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The Central and Eastern Europe Prosperity Report

Smart strategies to further improve
economic and social wellbeing

2018

CREATING THE PATHWAYS FROM POVERTY TO PROSPERITY

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We do this in three ways:

Our **Centre for Metrics** which creates indexes and datasets to measure and explain how poverty and prosperity are changing.

Our **Research Programmes** which analyse the many complex drivers of poverty and prosperity at the local, national and global level.

Our **Practical Programmes** which identify the actions required to enable transformational change.

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Erste Group is the largest banking group in Central and Eastern Europe with EUR 230bln in assets and serving more than 16 million customers in Austria, the Czech Republic, Slovakia, Romania, Hungary, Croatia, and Serbia. The group's commitment to spreading prosperity across the region is rooted in its 200-year old founding history as a savings bank for the unbanked. Erste champions financial literacy and sustainable growth in the region through its Social Banking programme that is providing traditionally unbanked groups with loans, money advice, business training and mentoring. Since launching the Social Banking programme in 2016, Erste has financed around 2,500 entrepreneurs and almost 400 non-profits and social enterprises, creating more than 5,000 new jobs across the region.

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CONTENTS

Foreword	2
Executive Summary	5
Introduction	8
Focus of 2018 Report: Economic Foundations	12
Three prosperity zones of Central and Eastern Europe	15
Personal Experience of Prosperity	18
Governance and the Single Market	28
Trade & Competitiveness	36
Enterprise and Digitalisation	50
Finance and Investment	58
Methodology	61
About the Author	63

FOREWORD

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A generation has passed since the first glimmerings of a political spring behind the iron curtain; for example in Poland with Solidarnosc and in the Soviet Union with Glasnost. Indeed it has been almost thirty years since new and newly democratic nations burst forth, promising an end to decades of isolation, stagnation and repression. The immediate agenda for these transition economies was clear—to build democracy, re-establish the basis for economic growth, and integrate into the global economy and community. As this report makes clear, for many countries of Central and Eastern Europe (CEE), these goals have been, to a greater or lesser, extent achieved. But in the intervening period the world has become a more complex place. New digital technologies and artificial intelligence combine with the consolidation of global supply chains to threaten European jobs and prosperity. The European Union (EU), into which many CEE countries placed their faith, is wracked by issues around migration and deeper integration. The economies of the CEE region thus now face their next set of challenges. This Report provides a summary of what has been achieved in the region thus far, and an evaluation of how to address the challenges ahead.

Let us begin with the achievements. After the major recession inaugurated by the change in economic system from planning to markets, CEE has seen strong and sustained economic growth, with real GDP per capita in the strongest economies rising by more than 800% over the past twenty years, and considerable expansion in GDP, prosperity and living standards, even in the slower-growing countries. This growth has been sustained and is perhaps the fastest and longest in the history of these countries. Legatum has developed its Prosperity Index which has a broader interpretation of human wellbeing beyond the GDP measures. This Report shows, on the basis of these indicators, that CEE is thriving; indeed as a single country, CEE would be the 38th most prosperous in the world, in line with Chile, South Korea and Israel. The region also scores well in terms of an inclusive society and empowered people, with a high rank for safety, security and education.

Even so, the pace of catch-up with the most developed parts of the EU has slowed in recent years, and new challenges are appearing at home and on the global stage. In common with much of the developed world, the countries of CEE have, from the perspective of economic growth, seriously unfavourable demographics, with declining fertility and longer life expectancy leading to an increasing dependency ratio; a problem exacerbated by free migration within the EU. For many CEE economies and firms, growth has until now been driven by integration into the global economy by positioning themselves within the global supply chains of European manufacturers, especially in the automotive sector. The future validity of this strategy is brought into question by two fundamental processes. The first is the shift in the balance of consumer demand from Europe to the emerging economies, notable in Asia, and the associated rise of potent competitors from that region. The second is disruptive technological change characterised in, for example, the automotive sector by

the growing substitution of electrical for internal combustion engines and the push towards self-drive cars. Behind these processes is the more general danger that CEE will fall into a “middle income trap”, unable to build on its previous economic achievements to move up value chains, raise labour productivity and embrace new technologies.

Perhaps the most significant contribution of the CEE Report is that it eschews a “one size fits all” approach for the region to address these challenges. When the transition process first began, analysts drew a distinction in terms of policy advice between the economies of Central Europe, which had previously been relatively successful market economies; the economies of Southern Europe, many of which had industrialised for the first time under socialism, and hence had no legacy of a market economy; and the countries of the former Soviet Union, which had been under socialist hegemony for three generations or more, and in which there was likely no memory of the market system. The Report takes into account the recent history to provide a more contemporary framework for categorising economies as a basis for policy-making.

The parts of CEE that have successfully integrated into the EU, notably the global supply chains primarily in manufacturing centred on Southern Germany, Eastern France and Northern Italy, are denoted the Industrial Hinterlands. These countries face the same challenges as those for the other countries in these supply chains, of producing new and exciting products; innovating to increase value added for consumers and implementing new technologies to reduce costs and address rising labour shortages. Policies to achieve these goals will include improving labour skills, raising productivity, enhancing access to capital for innovative ideas and strengthening infrastructure, not only material but also digital. In common with much of the EU, the response to globalisation and digitisation seems likely to come, not primarily from new entrepreneurial businesses but from adaptation and regeneration within existing large firms.

This contrasts with the options most suitable for the second region identified in the Report, the Baltic economies located on the so-called Entrepreneurial Sea. The Report charts the remarkable emergence of a high tech entrepreneurial hub in the Baltic countries, paralleling the already established strengths in these fields in Finland and much of Scandinavia. For these countries, the same challenges as for the industrial hinterlands seem likely to be best addressed by stimulating growth based on new firms which seek Schumpeterian innovation, combined with high degrees of open-ness to the global economy.

The Report identifies a further region that actually faces somewhat distinct challenges to the rest of CEE. The economies of South-Eastern Europe have always been among the least developed of the transition economies. Furthermore, the collapse of communist rule was associated for some countries with violence, war and the need to establish a new national

identity. The Report offers an original twist here, by emphasising the potential in this area for agricultural expansion. The possible upside is identified to be very considerable; South-Eastern Europe has fertile soil and an excellent climate for agriculture but a poor economic infrastructure, with a very large number of small and inefficient farms and weak transport links. The key policies proposed are: support for farm integration to increase the size of holdings and generate scale economies in production, and migration of labour surpluses to the cities to foster greater prosperity in both urban and rural parts of the economy.

