trust that institutions are enforcing those rules fairly (they might take bribes instead of higher tax payments). Governance deteriorates.

When trust between people extends only to immediate family and friends, as it tends to in the region, then financial development is held back. People turn to their close networks for credit, for example, in aggregate limiting their countries' savings pool and investment activity. The Business Environment deteriorates.

It is this deficit in Social Capital, particularly in institutional and generalised trust, that is key to the region's prosperity performance. Low Social Capital in itself holds back regional prosperity delivery, as it is part of prosperity, but also holds it back through its effects on Governance and the Business Environment.

It is unsurprising, then, that the Social Capital, Business Environment, and Governance sub-indices together explain 87 percent of the region's prosperity delivery compared to 43 percent for the rest of the world.

Building on the region's progress so far requires tough changes. Social Capital is a sub-index both central to progress and one that is difficult to change. One source of hope is the region's young population. In an analysis of 13,000 individuals across the region, we found that young Central and Eastern Europeans tend to have much higher levels of social capital than their older compatriots, they are more driven, better educated, more pro-business, and more demanding in terms of the reforms and policies needed to grow their region's prosperity.

At the same time, the young are also more inclined to emigrate. This presents both opportunity and challenges.

Diasporas contribute money through worker remittances, which add up to considerable sums for the region. They also contribute through the transfer of knowledge they acquire abroad. Together, these flows of money and ideas are a brain gain for the region. But the region's young are best able to contribute to their home countries' prosperity if they stay. For them to stay, they need to feel that hard work pays off, that they can make a difference, that they belong, and that they have a political voice. Otherwise, as more and more young people leave, the region risks a brain drain, and an acceleration in its aging and shrinking population.

The challenge for their home governments is to provide their young with the opportunities for civic engagement and participation they need to generate prosperity. We conclude with eight recommendations along these lines, and urge policymakers across the region to reflect on them.

The Prosperity Index Team

Contents

The Legatum Prosperity Index CEE Rankings 2016

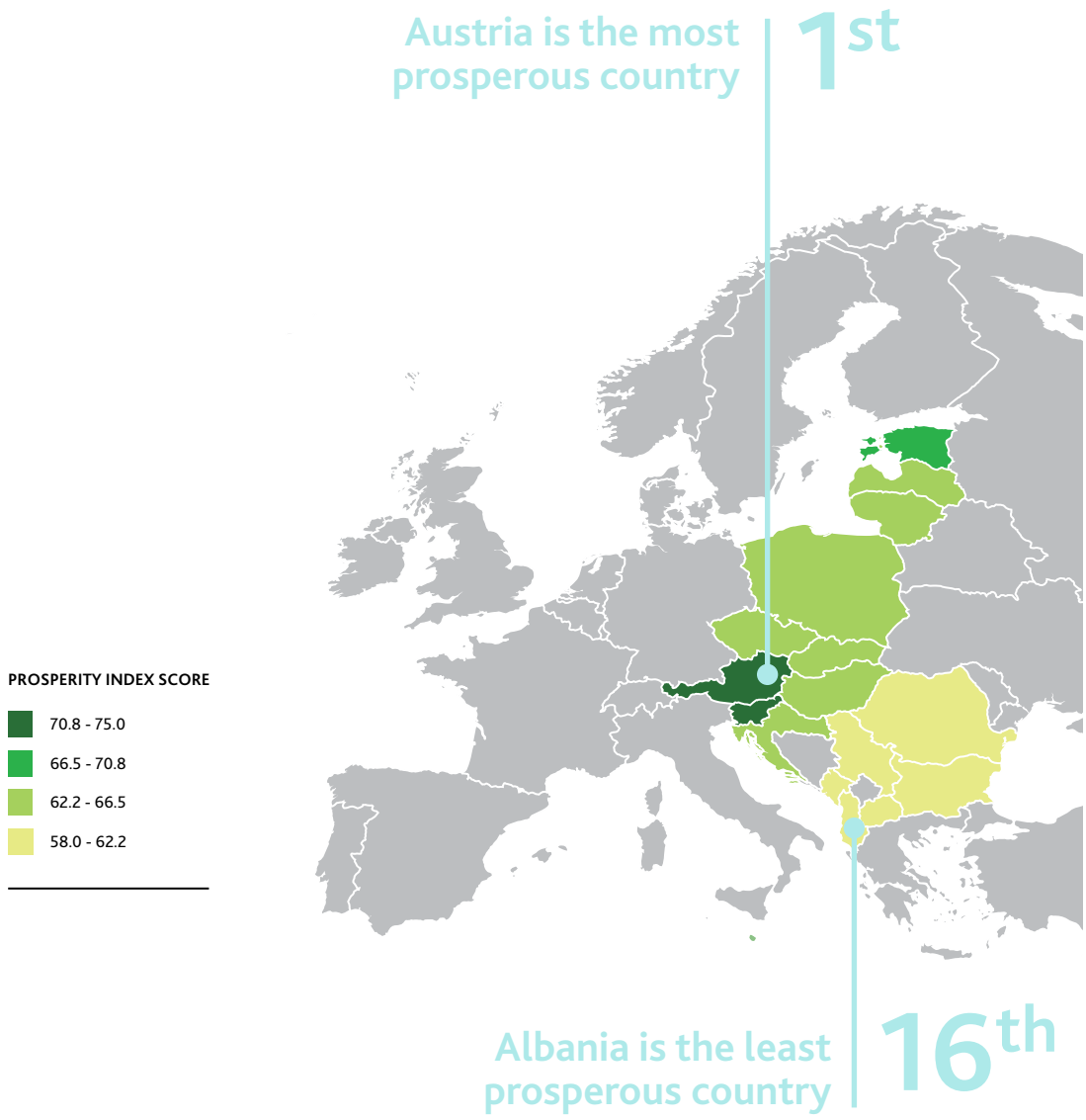
			SUB-INDICES								
CEE PI RANK	COUNTRY	GLOBAL PI RANK	ECONOMIC QUALITY	BUSINESS ENVIRONMENT	GOVERNANCE	EDUCATION	HEALTH	SAFETY & SECURITY	PERSONAL FREEDOM	SOCIAL CAPITAL	ENVIRONMENT
1	Austria	15	11	20	15	11	25	9	23	15	12
2	Slovenia	20	30	60	38	23	35	14	20	22	1
3	Estonia	26	27	26	20	29	55	43	32	71	7
4	Czech Republic	27	26	30	34	24	27	27	28	78	32
5	Poland	34	37	45	36	33	47	21	39	85	46
6	Slovakia	36	46	49	48	30	46	23	43	86	34
7	Latvia	37	34	34	39	32	82	42	57	94	16
8	Lithuania	42	45	55	37	43	80	45	41	125	33
9	Croatia	43	61	89	44	37	56	31	38	113	30
10	Hungary	47	52	56	46	38	50	38	46	114	93
11	Romania	50	65	41	64	47	85	46	48	97	61
12	Macedonia	53	93	44	62	40	66	37	69	119	85
13	Bulgaria	57	73	71	78	39	91	48	66	111	41
14	Montenegro	58	96	52	59	52	69	35	54	117	125
15	Serbia	66	101	102	70	46	86	40	59	127	105
16	Albania	74	107	67	71	76	49	68	60	106	121

Note: The regional ranking is based on the Overall Prosperity Index Score, and ranges from 1st to 16th while the global ranking ranges from 1st to 149th. Please see the Methodology section of this report for an explanation of the sub-indices and how they are constructed.

Prosperity in CEE 2016

As the map shows, we follow convention in defining "Central and Eastern Europe" (CEE). Our definition includes the historic "Central Europe" of Austria, the Czech Republic, Croatia, Hungary, Poland, Slovakia, and Slovenia, alongside the former socialist countries that extend east from the border of Germany and south from the Baltic Sea to the Greek border: Albania, Bulgaria, Estonia, Latvia, Lithuania, Macedonia, Montenegro, Romania, and Serbia. We are unable to include Bosnia and Herzegovina and Kosovo due to data unavailability.

This is a mixed bag: some countries were part of the Eastern Bloc, some were simply socialist, and many had different post-transition trajectories. Yet as we show in this report, CEE countries have very similar characteristics that make them distinct not only from Western Europe but all other world regions. This Report addresses the problems and opportunities CEE countries have in common.



A Decade of CEE Prosperity

Over the past decade, the average Central and Eastern European's income went from under to over half the average Western European's income.

CEE saw much of its income convergence in a buoyant global economic environment. Reintegrating into the global economy, CEE countries realised large gains from trade. Those countries that joined the European Union acquired institutional credibility and received large net capital inflows. Their citizens moved west across the European Union in search of work, reducing the wage gap between Western and Central and Eastern Europe.

This progress is rightly celebrated, but income convergence is far from complete and has slowed in more recent years. The region also finds itself in a less benign global environment.

Central and Eastern Europe's income has been 47 percent lower than Western Europe's since 2013. That year, the European Bank for Reconstruction and Development asked whether the region is 'stuck in transition'.[1] A year later, the International Monetary Fund described convergence as having 'stalled'.[2]

Looking at income alone, the picture looks bleak. But how does it change if we expand our view to look at a broader definition of prosperity?

The Legatum Prosperity Index™ assesses countries on the promotion of their citizens' flourishing, reflecting both wealth and wellbeing across nine sub-indices of prosperity: Economic Quality, Business Environment, Governance, Education, Health, Safety & Security, Personal Freedom, Social Capital, and Natural Environment.

CEE prosperity convergence has been faster than income convergence

The good news is that the Prosperity Index paints a more optimistic picture of CEE over the past decade. The region's prosperity score grew at a faster rate than Western Europe's prosperity score.

CEE's prosperity is now 4.2 percent higher than it was in 2007, compared to just 1.2 percent higher for Western Europe (see figure 1).

The sharp distinction between Western Europe and CEE is blurred when we look beyond income, then, and the region appears as one of the world's most prosperous after Western Europe and North America (see figure 2).

CEE's current prosperity score is now at 87 percent of the Western European average, up from 84 percent in 2007. This compared to 47 percent for income alone.

CEE outperforms Western Europe on various components of prosperity

CEE's performance in growing its prosperity over the past decade should warn us against taking an "orientalist" perspective of the region, where it plays student to its western teacher.

There are measures, like income, on which Western European countries perform better than CEE. But there are also measures of prosperity on which CEE countries dramatically outperform their "western" peers.

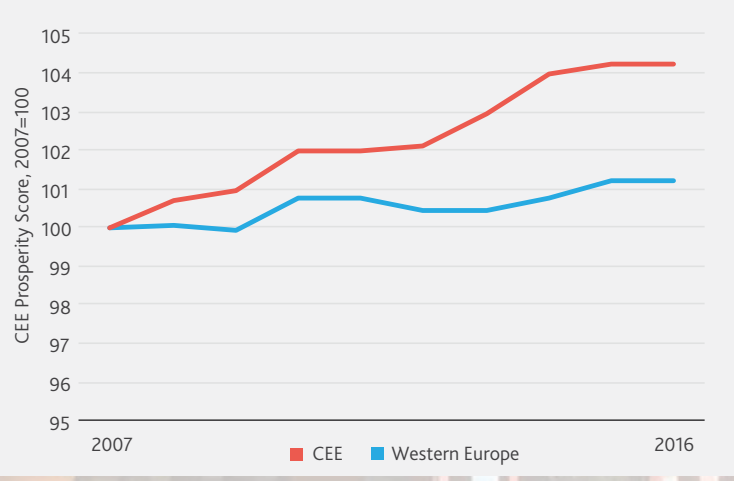


Figure 1: CEE prosperity growth between 2007 and 2016 was faster than that of Western Europe

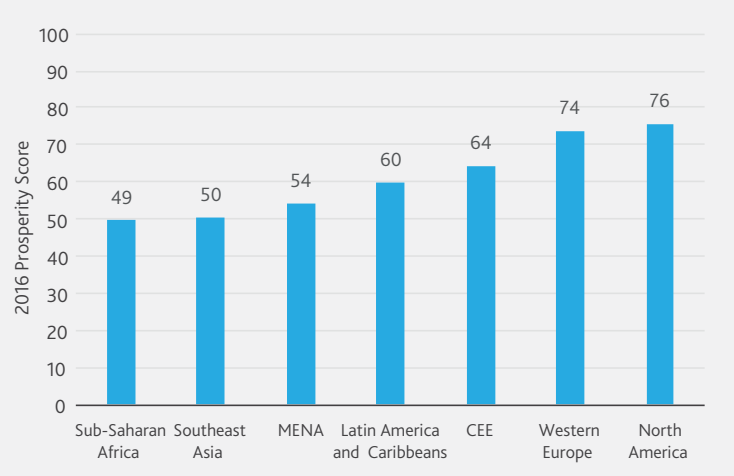


Figure 2: CEE's current Prosperity Score ranks it as one of the world's most prosperous regions

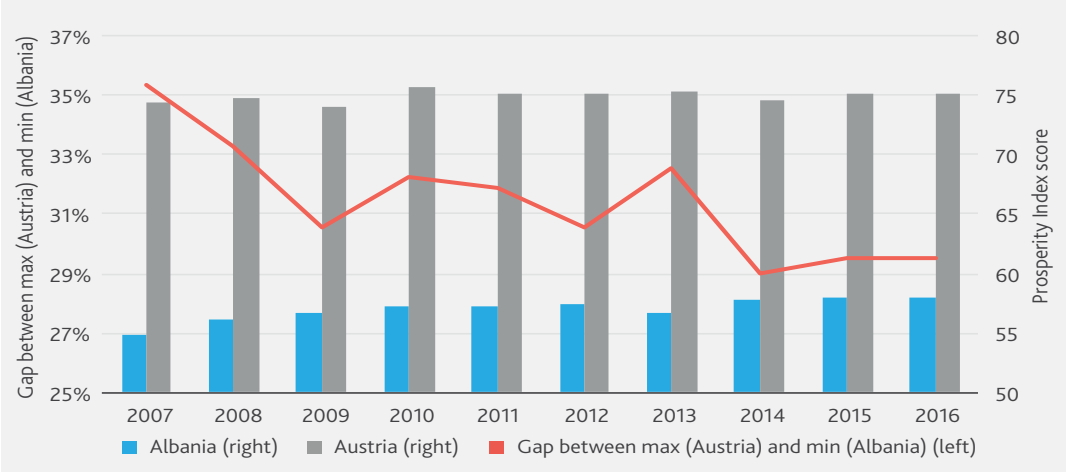


Figure 3: The gap between CEE's most (Austria) and least (Albania) prosperous country has narrowed over the past decade

The Czech Republic's Education sub-index score, for example, is higher than that of Portugal, Greece, Italy, Luxembourg, Cyprus, Ireland, Iceland, and only slightly lower than Spain's. The country has generated this success in part through ensuring equality of opportunity and outcomes across the education sector. The Czech Republic's education inequality score, part of the Education sub-index, ranks the country as the sixth most equal globally.[3]

The Czech Republic's rule of law, a central component of the Governance sub-index, is more similar to fellow EU members France and Belgium than Italy and Greece.[4]

CEE is home to the world's top-performer in the Natural Environment sub-index, Slovenia. The country's widespread protection of its marine and land environments have pushed its score 13.4 percent above the Western European average.

This progress among CEE countries is encouraging. We must remember that, on some fronts, it is Western Europe that needs to catch up.

We must also remember, however, that the performance of CEE countries varies widely. The Czech Republic's performance in Education may put it ahead of many Western European countries, but some of its neighbours – Hungary and Bulgaria, for example – lag behind many Western European countries in terms of educational performance.

Persistent differences in prosperity within CEE remain

The past decade has seen overall prosperity convergence *within* CEE, as initially less prosperous countries caught up with more prosperous ones.

Romanian prosperity went from 79 percent of Austria's, the top performer, in 2007 to 82 percent in 2016. Overall, the gap between the region's most prosperous and least prosperous country has narrowed from 35 percent to 29 percent (see figure 3).

Still, there remains considerable variation in prosperity within the region. Austrian prosperity is slightly above the Western European average while Czech prosperity is slightly below, and Romanian prosperity even further below.

Meanwhile, Serbia and Albania's prosperity is at the same level as Namibia's.

Given this variation within the region, does it make sense to lump CEE countries together? While there are large differences in prosperity within the region, those differences stem from the same sources.

CEE countries have much lower levels of social capital, weaker governance, and worse business environments than countries in other regions. Their weaknesses are constant in terms of origin, varying only in terms of degree.

These are the regionally-specific structural problems that are holding back convergence both *within* the region as well as *between* the region and Western Europe, and they are the focus of this report.

Faster convergence is needed to close these gaps in prosperity, but the data show that as income convergence has stalled, so too has prosperity growth.

As global income growth has slowed since the financial crisis, this might imply stalling income convergence for CEE. But this does not need to be the case.

The Prosperity Gap

There is a positive but imperfect correlation between a country's income level and its prosperity level. The world's most prosperous countries tend to be the richest, but there are many countries that deliver levels of prosperity disproportionate to their income.

The reverse is also true: many other countries fail to deliver the levels of prosperity we would expect given their incomes. We can describe the first group of countries as having a 'prosperity surplus' and the second as having a 'prosperity deficit.'

Most Central and Eastern European countries deliver a prosperity surplus (see figure 4). Indeed, the region is closer in prosperity than it is in income to Western Europe. Yet here again there is a high degree of variation within the region. Some countries, like Austria and the Czech Republic, are delivering prosperity surpluses while others, like Hungary and Romania, are delivering deficits. Others, like Poland, are delivering as much prosperity as we would expect given their income.

Now, in a global environment that is less favourable to economic growth, and a European environment increasingly hostile to integration, the region's prosperity depends increasingly on its ability to deliver more prosperity relative to its income.

To do this, the region must address the regionally-specific structural problems that are holding back its prosperity delivery.

Weak Business Environments, Governance, and Social Capital are holding back CEE Prosperity

Each one of the nine sub-indices of the Prosperity Index makes a unique contribution to a country's prosperity delivery, but when it comes to CEE there are three sub-indices in particular that stand out: Social Capital, Governance, and Business Environment.

- **Social Capital** measures the strength of personal relationships, social network support, social norms, and civic participation in a country.
- **Governance** measures a country's performance in three areas: effective governance, democracy and political participation, and the rule of law.
- **Business Environment** measures a country's entrepreneurial environment, its business infrastructure, barriers to innovation, and labour market flexibility.

CEE countries tend to perform poorly across all three sub-indices. The region has among the lowest social capital in the world, is home to weakening governance, and has stagnant business environments.

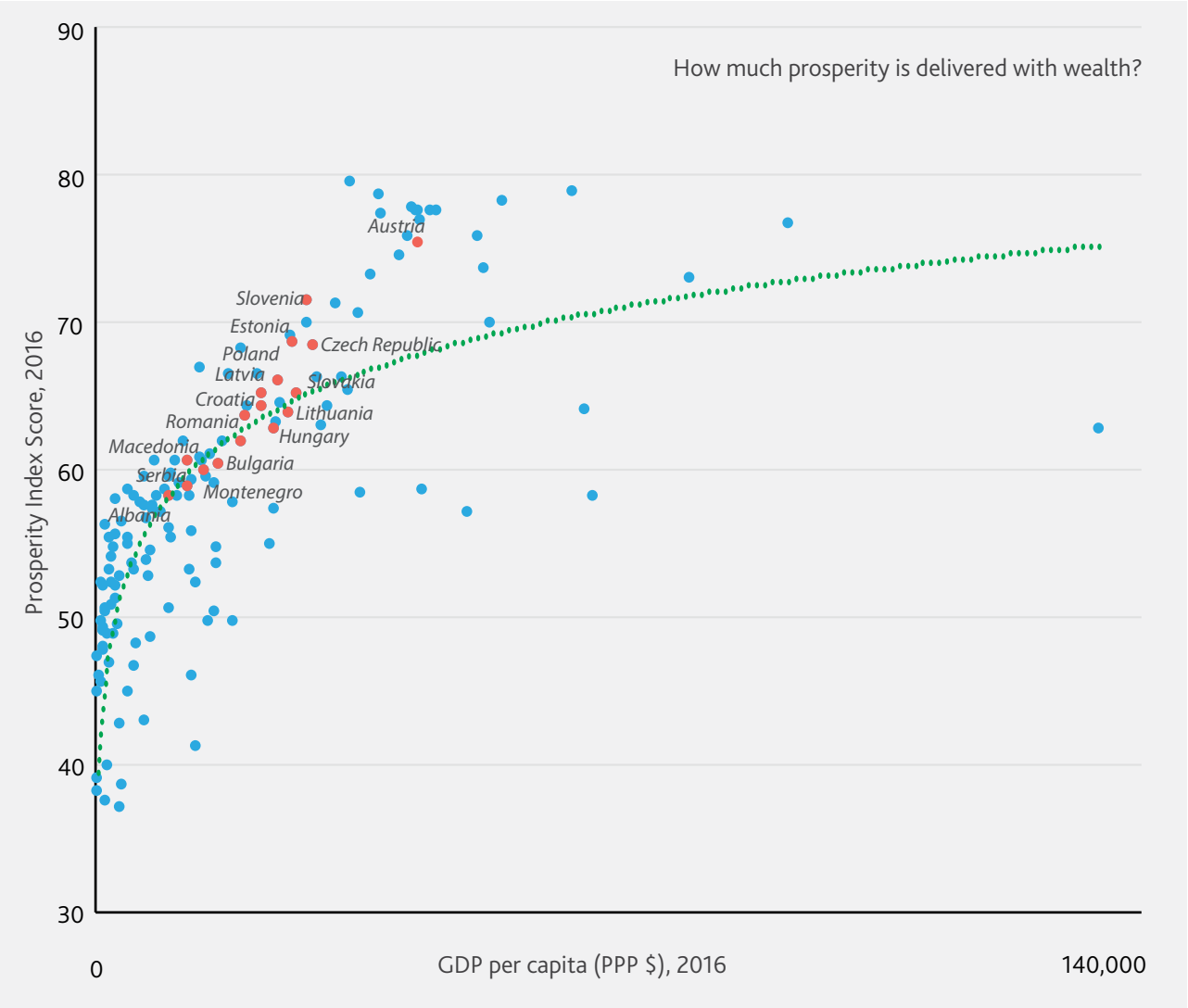


Figure 4: The Prosperity Gap - CEE countries vary in their ability to convert wealth into prosperity

While Central and Eastern Europe's overall prosperity is at 87 percent of the Western European average, its scores across these three sub-indices are, respectively, 79 percent, 75 percent, and 84 percent of the Western European averages (see figure 5).

Social Capital, Governance, and Business Environment have a disproportionately large effect on CEE's prosperity delivery

Not only do these sub-indices perform poorly in CEE, they also have a disproportionately large impact on the ability of countries in the region to deliver a prosperity surplus.

We split our global sample of 149 countries over 10 years into a Central and Eastern European sub-sample and a rest-of-the-world sub-sample. We then estimated the effect of these three sub-indices on countries' prosperity gaps, where values above zero indicate a prosperity surplus and those below a prosperity deficit.[5]

The significance of the sub-indices' effects on the prosperity gap, as well as their overall explanatory power of the prosperity gap, is higher for the Central and Eastern European sub-sample than it is for the rest-of-the-world subsample.

In the latter subsample, countries' Business Environment scores do not have a significant effect on their prosperity gaps. The Social Capital and Governance sub-indices do have significant positive effects on countries' prosperity gaps, but the overall explanatory power of all three sub-indices remains low. Together, in the rest-of-the-world subsample, they can only account for 43 percent of a country's prosperity gap.

In contrast, in the CEE subsample, all three sub-indices have significant positive effects on countries' prosperity gaps. Increasing a CEE country's Social Capital score by 10 points, for example, would raise its prosperity gap by 4.6 points. The corresponding effect for Governance is 2.9 points and 1.7 points for Business Environment. Together, the three sub-indices can account for 87 percent of a Central and Eastern European country's prosperity gap (see figure 6).

The effects imply, for example, that if we were to somehow

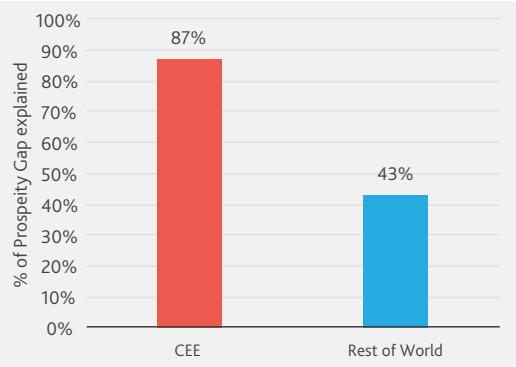


Figure 6: Altogether, Social Capital, Business Environment, and Governance explain 87 percent of CEE's prosperity gap, compared for 43% for all other countries

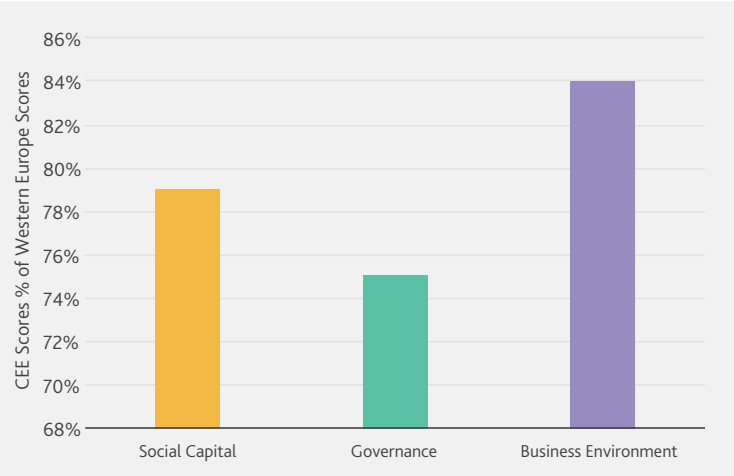


Figure 5: CEE countries perform poorly in Social Capital, Governance, and Business Environment

bring Hungary's Social Capital score up to the United Kingdom's level, it would move from having the largest prosperity deficit in Central and Eastern Europe to having one of the region's largest prosperity surpluses.

The question is, why do these three sub-indices - Social Capital, Governance, and Business Environment - perform particularly poorly in Central and Eastern Europe?

Linking Social Capital, Governance, and the Business Environment to CEE prosperity

All three sub-indices play a part in explaining CEE's prosperity performance but Social capital occupies the central role. Figure 7 shows how, and sets up the conceptual framework we use throughout the rest of this report, acting as a guide to what follows.

While CEE countries share in common underperformance in Social Capital, Governance, and the Business Environment sub-indices, it is their underperformance in Social Capital that marks them out as a distinct region. Statistically, the single best predictor that any one of the 149 countries covered in the global Prosperity Index is in CEE is a low level of social capital.[6]

Fifty years of communism did not only cause the region physical damage but also psychological damage. Central and Eastern Europeans living under communist rule survived by narrowing their circle of trust, restricting it to immediate family and friends, at the cost of wider social trust and trust in the institutions of government.

It is this historic legacy that explains the region's Social Capital deficit; a deficit which has a direct effect on the region's prosperity delivery, but also indirect effects that work through Governance and the Business Environment.

An erosion of social trust - an inability to trust people outside your immediate circle - makes it hard to do business with those people. In place of trust, interest rates and regulatory burdens increase, and we find that it is the credit market that is particularly hit by this. When financial development is held back, so is prosperity.