Thus, this Report on Central and Eastern Europe identifies the enormous progress that has been made in the region; indicates the challenges ahead; and provides a context-specific road map for how these might be addressed. At its heart, the Report argues that the CEE economies have the potential to continue their positive progress by ensuring the emergence of firms exploiting digital technologies, supported by an ecosystem of science research, technological training, deep capital markets including venture capital, and appropriate physical infrastructure. Precisely how this is best encouraged will depend on the precise national economic, institutional and historical context, with central European countries more likely to rely on incremental innovation within existing firms and the Baltic countries more on radical innovation in new entrepreneurial firms. There will be pockets of such innovation in the whole CEE, but these will likely be more limited in South Eastern Europe, where the most promising opportunities perhaps instead rest on the unexploited agricultural potential.

EXECUTIVE SUMMARY

Central and Eastern Europe is at a cross roads; the choices made over the next few years are going to determine the sustainability of future prosperity.

Over the last thirty years the rise in prosperity across Central and Eastern Europe has been truly remarkable. But as convergence with Western Europe has slowed over the last decade, less than 20% of the gap in prosperity has been closed, and serious questions now loom. Even so, the Legatum Institute believes that whatever path is followed the common foundations of prosperity, including: rule of law; government integrity and performance and an engaged citizenry are going to be critical to success. If the region were a single country, the average score in the Legatum Prosperity Index would now rank it at 38th in the world.

Long-term prosperity is ever more dependent on creating the conditions that develop, attract, retain, and welcome home, highly skilled citizens.

European demographic decline is as much a problem in Central and Eastern Europe as it is for Western Europe, but added to this is the challenge specific to Central and Eastern Europe: migration. The best and the brightest are all too often leaving, responding to slowing economic growth, or merely where foreign opportunities appear more tempting. Meeting expectations and creating the opportunities that the next generation expect is a key challenge.

European Union membership has made prosperity more achievable for countries in transition, but also made the consequences of failure more apparent.

Membership of the EU has opened up opportunities that were unimaginable a generation ago. Business investment has surged as the adoption of EU rules and standards gave a degree of confidence and trust that would have taken decades to build. But more mixed results are seen where domestic norms and rules still predominate from the effectiveness of business regulations, to judicial independence, to access to credit, to migration and non-tariff barriers.

There are differing starting points on the path to prosperity, but there are also common foundations: effective governance; property rights; international and domestic competition.

We are seeing different zones of prosperity emerge: the Baltic 'entrepreneurial sea', the central "industrial hinterlands" adjacent to Germany and Austria, and a south east "food hub". Each area has different advantages and challenges, and each will likely follow a distinctly different path in future. What underpins all successful paths is effective governance that stops corruption; property rights that facilitate investment and a competitive landscape that promotes the best ideas.

Estonia exemplifies the characteristics of the entrepreneurial sea. It has a relatively high penetration of venture capital, scores well on affordability of credit, and is ranked 13th globally for ease of starting a business. Estonia's people are pioneers in the digital society and have high levels of intellectual property protection. This is underpinned by a strong performance in Governance indicators. The country has the strongest rule of law and the most independent judiciary in Eastern Europe, together with a government that scores well for integrity and transparency.

The Czech Republic and Slovakia sit at the heart of the industrial hinterlands, and have become a key part of the integrated European supply chain. These countries have high levels of exports, and are logistically well connected. However, both countries score poorly on the perception and reality of starting a business, and have relatively restrictive labour markets. When compared with the Baltic countries, the quality of governance is also weaker, particularly regarding public sector corruption and transparency of decision-making.

Croatia's (in common with much of South East of Europe) agriculture remains a key industry. Like many of its neighbours, it scores poorly for its business environment. The costs of starting a business and securing financial support are both high, and many business rigidities remain, from a high degree of occupational licensing, to relatively rigid labour markets. The result is less diverse and lower value exports than those of countries in the other sub-regions.

To foster further prosperity, the countries of Central and Eastern Europe must look beyond existing partners and technologies to either integrate or invent, or best of all, do both.

The economic model built on comparatively low cost labour is coming under terminal pressure. This model was the right one in the immediate post-Communist world, but rising wages and wage expectations and the longer-term difficulty of having productivity match wage increases means the "middle income trap" becomes an ever more prevalent challenge. Looking to the next stages of economic growth requires businesses to be further integrated in the wider European and Global supply chains, but also to be far more entrepreneurial. This can be achieved through the creation of new ventures, or the facilitation of entrepreneurialism within existing businesses and efforts to build capital markets for long term prosperity needs to start now.

Prosperity has to be home grown, depending on a range of competitive small and medium businesses

Fostering growth beyond that generated by foreign direct investments is a key priority. But in practice, most people work for small and medium enterprises, and too many of these firms are not internationally competitive. A burden of bureaucracy makes growth difficult and working within the shadow economy too tempting. At the same time, larger firms are not greatly affected by the Governance issues because they have developed mechanisms to cope with bureaucracy and negotiate exemptions; such an approach is a serious hindrance to fostering widespread prosperity.

The digital and information age puts "creative adaptation" at the heart of business and government transformation.

The digital and information revolution means that the pace and scope of change seen over the past thirty years is likely to continue. The countries of the Baltic 'Entrepreneurial Sea' rank on average 29th in the world for broadband connections, whereas the 'Industrial Hinterlands' rank at 36th, with South Eastern Europe coming in at 49th. Finding the necessary investment for the digital challenge is primarily going to come from 'creative adaptation', existing companies using their cash flows to access capital and enable new business ventures to be built. Bringing about this adaptation is a challenge, and one that will be met much more effectively and readily embraced if the opportunities created are to be open to all.

INTRODUCTION

Central and Eastern Europe is at a cross roads; choices made over the next few years around how to meet the challenges of digitalisation, the next stage of business and government development and migration are going to determine if the rate in the growth of prosperity can be sustained.

The *Legatum Prosperity Index™* assesses countries on the promotion of their citizens' flourishing, reflecting both wealth and wellbeing. It captures the richness of a truly prosperous life, moving beyond traditional macro-economic measurements, which rely solely on indicators of wealth such as average income per person. In order to measure and track the multi-dimensional nature of prosperity the index is constructed from 9 pillars, comprising 104 distinct indicators (*see the methodology section for more details*).

Since the fall of Communism in 1989, the rise in prosperity across Central and Eastern Europe has been truly remarkable. GDP has risen by 150%, with growth leaders such as the Baltics seeing GDP per capita rise from less than \$2,000 per head in 1993 to more than \$18,000 in 2018.¹

While rises in GDP per capita have taken prosperity to levels never before enjoyed, this growth and convergence with Western Europe is slowing as wage differences diminish. The convergence model built on low cost labour was a good choice in the 1990's, but today Central and Eastern Europe countries face the increasingly critical challenges of demographics and the ever more dominant digital world.