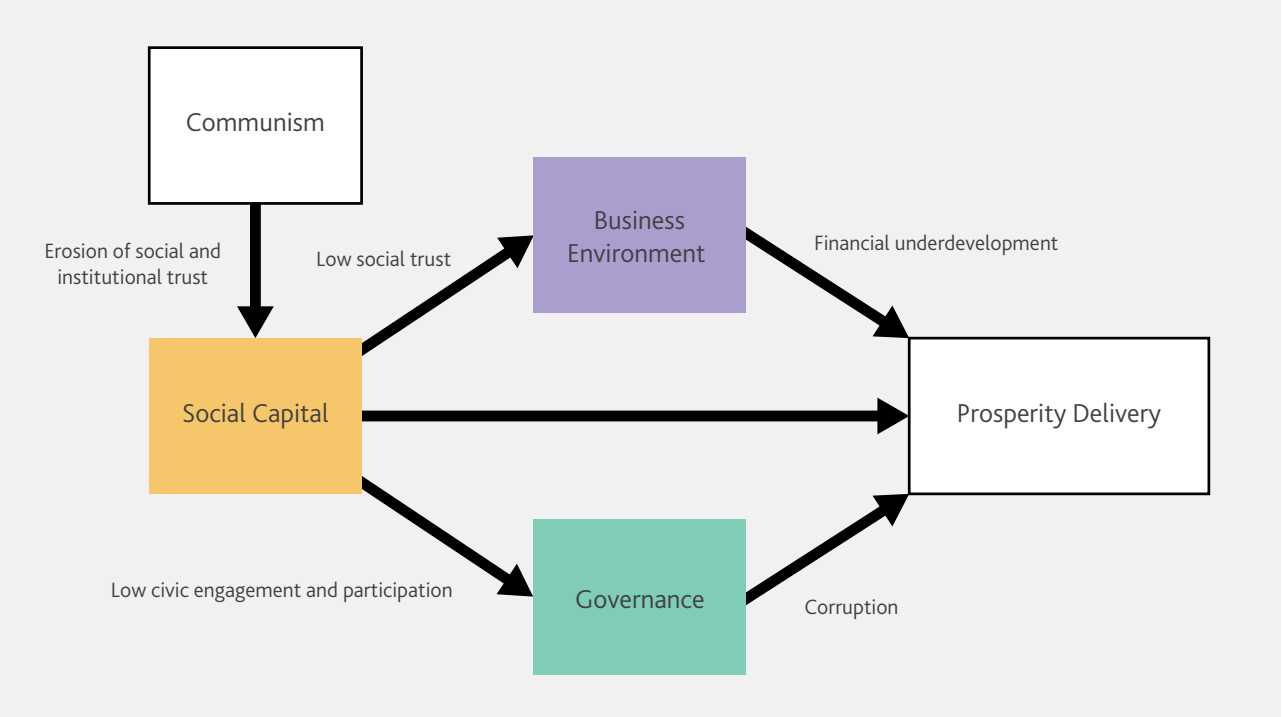


Figure 7: The links between Social Capital, Business Environment, Governance and Prosperity in CEE

An erosion of civic engagement and participation means people stop playing by the rules. They see no reason to, for example, pay their taxes when they think those taxes are squandered and when they think no one else is paying their taxes. People avoid formal channels of governance, turning to corrupt practices instead. When corruption reaches the levels we see in CEE, prosperity is held back.

Closing the Social Capital deficit is not easy, but neither is it impossible. Totalitarian rule is long gone and a new generation of Central and Eastern Europeans, who have higher expectations of their economies and governments, are entering the workforce. They trust each other more than previous generations did, but need to see bureaucracies that work fairly and objectively before they can trust their institutions.

Given the direct and indirect channels between social capital and prosperity, the pay-off of improving social capital is substantial. It is these improvements that must come first. Years of market and institutional reform, particularly in EU accession countries, have often failed to see their full potential because they are implemented on foundations of weak social capital. Reforms, especially the root-and-branch kind implemented in transition economies, need a basis of social capital to succeed.

The rest of this report explores the CEE challenge in detail, highlighting the drivers of prosperity delivery outlined in figure 7 over the past decade and how they can inform policy priorities over the next decade. In an environment of slower global growth and greater political uncertainty, the challenge for CEE is if, and how, it can delivery prosperity under its own steam.

Endnotes

[1] European Bank for Reconstruction and Development (EBRD) (2013), EBRD Transition Report 2013: Stuck in Transition?, London: EBRD.

[2] International Monetary Fund (IMF) (2014), 25 Years of Transition: Post-Communist Europe and the IMF: Regional Economic Issues Special Report, Washington DC: IMF.

[3] The Education Inequality Index is a Gini Coefficient of education distribution among 15+ population. Accounts for dispersion of average years of schooling among the population, and for levels of education within four categories and cumulative years of schooling at each level of education.

[4] This is the World Bank's Rule of Law measure from its Worldwide Governance Indicators. The extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Scaled from -2.5 to 2.5.

[5] These estimations are based on an ordinary least squares (OLS) regression of the Prosperity Index gap on the Social Capital, Business Environment, and Governance sub-indices. The sample for CEE is 16 countries over 10 years and for the rest of the world it is 144 countries over 10 years. The explanatory power refers to the overall R2 values. Standard errors are robust.

[6] This is based on Probit regression of the Central and Eastern Europe dummy indicator, that takes 1 for all CEE countries and 0 otherwise, on all nine sub-indices, and year dummies. Standard errors are robust. The largest t-statistic (the ratio of the regression coefficient to its robust standard error) was for the Social Capital sub-index, at -9.31.

Six things you need to know about Central and Eastern Europe's prosperity

1

CEE has seen faster prosperity growth than Western Europe. Now most Central and Eastern European countries deliver a prosperity surplus.

Over the past decade, Central and Eastern Europe's average prosperity score reached 87 percent of Western Europe's level. This is a neglected success story. Meanwhile, the region's income level reached 47 percent of Western Europe's. Most Central and Eastern European countries now deliver a prosperity surplus – that is, they deliver more prosperity than we would expect given their income.

2

Central and Eastern Europe has one of the world's largest deficits in social capital and this is holding back further prosperity growth.

Increasing a country's Social Capital score by ten points reduces the probability of it being in CEE by 19 percent. This social capital deficit, a legacy of communism, is holding back the region's prosperity.

3

Social Capital, Governance, and Business Environment have a disproportionately large effect on CEE's prosperity delivery.

Together, they explain 87 percent of the region's ability to deliver prosperity compared to 43 percent for the rest of the world. This relates to the region's exceptional social capital deficit: the transition towards full liberal market democracies, measured by performance in Governance and Business Environment, cannot happen without a basis of social capital.

4

In an environment of slower global growth and one that is increasingly hostile to EU integration, CEE's success depends on improving its own ability to deliver prosperity.

Yet reform efforts to this aim are stalling because of low social capital, which is significantly correlated with higher levels of corruption, weaker rule of law, and poorer business regulation. Citizens must feel that everyone is playing by the rules of the game for reform to succeed.

5

Countries with high initial levels of social capital experienced less severe economic downturns between 2007 and 2016.

In Central and Eastern Europe, improving social capital will therefore make countries both more resilient to shocks as well as unlock opportunities in areas that have so far been stuck at low levels: Governance and Business Environment.

6

The movement of young Central and Eastern Europeans away from their home countries represents "brain gain" as well as "brain drain".

Analysing 13,000 individuals, we found that young Central and Eastern Europeans have stronger social capital than their older compatriots, are better educated, more pro-business, and more demanding in terms of reform. But they are also more inclined to emigrate. This makes for both a "brain gain" and "brain drain". Diasporas contribute money through worker remittances and contribute through the transfer of knowledge they acquire abroad. But they are best able to contribute to their countries' prosperity if they stay. For them to stay, they need to feel that hard work pays off, that they can make a difference, that they belong, and that they have a political voice. Otherwise, as more and more young people leave, the region risks a brain drain, and an acceleration in its aging and shrinking population.

Social Capital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RADIO WIEN

Delivering Greater Prosperity: The Centrality of Social Capital

In his 1990 New Year's Address to the Nation, Václav Havel told his fellow Czechoslovakians that under Communism "We learned not to believe in anything, to ignore one another, to care only about ourselves."[7] Havel could have been speaking of any post-Communist or post-Soviet country.

As the Iron Curtain fell, and communism receded from Central and Eastern Europe, it revealed obsolete economies producing goods that no one needed or wanted, states that claimed to protect workers but instead humiliated and exploited them, and societies where individuals no longer trusted one another.

Dramatic progress has been made in reforming Central and Eastern Europe's economic and political institutions since Havel's speech. Most countries can now be described as having market economies that are integrated into the global economy and most are governed by democratic institutions. Progress on the last point, however, has been less promising and makes further economic and political reforms harder to achieve.

Communism decimated most of the region's social capital

Almost three decades after Havel's speech, we can still see communism's most pernicious legacy: countries in which people not only distrust their governments, but also each other.

During the Stalinist era, all communist countries in the region experienced a phase of harsh totalitarian rule. The era lasted long enough for people to treat public participation as a forced and ritualistic activity. They retreated from the public and civic spheres, into the privacy and safety of their immediate families and friends. Public institutions came to be seen as foreign impositions - developed externally, with the interests of external agents at their heart.

The communist legacy, in short, created countries with low social capital, a concept developed by Harvard political scientist Robert Putnam.[8] Social capital is a measure of the civic mindedness of a society, the presence of social norms that promote cooperation, including trust between individuals, and the degree of trust in public institutions.

CEE's social capital is low by global standards

To get a sense of how exceptionally low social capital is in Central and Eastern Europe, we ran the following experiment. Imagine a world map where countries are not yet assigned into regional groupings, like "Central and Eastern Europe" or the "Middle East and North Africa." Imagine, then, we had to sort countries into their regional groupings, based on their country characteristics as measured by each one of the nine sub-indices in the Prosperity Index.

We found that the single best predictor that any one of the 149 countries covered in the global Prosperity Index is in Central and Eastern Europe is a low level of social capital, as measured by the Social Capital sub-index.[9]

That is, the probability that a country is Central and Eastern European increases sharply as its social capital decreases (see figure 8).

The strength of this result increases if we drop Austria, which has no communist legacy, from the sample of Central and Eastern European countries.

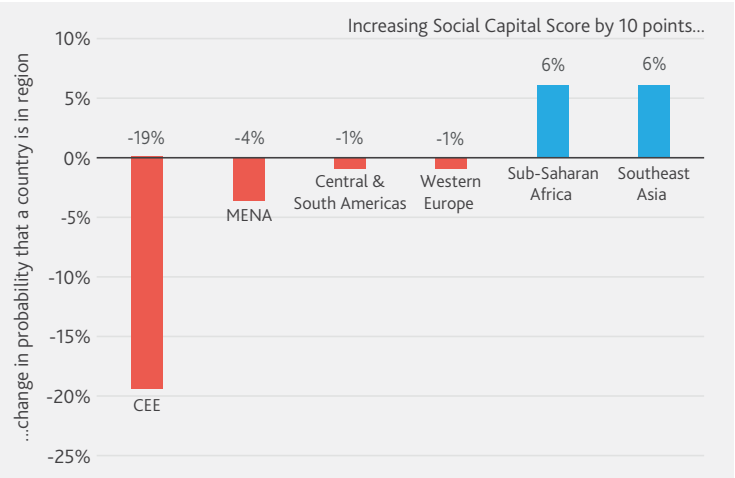

Figure 8: Increasing a country's Social Capital sub-index score sharply decreases the probability that it is in CEE

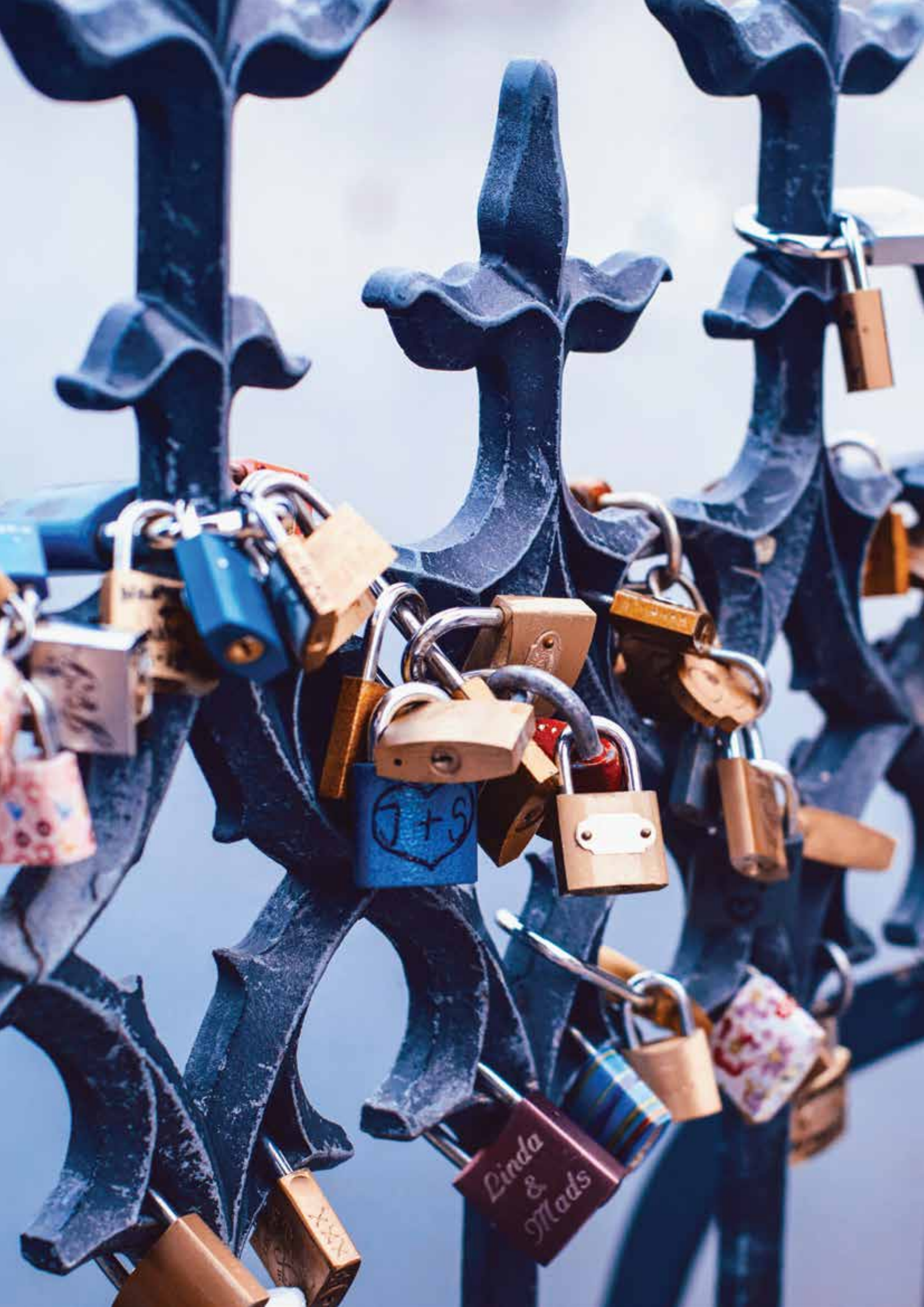
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Table 1: the four components of Social Capital

Region	Trust	Family & Community	Civic Engagement	Civic Participation
CEE	63%	57%	18%	28%
Western Europe	74%	65%	38%	37%
Southeast Asia	69%	63%	39%	20%
Sub-Saharan Africa	66%	55%	19%	20%

Notes: Trust: is the average of affirmative answers to the questions, "Have you helped a stranger or someone you didn't know who needed help in past month?", "Were you treated with respect all day yesterday?", and "Do you have confidence in the local police force?". Family and Community: "Satisfied with opportunities to meet people and make friends?", "Has your household sent financial help to another household in last year?" (same country), "Have you helped a stranger or someone you didn't know who needed help in past month?". Civic Engagement: "Have you volunteered time to an organisation in past month?", "Have you donated money to a charity in past month?". Civic Participation: "In the past month, have you voiced your opinion to a public official?", Turnout in most recent national legislative election (% registered electors) in seven years, else zero, sdjusted by democracy level.