Accession to the European Union by many of the Central and Eastern European countries has allowed them to introduce European Union regulations, and thereby gain the credibility and confidence that adhering to those regulations can rapidly give to international businesses and investors. These include an array of investor protections, easier resolution of insolvency, and guarantees of property rights. However, more remains to be done in areas of domestic regulation such as effective business regulations, anti-monopoly policy, access to credit, and non-tariff barriers to trade. Much of this is due to differing histories and institutional arrangements across the region, as well as differing approaches to business and the result is naturally differing outcomes. As we explain in this report, through our analysis we can see three distinct zones of prosperity emerge: the 'entrepreneurial sea' of the Baltics, the central 'industrial hinterlands' adjacent to Germany and Austria, and a southeast 'food hub'.

One of the key questions faced by governments around the world is how rapidly reforms can be enacted. As the President of the European Commission Jean Claude Juncker once said: "We all know what to do, we just don't know how to get re-elected after we've done it". So how rapidly can reforms be enacted, and should reform programs aim to act quickly, or cautiously? While bold reform may have an immediate negative impact, history of reform in Central and Eastern Europe has shown in the long term the economies and societies that

1 IMF World Economic Database, April 2018

undertook bold reform are more firmly on the path of greater prosperity. There is now an additional reason for action: freedom of movement within the European Union is allowing people to emigrate away from areas of economic stagnation and relative underperformance to cities and regions where there are greater opportunities. In short, membership of the European Union, with its freedom of movement, has made it extremely easy for the most mobile people of a country to seek opportunity elsewhere.

CENTRAL AND EASTERN EUROPEAN PROSPERITY IN 2018

If it were a single country, Central and Eastern Europe would, according to the Legatum Institute Prosperity Index, be comparable to Chile, South Korea and Israel. Breaking this overall ranking down into its constituent parts: for economic openness, Central and Eastern Europe is ranked 44th, due in part to the fact it was judged to have a weak business environment. The region overall scores poorly in labour market flexibility, ease of resolving redundancy, perceptions of the value of hard work and being a good place to start a business. In terms of an inclusive society; Central and Eastern Europe is ranked 36th—comparatively strong in safety and security, but weak in social capital. The countries of Central and Eastern Europe scored just above their overall rank in terms of empowered people—ranked 37th—comparatively strong in education, but weaker in health.

When looking at many countries of Central and Eastern Europe it can be useful to consider the pathways that others European economies have followed before. Much of Central and Eastern Europe is today on a par with where much of Mediterranean Europe found itself only a generation ago. So who are the best comparators? Which countries and societies are the examples to which the region can realistically aspire? Bearing in mind that most of the Central and Eastern European nations are relatively small, they are always likely to be subject to economic shocks and events beyond their control.

The 2017 Central and Eastern Europe Prosperity Report

The Legatum / Erste Group 2017 Central and Eastern Europe Prosperity Report focused on the need to rebuild “Social Capital”. The work of the Legatum Institute has focussed on three central tenets that sustain prosperity: Social Capital, Economic Capital and a strong set of institutions. The Legatum Prosperity Index has shown that the damage wrought by Communism and the subsequent skewed transition process to the “social capital” of Central and Eastern Europe was particularly acute.

We have found that around the world prosperous societies exhibit strong bridging social capital and civic norms, including social cohesion and engagement. The word “capital” in “social capital” highlights the contribution of social networks as an asset that produces economic returns and improves wellbeing. As with some other assets, the formation of social capital can be slow, but while it may take time to build, it can be rapidly damaged and such damage can be long lasting.

Equally important is trust: without trust institutions cannot function properly and people are less likely to comply with obligations. People will not pay tax if they do not trust the money to be spent wisely. Without trust, commercial transactions are slower and more costly. If trust does not exist between individuals and institutions, the government will have to step in and overcompensate with over-regulation. Social networks and the cohesion a society experiences when people trust one another has a direct effect on the prosperity of a country. Societies with higher levels of trust tend to experience higher levels of economic growth.

LEGATUM PROSPERITY INDEX SELECT RANKINGS—2017

Source: Legatum Institute

COUNTRY	POPULATION	SCORE	2017 PI RANK	2007 RANK		BUSINESS ENVIRONMENT	ECONOMIC QUALITY	GOVERNANCE	PERSONAL FREEDOM
Finland	5,495,096	78.46	3	5		72	75	85	88
Sweden	9,903,122	77.59	5	8		71	79	84	87
Denmark	5,731,118	77.06	7	6		72	78	80	87
Germany	82,667,685	76.41	11	14		71	76	78	86
France	66,896,109	72.01	19	19		66	72	69	78
Spain	46,443,959	71.42	20	20		61	68	64	86
Slovenia	2,064,845	71.31	21	23	↑	57	70	62	81
Portugal	10,324,611	69.55	25	25		61	68	66	88
Czech Republic	10,561,633	69.24	26	28	↑	64	72	64	76
Estonia	1,316,481	69.16	27	30	↑	63	71	70	73
Italy	60,600,590	66.20	30	24	↓	55	67	56	75
Poland	37,948,016	66.08	32	39		59	69	62	66
Slovakia	5,428,704	65.50	35	33	↓	58	66	57	68
Latvia	1,960,424	65.35	37	42	↑	61	68	57	65
Lithuania	2,872,298	63.69	41	53	↑	58	66	61	68
Croatia	4,170,600	63.48	43	46	↑	50	63	53	68
Hungary	9,817,958	62.30	45	41	↓	57	64	53	65
Romania	19,705,301	62.05	46	57	↑	59	64	51	66
Bulgaria	7,127,822	61.20	51	60	↑	53	63	49	62
Macedonia	2,081,206	60.31	56	71	↑	59	58	48	59
Serbia	7,057,412	60.20	58	70	↑	53	58	51	66
Montenegro	622,781	59.04	65	65		55	58	51	63
Albania	2,876,101	57.89	75	84	↑	55	56	48	67

For the entrepreneurial sea countries, the Baltic States and parts of Poland, the best comparator is perhaps Denmark, where a thriving small and medium enterprise sector has given the country an enviable level of prosperity (ranked 7th in the Legatum Prosperity Index), with GDP per head now exceeding €48,000. While these levels of prosperity are a natural aspiration, they are a distant one. That said, the Danish economic model offers many lessons for those proposing to achieve prosperity primarily through entrepreneurship. While the Danes maintain a very high level of social provision, they do this by levying significant taxes to fund services. Such an approach is preferred by small businesses who often find it difficult to cope with the more common approach in much of Europe, where complex regulatory systems are put in place that force employers deliver aspects of the welfare state.