Central and Eastern Europeans trust their family and friends but not their institutions

While the region's overall social capital is low, it is high in some areas. As trust in public institutions and civic mindedness decreased under communism, people in Central and Eastern Europe increasingly turned towards their immediate families and friends for support and help, strengthening social capital in that specific area at the cost of social capital in the former area.

Different areas of weakness in social capital have different implications. Low levels of civic participation, for example, make governance and political reform difficult while low levels of trust create an environment that is unfavourable to businesses. For this reason, it is useful to break down our Social Capital sub-index into four components.

- **Trust:** A central component of social capital is "trust", which we can think of as encompassing social trust and institutional trust. The first refers to how widely and easily citizens trust each other. The second refers to the degree to which citizens trust public institutions.
- **Family and Community:** The CEE experience shows us that higher levels of trust between immediate family and friends can compensate for low levels of wider trust. We can refer to this component as "family and community", which measures the strength of informal networks connecting families and friends together.
- **Civic Engagement:** Social networks can also work through more formal networks, such as volunteering and other charitable activities. We can think of this component as "civic engagement", which measures the strength of formal bonds between citizens.
- **Civic Participation:** Finally, we can think of the links between citizens and public officials as the "civic participation" component. This measures how involved and connected citizens are with their governing group.

Table 1 above lays bare CEE's social capital deficit. Its level of trust is among the lowest in the world, lower than Southeast Asia and Sub-Saharan Africa's. Trust within families and communities is also among the lowest in the world, only marginally higher than Sub-Saharan Africa's, meaning that it is failing to compensate for low general trust. Central and Eastern European civic engagement is also exceptionally low, implying that formal networks between citizens are not there to compensate for the missing informal bonds between them. While the region's civic participation is higher than that in Southeast Asia and Sub-Saharan Africa, reflecting its relative success with democratisation since the early 1990s, it remains substantially lower than that in Western Europe.

CEE needs social capital to complete its democratic and market transition

It is a cruel fact that communism decimated the foundation that Central and Eastern Europe most needs to fully rebuild its prosperity after decades of authoritarian rule. Transitioning from a centrally planned to a market economy and from a communist to a democratic regime was a process of rapidly accelerated institutional change. Societies had to adapt both to the needs of democratic governance as well as to the needs of market transactions.

Strong social capital is needed to ease such a transition. Generalised trust is required for a market-based division of labour and for a credit market that is efficient and fair. Ties between families and friends, already weak in the region, can only go so far. While they may be able to provide occasional financial support, for example, they are less likely to be able to finance a new business. The political institutions that uphold the rule of law, control corruption,

and so facilitate market exchange require strong civic participation and engagement.

CEE's social capital was not strong enough to adapt to these new circumstances. Its social capital was only able to take it so far.

CEE has democracy, but high levels of corruption. The region's average Democracy Level, ranging from -10 (fully autocratic) to 10 (fully democratic), is 9.3.[10] Yet its average Corruption Perceptions Index score, ranging from 0 (perception of total public sector corruption) to 100 (perception of no public sector corruption), is 52.6.[11]

CEE has market economies, but access to credit still varies widely across the region. Romania's credit access score ranks it at seventh from a global sample of 129 countries while Croatia's credit access score ranks it at 75th globally.[12]

Many CEE states have joined the EU, but fail to meet European Union standards of governance. While the Czech Republic's rule of law is stronger than that of fellow EU members Italy, Portugal, Spain, Malta, Greece, and Cyprus, Romania's rule of law is only stronger than that of one other fellow EU member state – Bulgaria.[13]

Havel's 1990 Address put relationships between individuals and their communities at the centre of his dream of a republic that is free, democratic, and prosperous, yet socially just. Despite Havel's early emphasis on what we now call social capital, the broader Central and Eastern European experience has shown us that it is a difficult characteristic to improve on.

The prize, however, is worth the effort.

Improving social capital is an end in itself. It is one of prosperity's components. But, crucially, it is also a means to multiple ends. With a solid foundation of social capital, a country can fully implement economic and social policies that help build prosperity. It is Central and Eastern Europe's social capital deficit that is holding back its potential. The next two sections of this report show precisely how.

Endnotes

[7] Havel, V. "New Year's Address to the Nation", Prague, January 1, 1990.

[8] Putnam, R. (2001). Social capital: Measurement and consequences. Canadian Journal of Policy Research, 2(1), 41-51.

[9] This is based on Probit regression of the Central and Eastern Europe dummy indicator, that takes 1 for all CEE countries and 0 otherwise, on all nine sub-indices, and year dummies. Standard errors are robust. The largest t-statistic (the ratio of the regression coefficient to its robust standard error) was for the Social Capital sub-index, at -9.31.

[10] This is the Center for Systemic Peace's "Polity2" measure. This measure depends on the competitiveness of executive recruitment, constraints on chief executives, regulation of political participation, and competitiveness of political participation.

[11] This is Transparency International's Corruption Perceptions Index: An index of perceived corruption in the public sector. Its basis is a combination of surveys and assessments of corruption, collected by a variety of reputable institutions.

[12] This is the World Bank's Ease of Doing Business Ease of Getting Credit score. It is t a distance to frontier score based on the components: 1) strength of creditor and borrower's legal rights (strength of collateral laws for borrowers and creditors, and bankruptcy laws for creditors); 2) depth of credit information; 3) credit bureau coverage; and 4) credit registry coverage.

[13] This is the World Bank's Rule of Law measure from its Worldwide Governance Indicators. The extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Scaled from -2.5 to 2.5.

Business Environment

Still in Transition: Business Environment

The past 27 years have seen CEE's reintegration into the global economy, its economic liberalisation, and large gains in its citizens' living standards. The region's average prosperity is now only 15 percent lower than that in the leader of the pack, Austria, and 13 percent lower than the Western European average.

Building a business environment where firms can start up, invest, and grow, and, when the time comes, shut-down, has always been a central part of the region's liberalisation programme. No transition countries had these reforms in place as they were about to begin their transition to market economies. Business was governed by central planning, corruption, and arbitrary political decisions.

While progress in reforming CEE's business environment has been substantial, two issues remain. First, there is a high degree of variation between countries. Second, progress has stalled in more recent years.

Why, despite the full assault of price and trade liberalisation and structural policies, have things stalled? And why has Austria, the only non-transition economy in the region, also stalled? The foundation for successful reform – social capital – is missing. This is especially clear in the financial sector, a central component of the business environment.

CEE countries vary dramatically in Business Environment performance

After twenty-seven years of transition, CEE countries still show a large degree of variation in their business environments, with varying implications for their future prosperity.

Business Environment sub-index scores range from 49 in Serbia, the same level as Egypt, to 66 in Austria, the same level as France (see figure 9).

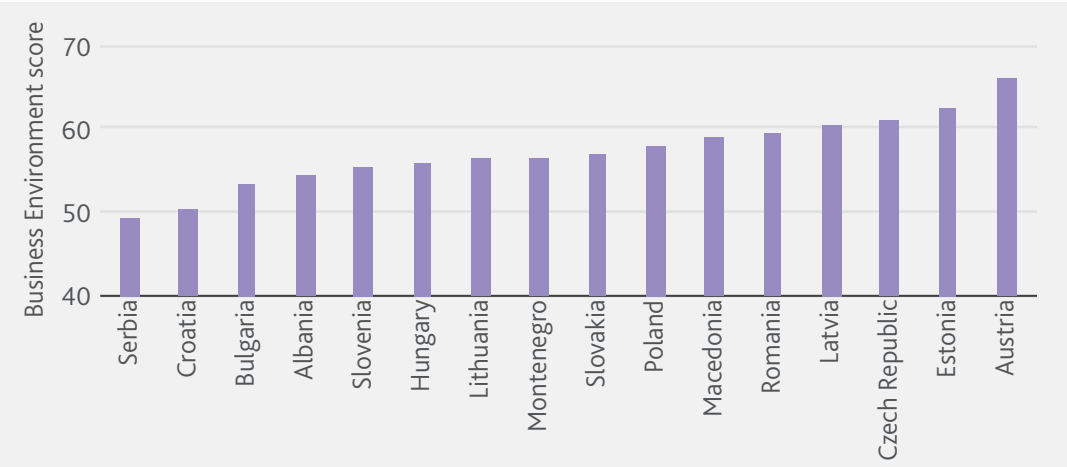

Figure 9: CEE countries vary in their Business Environment performance

Business Environment reforms are slowing down across CEE

Not only do business environments vary across the region, but in more recent years reform momentum has slowed. Transition countries made most of their progress in the 1990s, but the last decade has seen relatively less change, even in countries where the transition is far from complete.

The same is true of Austria, whose business environment has failed to improve in line with its Western European neighbours (see figure 10).

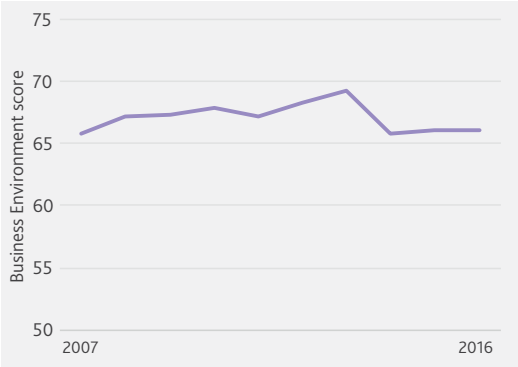

Figure 10: Austria's business environment has been stagnant over the past decade

Improving the Business Environment requires a stronger financial sector

When we drill deeper into the Business Environment profiles of CEE countries, we can see that the weakness lies in countries' financial development.

Looking across all CEE countries between 2007 and 2016, we find that variation in the Prosperity Index's two "financial" variables – "access to credit" and "affordability of financial services"[14] – explain 50 percent of the variation in CEE countries' overall Business Environment performance.[15]

Like overall Business Environment scores, these two variables show both large differences between CEE countries as well as stagnation in more recent years. For example, access to credit, where 0 is no access and 1 is easy access, is 0.35 in Croatia, but 0.85 in Romania, which is in the global top 10 in this respect. Looking at variation over time, however, Romania's access to credit has only increased from 0.81 since 2007 while Austria, whose Business Environment has stagnated over the same period, saw its own score *decline* from 0.75 to 0.60.

Why does financial development matter so much for countries' overall business environment and prosperity? Countries with deeper and better-developed financial markets grow faster.[16] Banks and other financial intermediaries provide access to finance for households as their financial needs grow. In doing this, they accumulate savings that they can then intermediate into business loans. This investment, in turn, boosts economic growth and prosperity.

Financial development reforms cannot success without a foundation of social capital

CEE has seen no shortage of policies aimed at deepening the region's financial development. Why haven't these fully succeeded?

After the region experienced a series of banking crises in the 1990s, most countries modelled their financial sectors on strong bank supervision and the intensive involvement in local financial sectors by Western European parent banks. These banks brought much-needed know-how and provided access to foreign capital. Credit boomed in the benign global environment of the 2000s, until the global financial crisis, following which the region recovered slightly until the Eurozone crisis hit.

The twin crises exposed a dependence on foreign financing, and the region's current recovery has been, as the International Monetary Fund put it, "creditless".[17] In Austria, credit extended to the private sector remains 12 percent below peak; 41 percent in Hungary; and 23 percent in Romania.[18]

Current reform programmes aim to make lending more sustainable by, first, addressing debt legacies (through, for example, creating markets for distressed debt and facilitating restructuring) and, second, reducing funding risks (through, for example, guarantee schemes).

While current reforms are promising, truly sustainable financing requires a solid foundation of trust. In other words, by its nature, financial intermediation between households, businesses and lenders cannot work properly without mutual trust.

Yet the kind of trust that is needed, the kind that goes beyond immediate family and friends, is in limited supply in CEE (see table 1). The region's communist legacy decimated generalised "social trust", pushing people deeper into their immediate networks of family and friends, while also acting to weaken these networks.

There is, in fact, a significant negative correlation between a country's "family and community" component of social capital and the ease with which its citizens can access credit (see figure 11).[19] This implies that as people are unable to trust intermediaries or, simply, people who are not personally known to them, they rely on their immediate networks of family and friends for support.

When asked whether they have confidence in their country's financial institutions and banks, 57 percent of Austrians, 59 percent of Romanians, and 66 percent of Hungarians said "no". Czechs are the most confident, with only 28 percent saying "no". Slovenians are the least confident, with 67 percent saying "no".[20] Slovenia has the lowest access to credit score in the region.