For those countries where prosperity is most likely to be achieved through deep integration with the industrial core of Europe, those countries forming the European Union's industrial hinterlands, the Czech and Slovak Republics, Slovenia, as well as parts of Poland and Hungary the obvious comparator is Germany (ranked 11th in the Legatum Prosperity Index). However, the diversity of the German economy and quality and resilience of its political and social institutions means that no hinterland country is going to be able to rapidly, replicate Germany's strengths. Austria (ranked 15th) is a more realistic aspiration, although here too Austria has made great strides in its prosperity in the last three decades, and expecting that such a path could readily be rapidly replicated by others may well prove difficult.

For south eastern European nations, which include parts of Hungary, Croatia, Romania, Bulgaria, Serbia, Former Yugoslav Republic of (FYRO) Macedonia and Albania, it is useful to consider the transition that Spain (20th) and Portugal (25th) have made since their accession to the European Union in 1986. Iberia shares at least some of what initially can be considered some of the challenges faced by south Eastern Europe. Iberia is geographically some distance from Europe's industrial core; and as with Central and Eastern Europe, prior to joining the EU these countries had only recently emerged from rigid political structures that had long held back their economies and societies. Iberia was also heavily reliant on agriculture—what manufacturing there was tended to be less advanced technologically. Finally, both countries had long suffered from serious levels of emigration. As with migration in much of south-eastern Europe, this was particularly prevalent amongst their youth. Iberia did not overcome these challenges quickly, but steady incremental progress over the past three decades has brought about a level of prosperity rarely dreamt of when they joined the European Union.

For any government, particularly those under pressure in the way that many Central and Eastern European governments find themselves, there is a temptation to 'go for growth'. But this economic growth has to be sustainable. This means growth should not be fuelled by excess debt, either government or private. Moreover trade and current account deficits should be sustainable, and driven by investment, not consumption. Ultimately if this means growth is less exciting, it is also going to be less disappointing.

FOCUS OF 2018 REPORT: ECONOMIC FOUNDATIONS

Last year's report focused on social capital as a key component of prosperity, and identified the challenges facing the countries of Central and Eastern Europe. This year's report looks at the Economic Foundations of prosperity and the system of governance required to underpin these foundations.

The Legatum Institute measures the Economic Foundations of prosperity through themes, each with a number of indicators. These themes comprise:

- Personal Experience of Prosperity: The extent to which people are participating in the nation's prosperity, both as generators of wealth, and as consumers.
- Governance and the single market: The extent to which there are effective political institutions, rule of law and political participation of a wide section of the populace.
- Trade and competitiveness: The extent to which trade and commerce are enabled.
- Enterprise and digitalisation: The extent to which the economic system encourages entrepreneurship and dynamism.
- Finance and Investment: The effectiveness of the capital allocation process.

Around the world, what the Legatum Institute defines as "Economic Quality" has improved only fractionally since 2007, although in the last five years the score has recovered from a low in 2012. Latin America and the Caribbean rose fastest in 2017 and only Sub-Saharan Africa fell. In terms of gains, there are fewer people now in absolute poverty, with a higher number of people reporting satisfaction with their standard of living than ten years ago. This is countered by slowing economic growth, signs that governments are less open to competition and a less engaged labour force.

The economic progress made by Central and Eastern Europe countries in the past two decades has been truly remarkable. For the top performers, real GDP per capita has more than doubled. There has been more growth, and more sustainable growth, since the fall of the Berlin wall than at any point in these countries' history.² Even where growth has been slowest, the pace of economic growth has been considerable with Croatia's GDP per head rising by over 80% and Slovenia achieving levels of GDP per head well above those seen in Portugal.

This pace of catch-up for CEE economies was always going to be subject to diminishing returns, and the Global Financial Crisis provided clear reasons for economic growth to slow in 2007. Typically, in developing economies, per capita GDP and GDP measured by Purchasing Power Parity (PPP) converge over time. This is driven by an economy opening up through trade, resulting in more prices and incomes being subject to international competition. This pattern was seen in Central and Eastern Europe, where between 2000 to 2006 per capita GDP on an exchange rate basis, went from being 30% of PPP, to 50%. However, since the Global Financial Crisis, this gap has not resumed its trend rate of convergence, a stagnation that the IMF expects to continue. This suggests

2 Maddison, Angus; *Historical Statistics of the World Economy: 1-2008 AD*

Economic Foundations of Prosperity

Personal Experience of Prosperity

- **Standard of Living** measures whether citizens have access to a range of affordable goods and services, and whether economic growth is persistent. Indicators—satisfaction with household income, satisfaction with standard of living, five-year economic growth rate
- **Economic Inclusiveness** means the degree to which everyone has the resources and opportunities to enable them to participate in society. Indicators—absolute poverty (percent of population living below \$1.90 per day), relative poverty, percentage of adult population with a bank account
- **Labour Force Participation** assesses the extent to which the population is participating in the workforce. Indicators—labour force participation rate (age 15+), female labour force participation rate (age 15+), unemployment rate

Trade and Competitiveness

- **Trade Competitiveness** looks at the extent to which an economy produces a diverse range of valuable goods and services in an internationally competitive manner with a wide set of trading partners. Indicators—export diversity index, export quality index
- **Openness to Trade** is about how well an economy welcomes domestic and international trade. Indicators—perceptions about non-tariff barriers to trade
- **Business Infrastructure** examines the infrastructure that enables market access for individuals and firms, which includes transport/logistics, utilities and communications. Indicators—logistics performance, broadband subscriptions rate, cost to obtain electricity connection

Enterprise and Digitalisation

- **Entrepreneurial Environment** assesses whether businesses are easy to start and run, and how easy it is to get ahead. Indicators—perception that business is easy to start, perception that working hard gets one ahead, ease of starting a business
- **Anti-Monopoly Policy** measures whether producers can compete freely in the marketplace and consumers have choice in what to purchase. Indicators—perceptions about effectiveness of anti-monopoly policy
- **Labour Market Flexibility** measures the ability of businesses to adapt to new challenges by hiring people they need, or to losing people and positions they don't need, without being impeded by costs and regulations. Indicators—redundancy costs in weeks of salary, perceived regulatory barriers to hiring and firing

Finance and Investment

- **Access to Credit** assesses whether individuals and businesses are able to get credit at an affordable rate to finance their ideas and thereby foster entrepreneurship. Indicators—ease of getting credit, perceived affordability of financial services
- **Investor Protections** measures the strength of rules around ownership and rights, particularly around intellectual property. Indicators—perceived level of intellectual property protection; duration, cost and effectiveness of insolvency resolution



Image credit: Tupungato / Shutterstock.com

that IMF forecasters do not expect significant integration of the less successful Central and Eastern Europe domestic economies with the wider economic prosperity of the rest of Europe. Essentially the expectation is that labour in these countries remains relatively undervalued. For those countries where there is an expectation of good growth in coming years, (Czech Republic, Slovakia, Slovenia and the Baltic States), there is equally an expectation of a convergence of exchange rate GDP and PPP GDP, although in no circumstance is the gap entirely eliminated.

The IMF³ sees Central and Eastern Europe's future economic growth following two paths, EU members and non-EU members (with Romania slowly converging on the rest of the EU while Bulgaria potentially lags behind, the only EU member on a trajectory similar to that of the non-EU countries of South Eastern Europe). The process of accession to the European Union, set out in Copenhagen in 1993, undoubtedly boosted reform efforts across the region, but there is a discussion to be had as to whether this more optimistic growth outlook for the better performing countries is a result of EU membership, or because those who joined the EU were already the better organised societies, so would in any case have always enjoyed better growth prospects. It is notable that the countries that have seen better growth over the last twenty years were already (slightly) more prosperous under Communism, suggesting that they have enjoyed higher skill levels and stores of social capital.

3 IMF World Economic Outlook Forecasts, April 2018

THREE PROSPERITY ZONES OF CENTRAL AND EASTERN EUROPE

There are differing starting points on the path to prosperity, but there are also common foundations: effective governance; property rights; and international and domestic competition

We are seeing different zones of prosperity emerge across Central and Eastern Europe: the entrepreneurial sea, the industrial hinterlands, and a south east food hub.

CENTRAL AND EASTERN EUROPE—KEY ZONES

Central and Eastern Europe may share a geographic proximity, and some elements of a shared history, but there is far more diversity than homogeneity across the region. Our analysis of a wide range of indicators points to Central and Eastern Europe being three distinct regions.

(below) Central and Eastern Europe: Key zones.

Source: Legatum Institute.



Entrepreneurial Sea—Where the Baltic Sea washes, entrepreneurship seems to flourish. Evidence from the Prosperity Index is that the Nordics are one of the most sustainably successful and prosperous parts of the world, and this prosperity has spread across the Baltic. The three Baltic States are amongst the most entrepreneurial in all of Europe, even Latvia, often considered to be less dynamic than its neighbours, and out-paces the rest of the Central and Eastern Europe countries.

Estonia exemplifies the characteristics of the entrepreneurial sea. It has a relatively high penetration of venture capital, scores well on affordability of credit, and is ranked 13th globally for ease of starting a business. The Estonian Government has been a pioneer in the digital society, and they have high levels of intellectual property protection. This is underpinned by a strong performance in Governance. The country has the strongest rule of law and the most independent judiciary in Eastern Europe, together with a government that scores well for integrity and transparency.

Poland is divided between the Entrepreneurial Baltic and the industrial hinterlands of Germany. The area surrounding of Warsaw is clearly the most prosperous part of the country, and there is a belt of industrialisation running from Gdansk down through Poznan to Wroclaw. In contrast, the southeast remains the most remote from either of the two drivers of Polish prosperity and consequently it remains the poorest region of the country by almost every measure.⁴

Industrial Hinterlands—Germany retains a deserved reputation for world-class engineering excellence, but this has been coupled with what has become a very high cost base. While the value of the euro, relative to German productivity, has been low and has helped their competitive position, German (and for that matter, Austrian) industry have also been eager to make the most of the neighbouring highly-skilled, but lower-cost, countries of central Europe. The combination of a relatively low-cost skilled workforce has also tempted in businesses from further afield in Europe and globally. Most obviously, this has supported the Czech Republic, but also Slovakia, with parts of Poland and Hungary also benefitting. Slovenia seems to have come under the wing of Austria, and be doing similarly well. These countries have a high level and diversity of exports, and naturally have a sophisticated logistics network. However, both the Czech Republic and Slovakia score poorly on the perception and reality of starting a business, and have relatively restrictive labour markets. When compared with the Baltic countries, the quality of governance is also weaker—particularly regarding public sector corruption and transparency of decision-making.

The Industrial Hinterlands' strategic bet on vehicle production has worked very well, leading to a rapid rise in prosperity, but there is a growing need for industrial and economic diversity, as well as a wider variety of investment partners. Moreover, the middle-income trap looms, where wage rises run ahead of productivity increases, resulting in firms and indeed industries becoming increasingly uncompetitive. The way out of the trap, and one

⁴ In part, this may also be due to historical differences, those parts of Poland which were at times a part of the German, or Austro-Hungarian, empires being more prosperous than those parts of the country that were part of a greater Russian empire. For a comprehensive breakdown of Polish prosperity on the county level, see: <http://swaid.stat.gov.pl/EN/AtlasRegionow/AtlasRegionowMapa.aspx>

that is well appreciated by the Czech Republic's government amongst others, is to encourage productivity increases. Sitting alongside this challenge is the fact that the global automotive industry could well face significant disruption and challenges in the years ahead.

South Eastern European Food Hub—South Eastern Europe is, through the Danube river basin, blessed with extensive and fertile agricultural lands. Moreover, while there are a number of new member states of the European Union, there remain a number of non-EU member states who are naturally much less economically integrated and far less prosperous. The greater development of urban centres across the region should be a priority, along with how local industry might use their strength as a food hub to move up the value chain of food processing.

Looking specifically at Croatia—like many of the countries in this sub-region, it scores poorly for its business environment. The costs of starting a business and getting finance are both high, as also is the degree of occupational licensing. Labour market regulations are rigid, and unemployment levels are relatively high. The effect of this less developed business environment is that Croatia's exports are lower (although there has been a modest surplus in recent years), less diverse and lower value-adding than countries in the other sub-regions. The good news is that public finances are sound, and this has been recognised in recent rating upgrades of Croatian debt.⁵

It is a further disadvantage for these countries that their long standing EU neighbouring states (Italy and Greece) are generally facing their own economic challenges, and so not generating the levels of business activity that might generate a natural spill over of lower value added work to their near neighbours. Even if such work were to become available, there is not the physical infrastructure to allow much of this region to be easily integrated into western European businesses. Finally, these nations continue to suffer from the historic harm of Communism and the ongoing legacy of a lack of trust reflected in some of the poorest Social Capital scores in Europe.