This is not to say that social capital is everything. Some countries have both high levels of "family and community" social capital and easy access to credit: Austria, the Czech Republic, and Romania, for example. In these countries, developed financial sectors and high quality regulation ensure financial development. In other countries, like

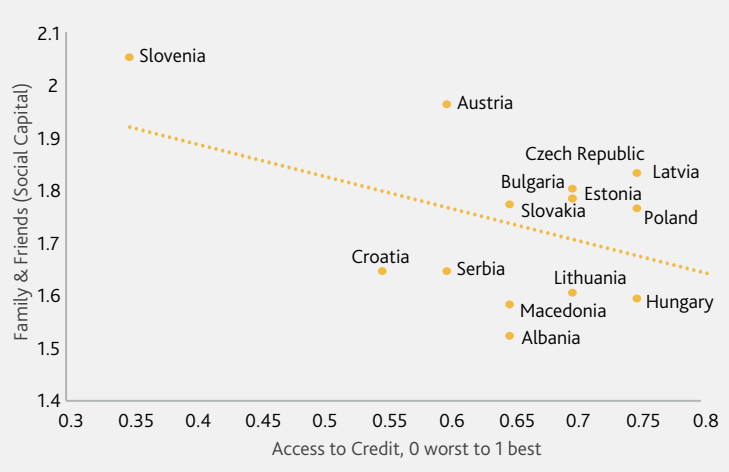

Figure 11: Stronger informal networks between family and friends compensate for harder credit access

Serbia, it is a history of macroeconomic and financial instability that have shaped the relationship.

Rather, it is to say that wider social trust is, on average across the region, the missing ingredient in sustainable financing. Reforms cannot fully take root without this foundation of wider, rather than family and community, trust.

Households, in this context, rely on each other for savings. In the Czech Republic, for example, a consistent 14 percent of households sent financial help to another Czech household over the past decade.[21] In Romania, the number averages 13 percent, and in Austria it dropped from an impressive 45 percent in 2012 to 12 percent in 2016, reflecting a business environment whose increasing stagnation is both necessitating and restricting the ability of households to help each other financially.

The result: broad-based financial development, seen in country's varied access to credit scores and needed to deliver prosperity, is not where it could be.

Business regulation cannot always compensate for low social capital

Seeking to get households and businesses out of this trap, policymakers intervene. Their goal is to formulate and implement regulation that compensates for the trust deficit. That is, to create a regulatory environment that makes households feel comfortable enough to deposit their savings at a bank, that makes banks feel comfortable enough to lend to businesses, and businesses comfortable enough to borrow from banks.

For this to happen, people must perceive that their governments are able to formulate and implement sound policies and regulations that permit and promote private sector development. The elimination of unfair competitive practices, for example, flexible labour markets, effective anti-trust law, and, crucially, investment freedom.[22]

While well intentioned, policy intervention of this nature can sometimes increase an economy's regulatory burden to

the point where it imposes additional costs on financing - the very problem it was intended to solve in the first place.

Rather than compensating for weak social capital, what the data show is that regulation that permits and promotes private sector development is only found within the context of strong social capital (see figure 12). The statistically significant relationship shows that as Social Capital performance strengthens, regulatory quality increases.[23]

For regulation to facilitate rather than hinder financial development, policymakers and regulators also need to be trusted. There is some progress to be made in this respect. Only 18 percent of Romanians have confidence in their national government, a broad proxy for citizens' perceptions of policy and regulatory quality.[24] The number for Austria is 43 percent; 42 percent for the Czech Republic; and 30 percent for Hungary.

For policies to take root, financial intermediaries, and businesses must feel that regulators are competent and have integrity just as much as regulators need to feel that all the other actors will play by the rules of the game.

The implication: providing a foundation of social capital must come before regulatory changes and policy reforms. Regulation without trust imposes further costs on a country's financial development, and hits the most disadvantaged the hardest.

A weak Business Environment creates an unequal distribution of prosperity

Those in most need of credit tend to have the greatest difficulty accessing it. New businesses are perceived as risky – and harsher regulatory requirements further tighten the conditions - so they face high borrowing rates.

While small and medium-sized enterprises (SMEs) in most Eurozone countries experienced an improvement in the availability of bank loans, SMEs in Austria reported a mild deterioration, in contrast to large enterprises.[25]

This produces both inequality of opportunities and of outcomes. Incumbent businesses are prioritised over start-ups, stifling innovation.

Sixty-four percent of Austrians think the area in which they live is a good place for starting a business.[26] This puts it ahead of its CEE peers, like Hungary (48 percent), but behind Western European peers, like Germany (72 percent). The proportion of Austrians who think they can get ahead by working hard is at its lowest point since 2010.[27]

It is important to note, however, that more Austrians think their area is a good place to start a business, from 61 percent in 2011 to 64 percent in 2016. In this respect, authorities' €185 million start-up promotion package announced earlier in 2017 —providing administrative and financial aid—is a helpful, as are greater funds for research and development.[28]

Austrian authorities are making a concerted effort to boost productivity and innovation in their country, but are these policies enough in themselves?

As the forerunning analysis has shown, strengthening social capital is central to enhancing the effectiveness of policy and regulation that promotes private sector development, particularly in terms of business competition and investment freedom.

Austria, having escaped a history of communism, has a higher-than-CEE-average level of social capital. But its overall Social Capital score has plummeted from 2007 to 2016, going from ten percent above to three percent below Germany's level.

Policymakers must also turn their attention to this decline in social capital, rather than lending conditions and regulation alone, if Austria is to create a business environment that delivers more prosperity and does so evenly.

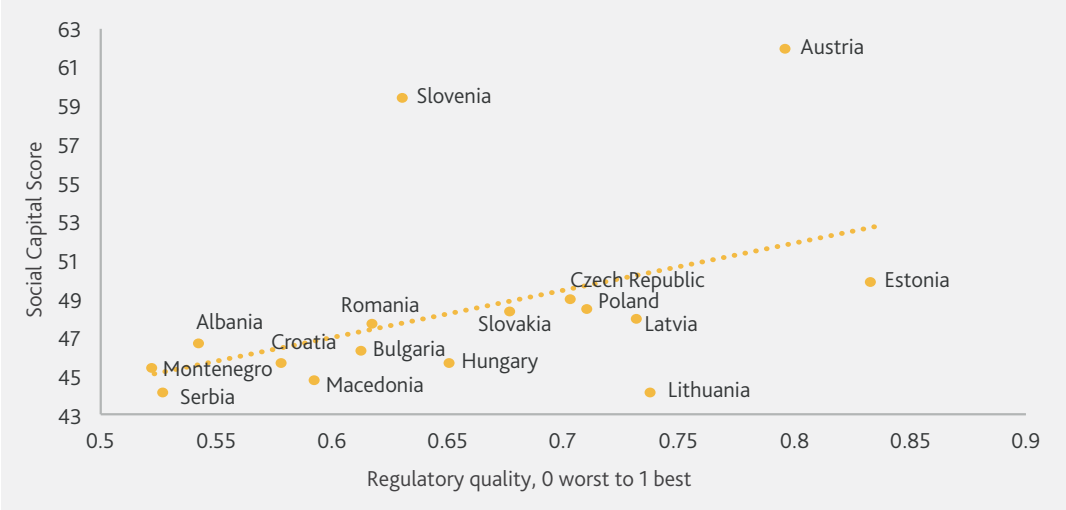

Figure 12: Regulations that promote and permit private sector development are found in environments of strong social capital

Endnotes

[14] The first is the World Bank's Ease of Doing Business Ease of Getting Credit score. It is a distance to frontier score based on the components: 1) strength of creditor and borrower's legal rights (strength of collateral laws for borrowers and creditors, and bankruptcy laws for creditors); 2) depth of credit information; 3) credit bureau coverage; and 4) credit registry coverage. The second is the World Economic Forum's Affordability of Financial Services score. It is based on Expert Opinion Survey: "In your country, to what extent are financial services affordable for businesses? [1 = not affordable at all; 7 =affordable]".

[15] This is the overall R2 of an OLS panel regression of the Business Environment sub-index on the access to credit and affordability of financial services variables, for the CEE sub-sample. Both variables are statistically significant at the one percent level with robust standard errors.

[16] Levine, R. (1997) Financial Development and Economic Growth: Views and Agenda. Journal of Economic Literature 35(2), 688-726.

[17] International Monetary Fund (IMF) (2014), 25 Years of Transition: Post-Communist Europe and the IMF: Regional Economic Issues Special Report, Washington DC: IMF.

[18] This is the World Bank's Domestic credit to private sector (% of GDP) measure. Current year refers to 2015. Peaks: 2011 in Romania, 2010 in Hungary, and 2010 in Austria.

[19] This an OLS regression of the family and community social capital component on the access to credit variable for CEE countries in 2016. The R^2 is 25 percent, and the coefficient on access to credit is -0.6, significant at the five percent level.

[20] These are "no" responses to the 2016 Gallup World Poll question, "In this country, do you have confidence in the each of the following or not? How about financial institutions or banks?". The samples are around 1,000 respondents per country.

[21] This is the "Informal Help" variable in the Social Capital sub-index. It is based on affirmative answers to the Gallup World Poll question, "Has your household sent financial help to another household in last year?" (same country)"

[22] We use the World Bank's World Governance Indicator's definition of "Regulatory Quality" here: Regulatory quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

[23] This is based on an OLS regression of the Social Capital sub-index scores on the regulatory quality variable from the Business Environment sub-index, for the subsample of CEE countries in 2016. The R2 is 21 percent, and the coefficient is significant at the 10 percent level.

[24] These are "yes" responses to the 2016 Gallup World Poll question, "In this country, do you have confidence in the each of the following or not? How about national government?". The samples are around 1,000 respondents per country.

[25] European Central Bank (ECB) (2016), Survey on the Access to Finance of Enterprises in the euro area, October 2015 to March 2016, Brussels: ECB, p. 3.

[26] These are "yes" responses to the 2016 Gallup World Poll question, ""Is the city or area where you live a good place or not for people starting new businesses?". The samples are around 1,000 respondents per country.

[27] These are "yes" responses to the 2016 Gallup World Poll question, ""Can people in this country get ahead by working hard or not?". In 2010, the proportion was 88 percent; 2016, 87percent. In 2009, 78 percent.

[28] See: https://investinaustria.at/en/blog/2017/03/startup-package.php. The measure is coordinated by the state financing bank Austria Wirtschaftsservice (aws).

FOCUS: Austrian Social Capital is in Decline

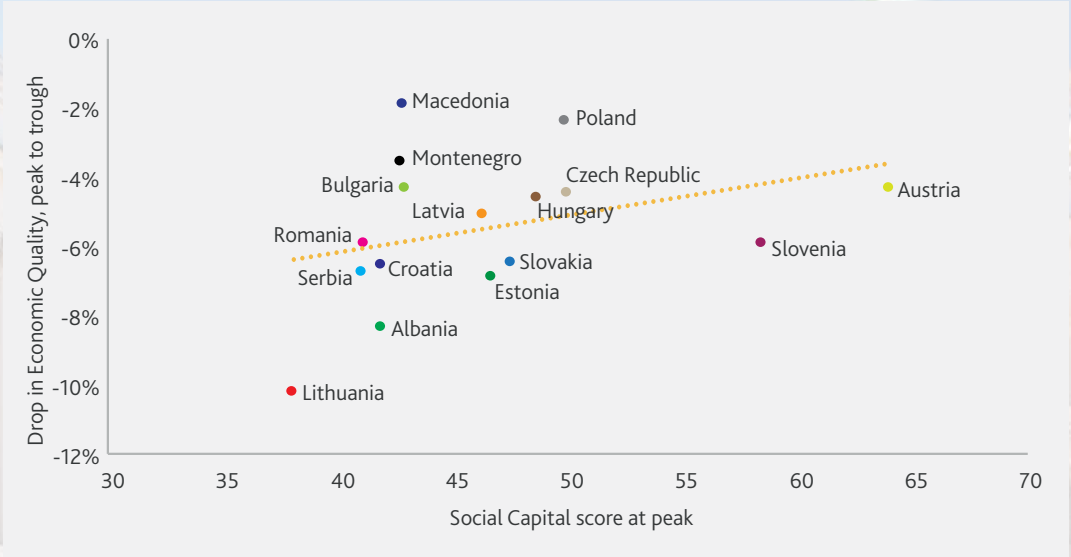

Figure 13: The severity of economic shocks is alleviated by higher levels of social capital before the shock, 2007-2016

From 2007 to 2016, Austria's Social Capital score dropped by 9 percent. Its global ranking in Social Capital went from 2nd to 15th.

Underlying this drop, are declines across the four sub-components of Social Capital – Trust, Family and Community, Civic Engagement, and Civic Participation. It is in Family and Community and Civic Engagement, however, that Austria saw its sharpest declines.

Within Family and Community, the drop is accounted for by a shrinking percentage of households that have sent financial help to another household within Austria. The percentage of households that have done this went from 45 percent to 12 percent between 2007 and 2016. Within Civic Engagement the decline is accounted for by a shrinking percentage of people who have donated money to a charity. The percentage of people who have done this has dropped from 69 percent to 50 percent over the past decade.

Both declines can be explained by Austria's ongoing economic malaise, particularly stagnant household incomes, which both necessitates financial help but also restricts households' ability to offer it. The Prosperity Index shows Austria's Economic Quality global ranking dropped by eight places over the past decade. Its Business Environment has been stagnant over the same period.

The Austrian case raises the question: does social capital really ease economic shocks or does it simply give way? We have already seen that in many CEE countries, low levels of social capital made economic and political reforms difficult. Social capital is needed to ease major economic and political upset, but it can also give way under these forces if they are strong enough. In the Austrian example, an economic shock both drove households to help each other but simultaneously restricted their ability to do so.

Figure 13 plots the severity of each CEE country's economic shock, measured by the peak-to-trough decline in its Economic Quality score, against its level of social capital, measured by its Social Capital score, at the peak. It shows, in general, that countries that entered an economic crisis with high initial levels of social capital experienced a smaller economic shock. Figure 13 indicates that Austria's economic decline was large given its social capital starting point (as it falls slightly below the trend line), but the general tendency implies that it would have been larger still if its initial social capital were weaker.

Governance

Reform without Trust: Governance

When in 1989 Romanians reacted with anger to Nicolae Ceaușescu's final speech, the dictator's own reaction – stunned disbelief, turning quickly into fear – gave us one of the defining moments of the end of communism in Europe. Romanians did not choose Ceaușescu as their leader, but after decades of corruption and mismanagement they forced him out.