Looking at these three regions and the Legatum Prosperity Index, the main trends are:

- 1 The Baltic countries (the Entrepreneurial Sea) are catching up with the central Industrial Hinterlands levels of prosperity. Progress in future depends upon maintaining their present levels of economic and social agility.
- 2 Good levels of prosperity have been achieved in the Industrial Hinterlands, but success has been very concentrated in a narrow set of industries, notably automotive. Greater business diversification is going to be necessary to promote future prosperity.
- 3 Steady growth has been made in the prosperity of the South East Food Hub, but the gap between this region and the rest of Central and Eastern Europe is growing. Slow consolidation of agriculture holdings and building opportunities in urban centres remain key priorities.

5 Kunstek, Ivana; "Croatia hits fever pitch"; Erste Asset Management; 17 May 2018

PERSONAL EXPERIENCE OF PROSPERITY

What prosperity means can be very different to different people, much depends on experiences ranging from the national to the very personal. Some of this measure of prosperity is quantifiable, from incomes to acquisition of material goods, some aspects such as access to information flows are harder to measure, some are invariably more subjective, and can include everything from relative wealth to relationships. Legatum's view is that any comprehensive view of prosperity has to include both social and material wellbeing, the importance of having a job, and also feeling a part of a wider society, as well as having the ability to meet your ambitions.

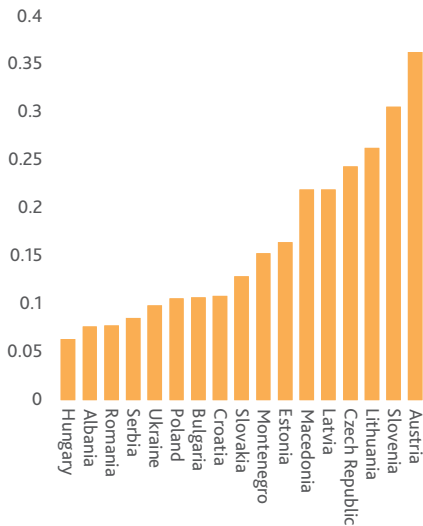
SOCIAL WELLBEING

In charting a pathway from poverty to prosperity, Legatum has always looked beyond measures of GDP to a broader appreciation of non-economic aspects of life. What is interesting is that while various measures of life satisfaction do broadly tie into economic success, the correlation is far from perfect. The Harvard economist Benjamin Friedman in his study "The Moral Consequences of Economic Growth" postulates that where people experience rapid economic growth, they are generally happy as they see their personal circumstances improving. Contrastingly, in situations where low (or no) economic growth prevails, one person's gain is all too often interpreted by others as having been at their expense and hence is resented. While this approach is true in a wide range of circumstances and indeed at times true in Central and Eastern Europe, it is an incomplete explanation.

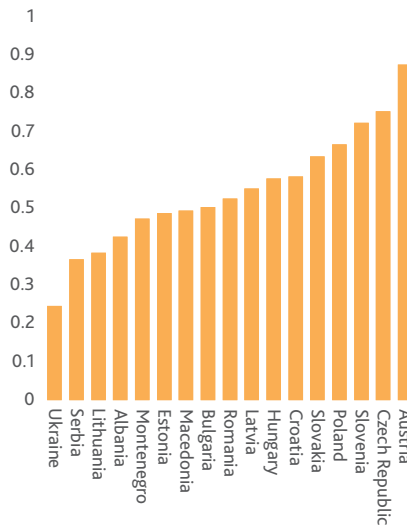
The economy of Hungary has grown by over three and a half times since 1990, yet it appears not to be a particularly happy place: middling in terms of satisfaction with standard of living, but at the very bottom of the satisfaction with income score. Have Hungarians now concluded that anything short of a German standard of living is to be deemed unacceptable? A lack of satisfaction with standard of living scores, and even more critically levels of emigration, suggests that many citizens of the Baltics states are also unhappy enough to move, even after experiencing extraordinarily rapid economic growth for a generation. Is it that they increasingly view themselves not as a citizen of a country that has seen extraordinary growth, but as a citizen of a region and they are naturally drawn to local opportunities, which happen to be in another country just across the Baltic Sea? Natural comparators seem to fill a vital role in people's aspirations.

Governments around the world are looking at a host of measures that attempt to measure a broader spectrum of economic and social wellbeing. From the UK's measure of national wellbeing, to the EU's new measures used to calculate need for regional funds based on a wider range of inputs than GDP per capita, the concept of well-being is being extensively discussed.

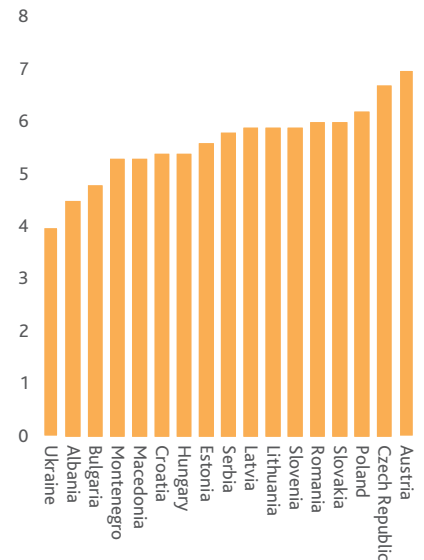
Satisfaction with Income
Gallup World Poll 2017



Satisfaction with standard of living
Gallup World Poll 2017



Cantril's Ladder



MATERIAL WELLBEING

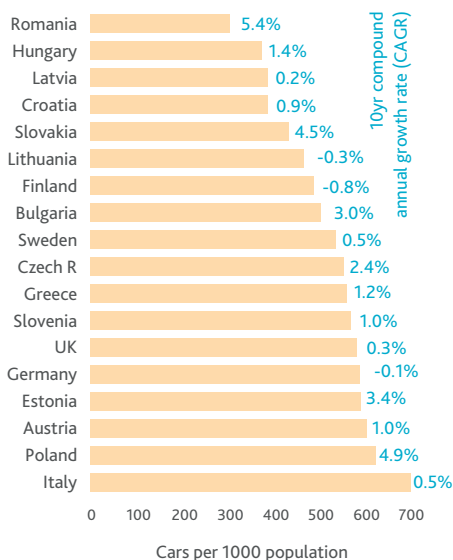
In addition to looking at measures of happiness, or other more subjective measures, there is also a need to appreciate how material wellbeing has improved. In particular what appears to be missing from most of these assessments is any measure of how business and free markets are improving material wellbeing and through that people's lives. Three distinct trends are increasing material well-being: more competition, technological advances and greater freedom.