Fast-forward to January 2017 and again an angry crowd floods Bucharest. Some 10,000 people protested against a government proposal to pardon thousands of prisoners, seen by critics as a way of weakening anti-corruption efforts. Two weeks later, an estimated 500,000 people protested over six straight days against the government's decree that decriminalised some corruption offences. The government agreed to repeal the decree, but the protestors were not satisfied: they wanted the government, elected only a month earlier, out.

In its last annual corruption report, the European Commission said Romania has a history of "regular attempts to modify the laws incriminating corruption, often without consultation of the key state and judicial institutions in this area".[29] Why is it so hard for a country to move from endemic corruption to good governance?

Weak governance still distinguishes post-communist CEE from Western Europe

Similar patterns of persistent corruption and weak governance characterise Central and Eastern Europe, from the shores of the Black Sea and the Baltic Sea, all the way to the old Iron Curtain that once separated the Visegrad states from democratic Western Europe.

After more than 26 years since the dissolution of the Soviet Union, weak governance still sharply distinguishes post-communist CEE countries, where it varies only in degree, from their Western European neighbours. To see this distinction, it is useful to break governance down into its four main components.

- **Effectiveness:** government's ability to formulate and implement policy and to provide the prospect of social and economic progress.
- **Representativeness:** extent to which governance works for all citizenry, and extent to which voices are heard and given consideration.
- **Predictability:** extent to which policies and laws are clear, predictable, and subject to checks and balances.
- **Transparency:** extent to which public sector management and public services are open to scrutiny.

Table 2 below, where Western Europe's average score is set to 100 across the four components and other regions' are shown as a percentage of Western Europe's score, lays bare CEE's relative underperformance in Governance. This distinction is all the more surprising given many CEE countries have embarked on a range of political reforms,

Region	Effectiveness	Representativeness	Predictability	Transparency
Western Europe	100	100	100	100
East Asia	84	62	82	77
Southeast Asia	87	62	68	75
CEE	79	86	65	73

Table 2: CEE Lagging in Good Governance

under strict and specific legal, policy, and institutional requirements stipulated by the *acquis communautaire*, ahead of and during their accession to the European Union. Despite these reforms, CEE's average Governance score is still closer to that of Southeast Asia or Latin America than Western Europe.

Governance is weak and reform is hard when trust is low

A country's political system is a means of organising collective life; of collecting and allocating public resources in order to advance the public good. When the public good itself is ill-defined or disputed due to distrust between citizens and between politicians and citizens, good governance is impossible: it depends on strong social capital (see figure 14).

Lech Wałęsa, the leader of the Polish Solidarity Movement that started the revolutionary tide across the communist bloc, said in his 1983 Nobel Lecture, "it is hardly possible to build anything if frustration, bitterness, and a mood of helplessness prevail".[30]

Strong and resilient social ties, coupled with mutual trust among citizens and between the governing group and the public, help improve governance and drive progressive reforms in various ways.

Trust in institutions and between citizens provides a basis for reforms by facilitating communication and negotiation between actors, and by promoting an understanding and acceptance of public policies.

Similarly, when citizens have confidence in the impartiality of the rule of law, they will play by the official 'rules of the game', rather than engage in corruption, setting an example for their fellow citizens and upholding the rule of law itself.

This is why we observe a highly significant positive correlation between trust and the rule of law across CEE over the past decade.[31] Austria has the strongest rule of law in the region and the highest level of trust while Serbia has the weakest rule of law and the lowest level of trust.

Conversely, with a deficit in generalised trust, and perceptions that public officials and politicians are willing and able to take advantage of their positions, citizens will resort to informal networks built upon informal deals. Citizens, unable to trust each other and their officials, will no longer play by the official 'rules of the game', and corruption becomes endemic. While Austrians and Estonians have very low perceptions of public sector corruption, putting them both at the Western European average, other CEE countries fall far behind: Romania is at the same level as Oman and Bulgaria at the same level as Belize.[32]

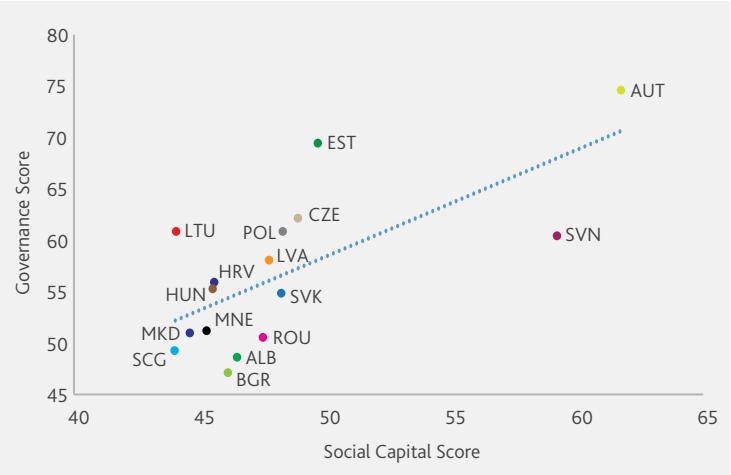

Figure 14: Stronger Social Capital is associated with better Governance

This is why we observe a tendency in the region for people to lose faith in "getting ahead by working hard" as their perceptions of public sector corruption increase (see figure 16), and also a positive and highly significant correlation between trust and public sector transparency across CEE over the past decade (see figure 67).[33] Here again Austria has the lowest perceptions of public sector corruption in the region and the highest level of trust while Serbia has the highest perceptions of public sector corruption and the lowest level of trust.

All citizens understand they would collectively gain from stamping out corruption, but as they cannot trust each other to refrain from corrupt practices, they stand to lose individually from not paying or demanding bribes. No one individual wants to be the "sucker" who operates legitimately, who pays all their taxes and claims all their income, when they suspect no one else is.

Collectively, reforms stall and governance stagnates. This is what some authors have called the "social trap".[34]

Moving from endemic corruption to strong governance requires escaping this trap. It requires citizens to trust each other and their officials; for them to work together collectively rather than individualistically.

Increasing civic mindedness is needed for better governance

In practical terms, civic participation is one escape route from the social trap. Individuals form a sense of "civic mindedness" based on reciprocity. Enough participation of this kind will establish reciprocity and civic mindedness as a social norm.

However, many CEE countries with low Governance scores have low levels of civic engagement, especially in activities

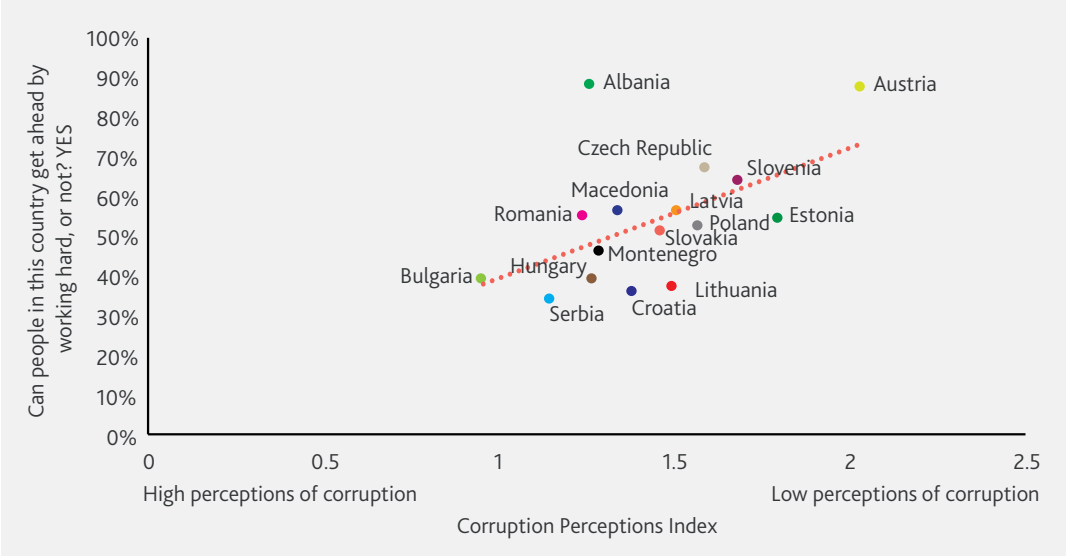

Figure 15: The Social Trap: when people perceive high levels of corruption they lose faith in fair play

such as charitable donations and volunteering. In the Czech Republic, for example, 14 percent of people volunteered their time to an organisation in the past year compared to 27 percent for Germany or 33 percent for the United Kingdom.[35] The numbers for Hungary and Romania are, respectively seven and nine percent.

Bringing these numbers up will go a long way in establishing a norm of reciprocity. But there are also other ways out of the trap.

Political participation is another way to better governance

Political participation, voting in particular, functions as the principal link connecting ordinary citizens and the political elite. A functioning election cycle is where the former signal their expectations and concerns over the management and direction of their country, and for the latter to communicate and explain their strategy and proposed policies in response.

Yet it is here the siren has been sounded the loudest. Central and Eastern Europeans have been consistently less inclined to turn out at national elections than their counterparts in the west. The difference in voter turnout rates, adjusted for countries' democracy rating, between CEE (61 percent) and Western Europe (69 percent) has been hovering above eight percentage points over the past decade.[36]

Moreover, the region's voter turnout rate is falling, and falling even faster with the younger generation. This partly reflects frustrations about the irresponsiveness of official political channels.

Consequently, young citizens are increasingly turning to more direct yet radical measures to express their opinions, and emotions: protests, demonstrations, and riots. This is both good and problematic.

It is good because protests are a sure sign of a desire to change the current situation. The 500,000 protesters we saw in Romania want change for the better. Neither is this hope restricted to Romania, or to the present. There have been protests against corruption and cronyism in Prague (November 2010), Sofia (June 2013 to July 2014), and across Poland (December 2016).

These protests show us, in short, that Central and Eastern Europeans are choosing what the late economist Albert O. Hirschman called "voice" over "exit".[37] That is, they are choosing to stay in their home countries and "voice" their demands and proposals for change rather than simply "exit" or, in another word, emigrate.

It is problematic because the form of "voice" taken – mass demonstrations and protests – is unsustainable. It is an extreme response to a difficult and frustrating situation. Central and Eastern Europeans should not have to take to the streets with such vigour and so frequently at each incident.

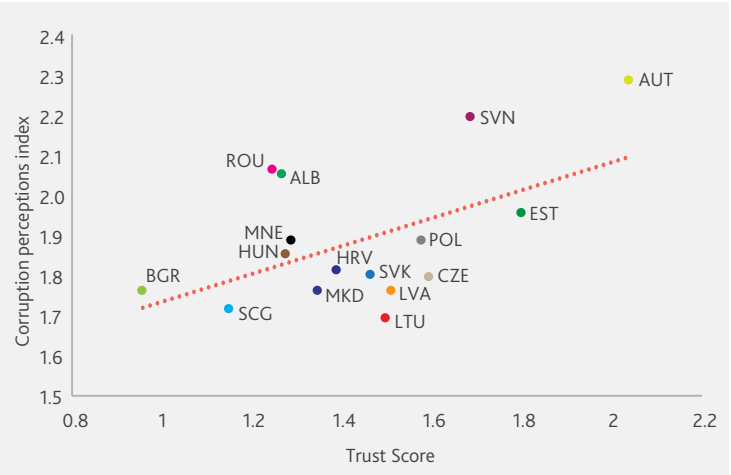

Figure 16: High trust is associated with low public sector corruption in CEE

Governments should encourage rather than restrict civic participation

Facing greater demands for wider political participation and a flourishing civil society, governments in the region should embrace rather than restrict the situation. It as an opportunity to improve their own standing.

On the political front, governments should strive for the restoration of public confidence and trust in state institutions and officials through a range of measures. These include better defined boundaries of power and responsibilities between governmental organisations; the introduction of independent anticorruption organisations with earmarked funding; reformed recruitment and examination system for state bureaucrats; enhanced external scrutiny from general population and free media and; improvements in the interactions and communication between public and civil sectors. An important case in this respect is Estonia.

Estonia is a great example of how a country can use information technology to tackle public sector corruption.[38] The government first gave all households access to e-government services, and provided public internet access points across the country. It then addressed middle-man bribe taking by making almost all interaction with the government to be done online, and by publishing online public procurement data. These initiatives also acted to reduce bureaucracy. Estonia now has the 2nd best performance in CEE, after Austria, in public sector corruption.[39]

The accumulation of social capital, both the bonds between citizens and links between citizens and the government, is equally crucial. The principle should be that, civil society, as long as it is organised and operating according to the rule of law, is something to be encouraged rather than suppressed.

More than a decade since most of the countries in the region joined the EU, the prospects for good governance should no longer rely on external pressures for convergence to the EU standards, but rather come from within. This is especially true at a time when the EU faces some of its greatest challenges yet.

Endnotes

[29] European Commission (2017) REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL On Progress in Romania under the Co-operation and Verification Mechanism, COM/2017/044 final.

[30] Walesa, L. (1983), The Nobel Peace Prize 1983 – Nobel Lecture.

[31] This is based on an OLS panel regression of trust (Table 1) on the rule of law (World Bank Governance Indicators), with country fixed effects and robust standard errors, restricted to the CEE subsample. The coefficient on trust is significant at the one percent level, and the R^2 is 24 percent.

[32] This are Transparency International's Corruption Perceptions Index results.

[33] This is based on an OLS panel regression of trust on the Corruption Perceptions Index, where higher values indicate lower corruption perceptions, with country fixed effects and robust standard errors, restricted to the CEE subsample. The coefficient for the Corruption Perceptions Index (public sector transparency) is significant at the 10 percent level, and the R^2 is 0.31.

[34] Rothstein, B. (2005). Social Traps and the Problem of Trust. Cambridge: Cambridge University Press.

[35] These are "yes" answers to the Gallup World Poll survey question, "Have you volunteered time to an organisation in past month?". Response samples are around 1,000 people per country. Data refer to 2015/6.

[36] This turnout in most recent national legislative elections (% of registered electors), rolling average of the past seven years, adjusted by countries Polity2 Democracy level.

[37] Hirschman, A.O. (1970) Exit, Voice, and Loyalty: Responses to Decline in Firms, Organisations, and States. Cambridge MA: Harvard University Press.

[38] Harvard Business School, Technology and Operations Management, e-Governments vs. Corruption. The case of Estonia, November 18, 2016.

[39] Transparency International Corruption Perceptions Index. Estonia's score is 70 to Austria's 76.


A NÉMET MEGSZÁLLÁS ÁLDOZATAINAK EMLÉKMŰVE
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Case Study – Romania


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Romania's Unfinished Transition

People protests are trying to rid Romania of an insidious system of endemic corruption and power inherited from the former communist regime

It was after 10pm. March 2006. A few lights were still on in Romania's justice ministry. I made my way to Monica Macovei's office.

Macovei, a lawyer specializing in human rights, had been asked by the then Prime Minister Calin Tariceanu to quit her job in Sarajevo and return to Bucharest. Her mandate: to reform the judicial system with the aim of stamping out corruption. "We are talking about the classical form of corruption," Macovei said in her dimly-lit office tucked away in a giant neoclassical-style building in the heart of Bucharest's administrative district. "It is the abuse of public funds to make profit. This spills over into economic crimes because, at the end of the day, a bribe is given for something in return."

But why such persistent corruption in a country that was preparing to join the European Union in 2008 and whose citizens had resorted to people power that had violently overthrown the Ceausescu regime in December 1989?

Across the other side of town, Marius Oprea tried to provide some answers.

Oprea had just been appointed the first director of the Institute for the Investigation of the Crimes of Communism. Until then, successive governments had blocked any attempts to delve into the country's past, particularly the role played by the ruthless Securitate, or secret police. "It would have meant condemning themselves," Oprea told me. "Under a different guise, the Communist Party and the Securitate was always in charge here since 1989," he added.

Even though Romania joined the EU in 2008, corruption and the abuse of power continues almost unabated. This is despite the plethora of institutions set up under pressure from the EU to combat corruption, increase transparency and ensure that public procurement tenders are not pre-decided.

Bianca Toma from the Romanian Center for European Policy says the corruption is ubiquitous. Students pay bribes to professors in order to get good grades. Sick people have to pay bribes to make an appointment before even seeing a doctor. She said the old networks continue as before, with a younger generation of those elites perpetuating it.

These networks also affect the way of doing business. "You should try doing business here and negotiating contracts," said a banker who, understandably requested anonymity.

"A minister can say yes to an investment idea. But then it is blocked by lower-ranking civil servants or a new minister. Either they don't want to take responsibility in case they make a mistake, or they receive a bribe not to implement a decision," he added. "If you ask me, there's a continuity of non-governance. A continuity of non-responsibility."

This continuity of non-governance is linked to a continuity of the mentality and culture that existed under the Ceausescu era. It was a culture based on spying and fear. Compounding that was the existence of shortages. When Ceausescu decided in the early 1980s to pay off the country's external debts, imports dried up and anything that could be exported was shipped out of Romania. Heating and electricity was rationed to just a few hours a day. Ordinary people paid bribes for almost everything from medicine to batteries for flash lamps. Corruption and bribes became a way of daily existence, of survival.

Food was particularly scare. I won't forget the hungry crowds rushing to the city's main outdoor market that has been stuffed with the finest meat, fruit and vegetables in order to impress the former Soviet leader Mikhail Gorbachev during his visit to the capital in May 1987. Pandemonium broke out as soon as his entourage left. Within minutes the stands were emptied. Shortages and corruption fed off each other.

There are no material shortages today.

Instead, there is a fundamentally different kind of shortage which the banker referred to: a shortage of good governance. This is manifested on a day-to-day level. The public sector is not delivering on the most basic services, such as hospitals and education, transportation, infrastructure and safety standards.

"It seems that people's dissatisfaction with public services, constant appearances of high-profile corruption cases, moderate press freedom all feed the pessimism that things are not going in the right direction," according to a joint study by the OECD and the Romanian Ministry of Justice.

The European Commission has been constantly monitoring Romania's progress in fighting corruption and introducing good governance. It recently stated that public service delivery was hampered by low efficiency of public administration, a complexity of procedures and corruption, while red tape, legal uncertainty and judicial inefficiency "remain challenging" for companies.

In reaction to this deficit of good governance is the growing role of citizens and people power. Both had remained largely dormant after the "overthrow" of the Ceausescu regime in December 1989. That revolution had been

hijacked by the Securitate and the Communists who, as Oprea said, simply changed their political clothes. During the 1990s, the old guard ran the country. Transformation to a market economy or a political system based on the rule of law and accountability postponed.

During the 2000s, non-governmental organizations began to crop up. They campaigned for more transparency, an end to the culture of bribes and impunity. The traction was limited.

Then came the election in November 2014 of Klaus Iohannis, an ethnic German who ran a campaign based on fighting corruption. It hit a raw nerve with young but also old Romanians. Those working in other EU countries lined up for hours outside embassies and consulates to vote for someone who was prepared to challenge the status quo.

That growing disgust with corruption by citizens was tested in October 2015 when dozens of young people died after a fire broke out in a disco in Bucharest. It unleashed huge public anger. At least 20,000 people took to the streets demanding the resignation of Prime Minister Victor Ponta.

Ponta had already been indicted the previous July of tax evasion and money laundering and making false statements while practicing as a lawyer back in 2007. But no matter. He had refused to resign. It was that arrogance, compounded by the tragedy of the fire that brought so many people out onto the streets. In a matter of days, Ponta resigned. It was as if the public had had enough of corruption and abuse of public office.

Despite this shift among the public that wanted politicians to be accountable and subject to an independent judiciary, the elites seemed immune to this change in attitude. They continued to assume a politics of entitlement.

"There's a continuity of the old system," Macovei told me in a recent interview. "The old links have been preserved," Oprea said. "The old networks protect each other."

Indeed, such is their right to power, if not their disregard of their office to serve, that in February of 2017, an emergency law was pushed through by the governing Social Democratic Party. If implemented, the legislation would have decriminalized corruption of less than €45,000 ($48,000), which is a very substantial sum for most Romanians. That decree meant that the party's leader, Liviu Dragnea, would have benefited. He is facing fraud charges involving a sum of €24,000 ($26,000). He is not alone.

This time round, hundreds of thousands of Romanians took to the streets, not only in Bucharest but in other cities and towns to protest the abuse of power and corruption.

On February 5, the government scrapped the decree but will submit a revised bill to the parliament. The protesters, who called on Romanian Prime Minister Sorin Grindeanu's government to resign, are not giving up. Too often, they have seen how successive parliaments have run roughshod over the rule of law.

"What you still have in Romania is a stubborn continuity of the old system," said Macovei, a member of the European Parliament since 2009 after she was sacked as justice minister. But, she added "don't underestimate the role of the private sector."

Over the years of this flawed transition, young people opted for the private sector. Macovei said they made it their comfort zone. They didn't want to get interested in politics. "But now they realize they have to get involved. They can no longer stand aside. They have to get out of the comfort zone. That's the hope of the country. They want to finish the transition, the transformation of the country."

Judy Dempsey is a non-resident senior fellow at *Carnegie Europe* and editor-in-chief of *Strategic Europe*

Looking Ahead

The Future of Central and Eastern European Prosperity

Central and Eastern Europe's future might look bleak. We have seen that the region has large deficits in its Governance and its Business Environment and, crucially, its Social Capital. In the news, we see how the institutions of checks and balances, particularly in Hungary, Moldova, Ukraine, and Poland, are being tested. The EU, once a catalyst for positive economic and political reform in the region, is now under severe stress, and deeper integration seems unlikely. Global economic growth is forecast to increase only marginally for the next five years.[40]

Yet among this bleak picture, protestors out in the streets of Bucharest, Sofia, across Poland and Ukraine, and a blossoming civil society, offer us hope. So do recent developments in the region's EU accession countries.

The European Union has been a catalyst for change in CEE, but is now under pressure

Romania's civil society, an integral part of a country's social capital, has blossomed since it joined the EU a decade ago. As Judy Dempsey at Carnegie Europe writes, 'individuals, especially the young, feel empowered. EU membership has given Romanians the chance to travel to and work in other EU member states and see how accountability works.' It is not just Romanians who have reaped these benefits or just EU member states.

Ever since their accession to the European Union started, the four candidate countries in the region – Albania, Macedonia, Montenegro, and Serbia – have seen their social capital rise dramatically (see figure 17). Accession programmes for these countries involved moving towards more transparent and inclusive civil society organisations.

In Albania, for example, the European Commission recommended that this should be done by the promotion of civil society organisations and by strengthening the capacity of citizens and organisations to participate actively

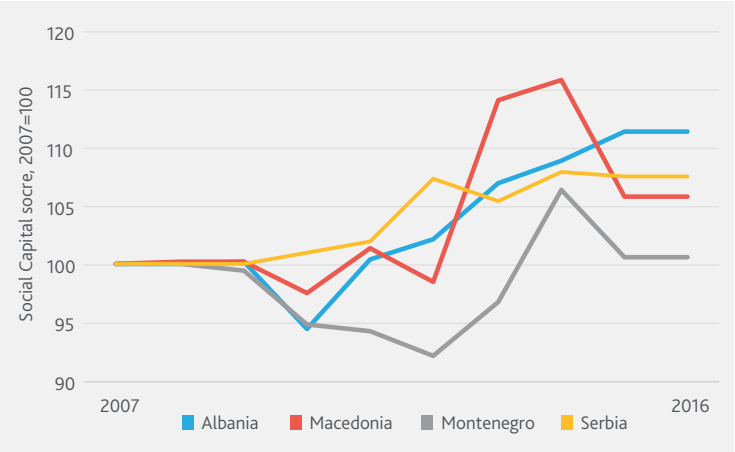

Figure 17: Social Capital in EU accession countries is rising

in social dialogue. In Serbia, the European Commission urged the government to implement an Anti-Discrimination Strategy that builds a society in which everyone is equal regardless of their gender, sexual orientation, origin, or religion. In Macedonia and Montenegro, the European Commission's European Economic and Social Committee is funding civil society organisations that build horizontal links across society, that monitor public institutions, and that protect fundamental rights.

Now the EU faces some its greatest challenges: Britain's exit, pressures from refugee inflows, ongoing economic crisis in Greece, and the emergence of political parties that threaten the EU's integrity. In this context, CEE can no longer rely on EU incentives and pressure for positive change. That change must come from within the region itself. If they are properly harnessed, that change can come from its young citizens.

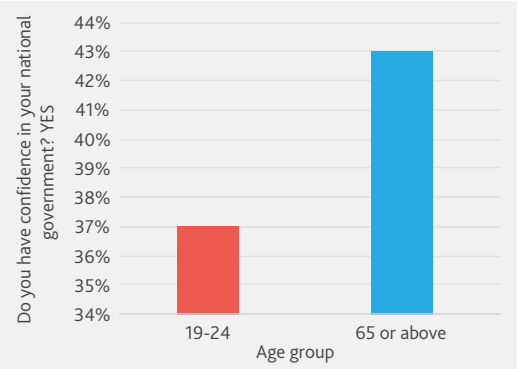

Figure 18: Young Central and Eastern Europeans are less content with the political system in their countries

The young are driven, more pro-business, better educated, and have higher social capital

Young Central and Eastern Europeans are dissatisfied with their countries' governance. While 43 percent of elderly Central and Eastern Europeans (65 and above) said they had confidence in their national government, less than 38 percent of the younger population (between 19 and 24) expressed the same optimism (see figure 18).[41]

Young Central and Eastern Europeans have what it takes to move their region forward: social capital. Each age group, compared to those aged 65 or above, shows higher trust in their fellow citizens (see figure 19). For instance, only about 30 percent of people above 65 years old helped a stranger in the past 12 months while nearly half of those under 25 reported doing so.[42] This is the kind of trust that is in aggregate so low across the CEE (see table 1).

Higher levels of trust among the young have pushed civic

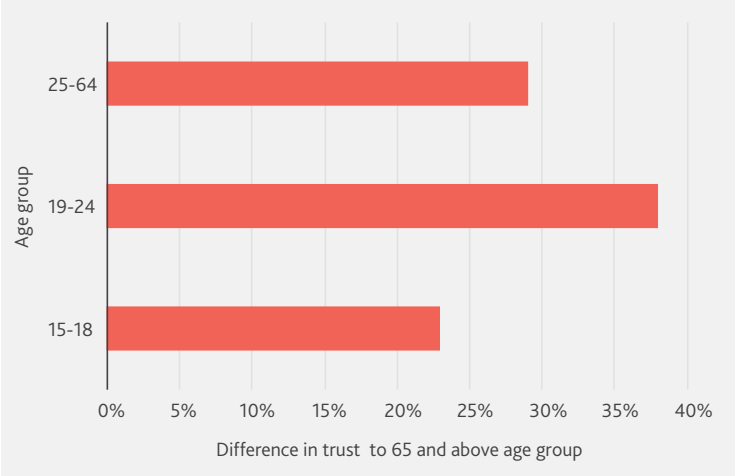

Figure 19: The young have more trust in their fellow citizens than the old

engagement up to levels not seen in previous generations. Under-25s are the most generous age group in giving up their time to help those in need and to help build a better society (see figure 20). Nearly one-fifth reported having done so in the past 12 months, more than double the proportion among over-65s.[43] Civic engagement is key to building the region's social capital.

Young Central and Eastern Europeans know that successful businesses are key to their countries' success. People who lived through communism, when the state owned most businesses, tend to think less of private business owners. Their offspring, however, increasingly think of business success as something to be proud of and something to aspire to (see figure 21).

Put together, these characteristics – a young generation disappointed by their domestic system, that is more cohesive and confident in the citizenry, and that is pro-business – is the region's way to internally-generated success. Many are considering emigration, however.

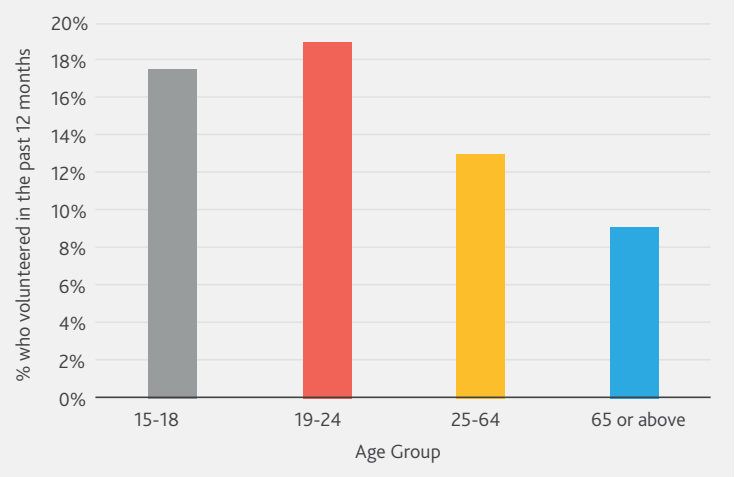

Figure 20: Higher volunteering rates among the young indicate a greater propensity for civic engagement and participation

Brain drain or brain gain?