More competition. Long gone, and in many cases seemingly almost forgotten, is the inferior Eastern European automobile. Even where the same manufacturer (in the case illustrated, Skoda) has survived, what is produced today is in a different league to what was produced prior to 1990. So even as the number of cars per head of population in many countries reaches what looks likely to be saturation levels, somewhere between 400-600 cars per 1000 people, there has been a marked increase in the quality of car that ordinary people drive. Increased competition is at the core of this change.

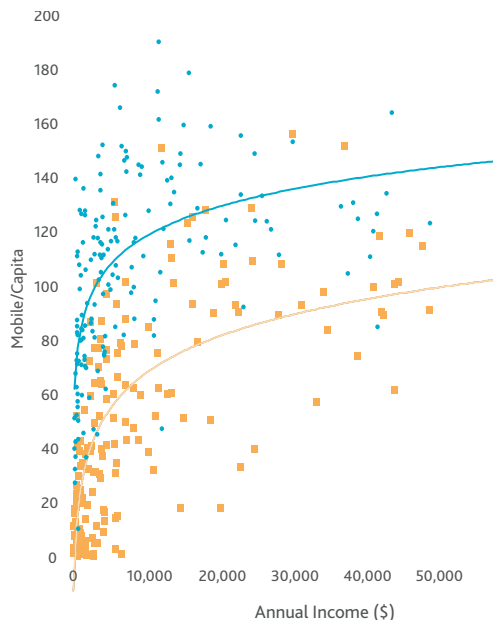
Technological advances. Consider the now ubiquitous mobile telephone. In 2002 a GDP per capita of \$25,000 generally lead to a mobile telephone penetration rate of approximately

Source:
Legatum Prosperity Index

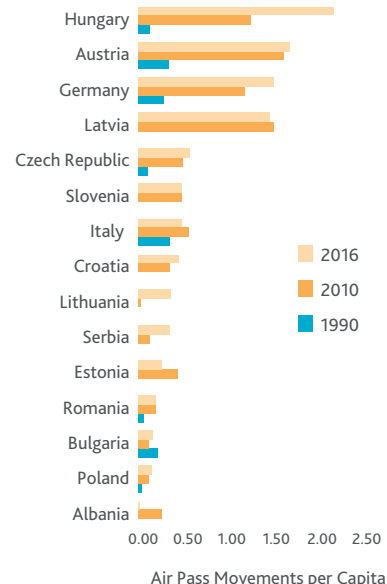
More competition better cars



Technological advances mass communications



Greater freedom to travel



(above) Material Prosperity

Source: Legatum Institute, ITU

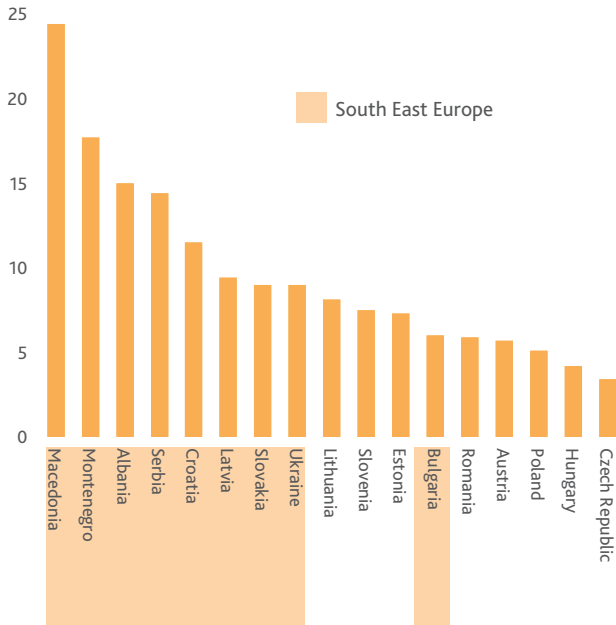
50%. And the phone was essentially a brick. By 2012 over 50% of people on a dollar a day had a lightweight often internet enabled, mobile. Today (2016 data) the average citizen of the Baltic states has one and a half mobiles (in other words, one in every two people also has a mobile enabled device) and even in the least developed Central and Eastern Europe states, mobile penetration rates are above 100%, (excepting Macedonia where mobile penetration is only 99%, everyone else is comfortably above 100%).

MATERIAL PROSPERITY

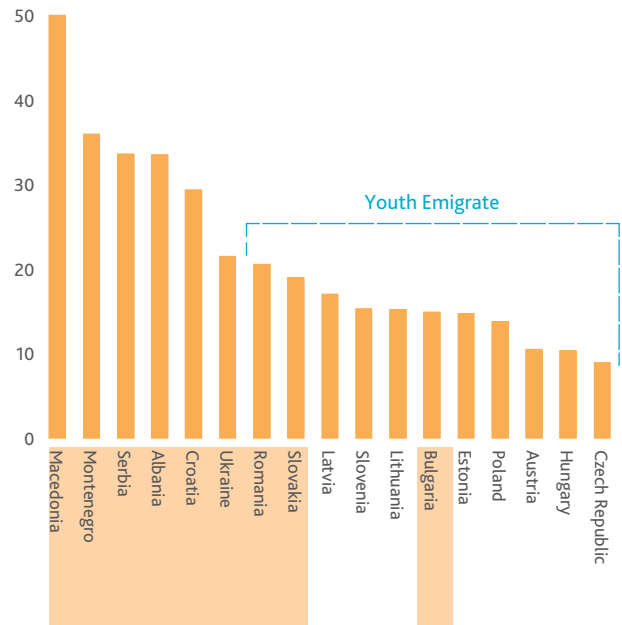
Greater Freedom. There are two factors at work here. Under Communism, there were significant restrictions on travel, but even if these had not existed, the cost of air travel in particular, was prohibitive. Both impediments have thankfully disappeared. The result has been a significant rise in the amount of air travel.⁶ This has of course facilitated migration, enabling at least in theory many migrants to maintain contact with their home countries in a way that would not have been possible in previous generations of migrants.

⁶ Some countries, such as Slovakia have seen falls in air passengers, but this is due to people simply accessing a larger hub airport in a neighbouring country.

Unemployment
World Bank World Development Indicators



Youth Unemployment
World Bank World Development Indicators



EMPLOYMENT

For most people the foundation of prosperity is naturally a job. This provides income of course, but also at least ideally, a sense of worth and place within a wider society, a way to tangibly contribute. The degree of upheaval that accompanied the end of Communism would have been a challenge for any society. Losing one's job in the aftermath of the collapse of Communism also often meant losing a place at a particular school for your children, or even home, simply added to the magnitude of the upheaval.