The EU has provided the young with both the impetus to change their home countries along with the ability, through the principle of free movement, to leave. It has given them both "voice" and "exit", in Hirschman's words.

As opportunity at home is not growing as fast as that in Western Europe, The Economist,[44] among others, argued that CEE is facing a "brain drain". Our data show that almost six in ten teenagers would consider permanently moving to another country (see figure 22).[45] The inclination to emigrate is also high among young adults, at around 44 per cent. It is higher still among the highly educated. Some 44 per cent of under-25s who attended university want to move permanently to another country.

This movement, however, can present opportunity. Large diasporas, as during communism, are sources of hope, experience, and wealth.

Diasporas are linked to their home countries through remittances, transmitting material wealth. Remittances received by Hungary from Germany totalled $893 million in 2015, around $5,162 per Hungarian immigrant resident in Germany.[46] Poland received $1.2 billion from its immigrants to the United Kingdom, around $1,707 per immigrant, and $2.2 billion from its immigrants to Germany, around $1,140 per immigrant.

They are also linked to their home countries through an extensive European infrastructure network and through cyber-space, bringing back and transmitting new ideas and new learning. Diasporas and return-migrants have played an important role in supporting the region's blossoming civil society, for example.[47]

Fully considered, young, educated, high social capital migrants exert pressure for change on their home governments, through the threat of "exit", while also providing the means and know-how for change, through their remittances and acquired skills and knowledge. The young continue to be a resource and can be an even greater one, if properly engaged in civic forums.

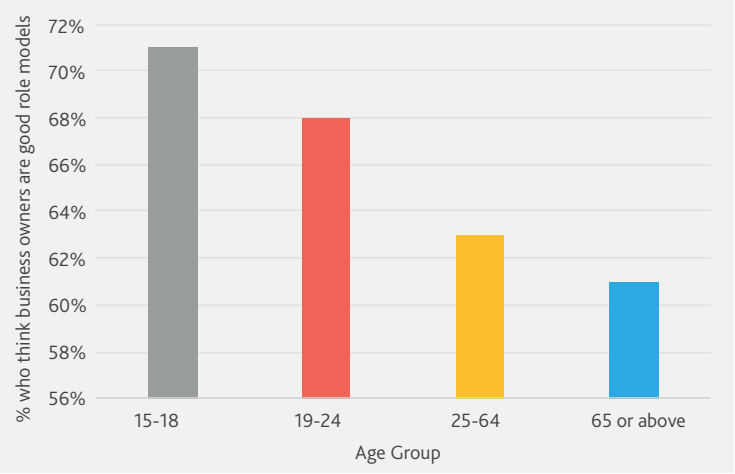

Figure 21: Proportion of people who think business owners are good role models declines with age

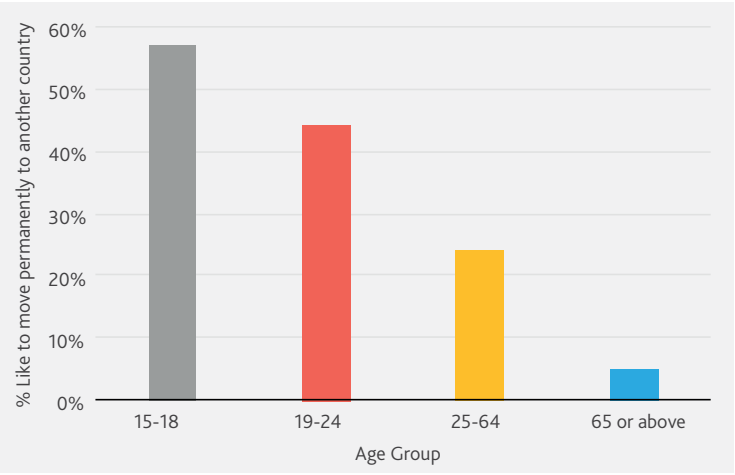

Figure 22: Younger Central and Eastern Europeans are more likely to consider permanently moving to another country.

Endnotes

[40] International Monetary Fund, World Economic Outlook, October 2016, World Gross Domestic Product, constant prices, percent change. The number for 2017 is 3.44, going to 3.78 in 2021.

[41] These are "yes" responses to the 2016 Gallup World Poll question, "In this country, do you have confidence in the each of the following or not? How about national government?".

[42] These are "yes" answers to the Gallup World Poll question, "Have you helped a stranger or someone you didn't know who needed help in past month?".

[43] These are "yes" answers to the Gallup World Poll question, "Have you volunteered time to an organisation in past month?".

[44] The Economist, The old countries: Eastern Europe's workers are emigrating, but its pensioners are staying, January 19th, 2017.

[45] These are "Like to move to another country" responses to the Gallup World Poll question, "Ideally, if you had the opportunity, would you like to more PERMANENTLY to another country, or would you prefer to continue living in this country?".

[46] Migration Policy Institute (2017), Data Hub - Bilateral Remittance Flows: http://www.migrationpolicy.org/programs/data-hub/charts/bilateral-remittance-flows.

[47] Banulescu-Bogdan, N. (2011) The Role of Civil Society in EU Migration Policy: Perspectives on the European Union's Engagement in its Neighborhood, Washington DC: Migration Policy Institute.

Recommendations to grow CEE's prosperity

1

LINK BUSINESS POLICY WITH SOCIAL CAPITAL REFORM

Reform packages aimed at kick-starting the region's business environment, like Austria's recent start-up package or easing credit access, and reforming political processes, are commendable. To make such reforms fully successful, policymakers should also turn their attention to improving social capital foundations. The following recommendations offer ideas.

2

REBUILD INSTITUTIONAL TRUST

Rebuild trust in state institutions starting from systematic anticorruption measures. This should include the reassertion of judicial independence, enhancing independent auditing, and an ombudsman with financial and policy support. Institutions must be open to media and public scrutiny as are public procurement procedures. There must also be stricter rules on political funding. A model worth following is the Special Investigation Service in Lithuania. It has a broad-based anti-corruption mission, a relatively autonomous institutional identity directly accountable to the President and the Parliament, and an ability and willingness to gain international cooperation.

3

CURB BUREAUCRATIC CORRUPTION

Reduce bureaucratic graft and embezzlement by clarifying functions and responsibilities. This should include both slashing unnecessary procedures and setting up transparent bureaucratic recruitment and examination rules. Recent successful experiences includes Estonia's e-government experiment, which uses technology to coordinate governance and public services, reduce bureaucratic procedures, and narrow distance between officials and citizens. The results have been enhanced bureaucratic efficiency, a dramatic decline in bribery, and restored institutional trust.

4

IMPROVE AND CLARIFY REGULATIONS ON NGOS

Encourage civil association and free speech under the rule of law. The government should improve regulation for NGOs by providing a transparent, predictable, and rules-based environment. Here again Estonia provides a promising example. Under its current legal system, NGOs are classified into two categories – non-profit associations and foundations – and both are regulated with laws which provide clear definitions and permissible activities. NGOs are also differentiated from political parties, and the Income Tax Act offers them tax reliefs and incentives.

5

INVITE CIVIL SOCIETY TO SHOULDER MORE RESPONSIBILITES

Encourage NGOs to diversify their functions. This includes creating space for them to assist in holding government to account, participate in policy making, and to fill up gaps between government capacity and social needs, such as social care services. Slovakia established the Council of the Government for Non-Governmental Organisations specifically designed to improve communication between government and civil organisations, as well as to encourage them to participate in government administration and decision-making processes.

6

ENCOURAGE CIVIL DELIBERATION

Strengthen deliberative democracy through public meetings or virtual online groups where citizens can discuss and debate public policy issues. This could foster generalised trust among citizens and between citizens and politicians. A recent case of voluntarily organised civic forum is the "Living Memorial" in Budapest, where citizens are called on to gather together to share their memories of the country's contemporary history and commemorate family who died during the war.

7

PROMOTE INTERNATIONAL CIVIL COOPERATION

Cultivate and improve networks between domestic and international NGOs to enhance international cooperation and knowledge exchange. An important platform has been the European Civic Forum, where civil organisations in Europe regularly convene and discuss experience and development in the promotion of civic participation and civil dialogue in both their home country and at European level.

8

TAKE ADVANTAGE OF DIASPORA AND EMIGRANT TALENTS

Central and Eastern Europe must not only provide their young, educated, and more reform-minded citizens with opportunities at home, but they must also exploit the feedback effects of emigration. Returning migrants can bring back skills and work experience needed to boost local economic growth. Expatriates who remain abroad can contribute money through worker remittances and the transfer of the knowledge they acquire abroad. Already CEE countries have been working on this area. The Lithuanian government in 2012 launched a pioneer project "Junior Professionals Programme", which aimed at attracting young professionals and students living abroad to come back to the country, with provision of jobs in the public sector. Noticing the programme's success, many other countries have been following suit. More efforts should be made in this area to bring talents and investment back into the domestic private not only public sector.

Methodology of the Prosperity Index

The Legatum Prosperity Index is a framework that assesses countries on the promotion of their citizens' flourishing, reflecting both wealth and wellbeing across nine pillars of prosperity and 104 variables. It captures the richness of a truly prosperous life and with it seeks to re-define the way we measure national success, changing the conversation from what we are getting to who we are becoming. This makes it an authoritative measure of human progress, offering a unique insight into how prosperity is forming and changing across the world.

A nation's prosperity has traditionally been measured by macroeconomic indicators of wealth such as average income per person, GDP per capita. In moving "beyond GDP" to cover both wealth and wellbeing, and not just one or the other, the Prosperity Index faces challenges that the Legatum Institute has striven to meet with academic and analytical rigour over the past decade.

This short methodological overview offers the reader an understanding of how the Prosperity Index has is constructed. It is constructed by combining established theoretical and empirical research on the determinants of wealth and wellbeing, and with the input of academic and policy expert advisors.

We endeavour to create an Index that is methodologically sound. To that end, we also publish a full methodology document provide the reader with all the information required to understand the Legatum Prosperity Index in a way that is transparent, useful, and informative. For more information on our methodology please refer to the 2016 Methodology Report published on www.prosperity.com.

Step-by-step guide

1 Selecting the variables

Starting with the academic literature on economic development and wellbeing, we identified over 200 variables that have an effect on wealth and wellbeing. We refined this list down to 104 variables by selecting only the variables that displayed a statistically significant and economically meaningful relationship with at least wealth or wellbeing. As a final check on our list of 104 variables, we consulted with a group of academic and policy experts who advised us on the reliability data sources, the credibility of variables' measurement, and the correct form in which to express these variables. We distributed these variables across nine sub-indices.

2 Standardisation

The variables in the Index are based on many different units of measurement such as numbers of individuals, years, percentages, and ordinal scales. These different units need to be normalised for comparison between variables and countries to be meaningful. A distance to frontier approach is employed for this task. The distance to frontier approach compares a country's performance in a variable with the value of the best case as well as that of the worst case across the entire sample of the 149 countries covered by the Index. As a result, the country's relative position can be captured by the distance to frontiers score generated.

3 Variable weights.

Each variable is assigned a weight, indicating the level importance it has in affecting prosperity. Weights fall along four buckets: 0.5, 1, 1.5, and 2. Each variable by default is weighted as 1, and based on their varying significance to prosperity their weight may be adjusted downwards or upwards accordingly. For example, a variable with a weight of 2 means that it is twice as importance in affecting prosperity as most other variables. Weights were determined by three factors, ordered according to priority: (1) the relevance and significance of the variable regarding the accumulation of material wealth and the enhancement of wellbeing as informed by the academic literature; (2) expert opinions offered by the Index's special advisors; and (3) the degree of compatibility with the Legatum Institute's view of prosperity as human flourishing across wealth and wellbeing.

4 Pillar scores

In each of the nine pillars, variables' distance to frontier scores are multiplied by their weights and then summed to generate countries' pillar scores, and the countries are then ranked according to their scores in each pillar.

5 Prosperity Index score

The Prosperity Index score is determined by assigning equal weights to all nine pillars for each country. The mean of the nine pillars' scores yields a country's overall Prosperity score. The overall Prosperity Index rankings are based on this score.

What's in the Index?

Pillars

Economic Quality. The Economic Quality pillar measures countries' performance in structural policies, economic satisfaction and expectations, distribution of prosperity, engagement, and production quality and diversity.

Business Environment. The Business Environment pillar measures these factors in the following categories: access to infrastructure like the Internet, transport, and to credit, business, clear and fair regulation, and perceptions of meritocracy and opportunity.

Governance. The Governance pillar measures countries' performance in three areas: effective and accountable government, fair elections and political participation, the rule of law, and the level of a country's democracy.

Education. The Education pillar measures countries' performance in four broad areas: access to education, quality of education, human capital, and competitiveness.

Health. The Health pillar measures countries' performance in three areas: basic health outcomes, health infrastructure and preventative care, and physical and mental health.

Safety & Security. The Safety & Security pillar measures countries' performance in three areas: national security, personal precariousness, and personal safety.

Personal Freedom. The Personal Freedom pillar measures countries' performance in two areas: individual freedom and social tolerance.

Social Capital. The Social Capital pillar measures countries' performance in three areas: social cohesion and engagement, community and family networks, and political participation and institutional trust.

Environment. The Environment pillar measures countries' performance in three areas: quality, openness, and preservation.

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We encourage you to share the contents of this document. In so doing, we request that all data, findings, and analysis be attributed to the 2017 *Central and Eastern Europe Prosperity Report*.

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@ProsperityIndex
@LegatumInst

Unless otherwise stated, all data are from the Legatum Prosperity Index. All data sources can be found in the methodology report and online at www.prosperity.com.