Fast forward to today, and the concept of a job for life has vanished for ex-Communist and Capitalist economies alike. Sustainable work in the future is only going to be possible where flexible and adaptable workers are able to add value—our demands as consumers will allow nothing else. Many of these new and sustainable jobs exist at present, but many do not. The question looking forward is how can these new jobs be fostered, and how might these new jobs be at least a part of the solution to the chronically high levels of underemployment, unemployment and youth unemployment, seen across parts of Central and Eastern Europe?

(above) Employment

Source: Legatum PI

The challenges of high levels of underemployment are not unique to Central and Eastern Europe, much of Mediterranean Europe suffers similarly. The economic explanation for these high levels of unemployment are clear enough: if it is difficult to let a worker go in a downturn, time and again it has been seen that employers will be reluctant to take on workers in the good times. Yet the difficulties in reform should not be underestimated. Often the regulation that sits behind such social protection is seen as a defining part of a culture or national identity by at least some citizens. Typically those in work and under the protection of extensive social regulations value them very highly, and see such rules as an important part of wider rules on how society should operate. The challenge is that those who are protected are often older workers and the growing division between older and younger workers is only being made socially tolerable as so many young workers choose to emigrate to find work. That such a policy approach is in the long term unsustainable should be self-evident.

PREVALENCE OF OCCUPATIONAL LICENCING ACROSS CENTRAL AND EASTERN EUROPE

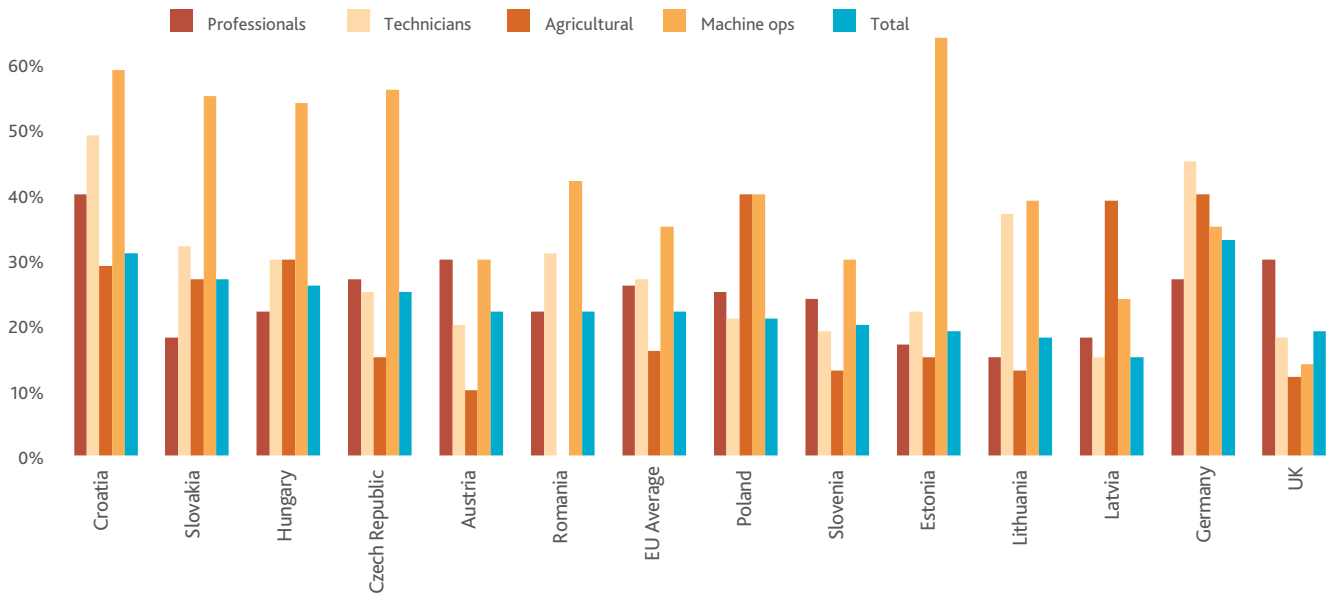
Nor are redundancy costs the only impediments in the labour market. Occupational licencing, which effects on average 22% of EU jobs, can be seen as a part of this culture of protective regulation and is one of the most invidious forms of employment protectionism. Such qualifications can easily be confused as being necessary to perform certain roles and to be the legitimate business of the state when determining standards. What is also clear is that occupational licencing all too often becomes inherently inflexible, valuing codification of knowledge rather than agility and standing in the way of the incorporation of better technology. That consumers rarely benefit from, or even value, the standards set by such occupational licencing does suggest that a great deal of liberalisation could take place with little harm. Few managers, professionals, or craft trades are covered by occupational licencing, but areas of traditional Trades Unionisation such as machinery operation see their positions buttressed by legislation, which lessens domestic competition and limits entrepreneurship both for start-ups and within existing firms.

INCOME DISPERSION

While incomes have risen across much of Central and Eastern Europe, these incomes are notable in that they are not very diverse. For some this egalitarianism is a highly desirable social outcome, but such an outcome also tempts ambitious citizens to migrate, and leaves many countries with little accumulated wealth needed to invest in new technologies.

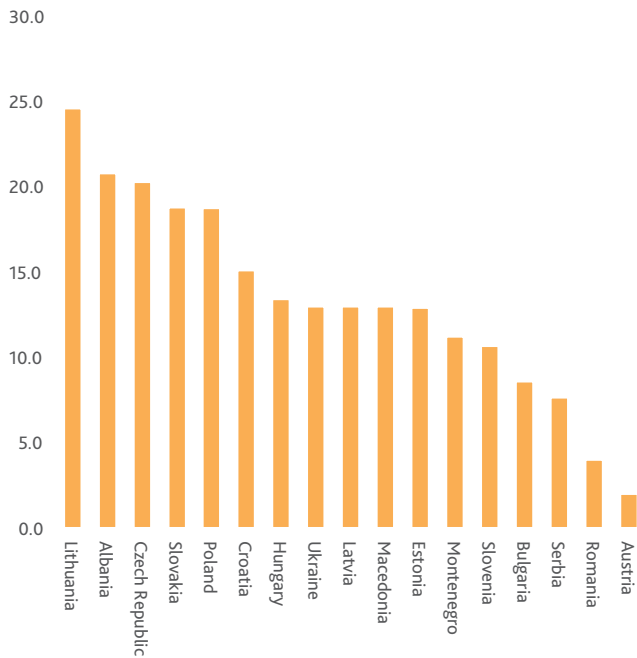
A glance at the map of income per capita on a regional basis demonstrates that apart from small enclaves around capital cities, poverty remains a key issue for almost all of Central and Eastern Europe. This is backed up with data from the Prosperity Index, where

Occupational Licensing



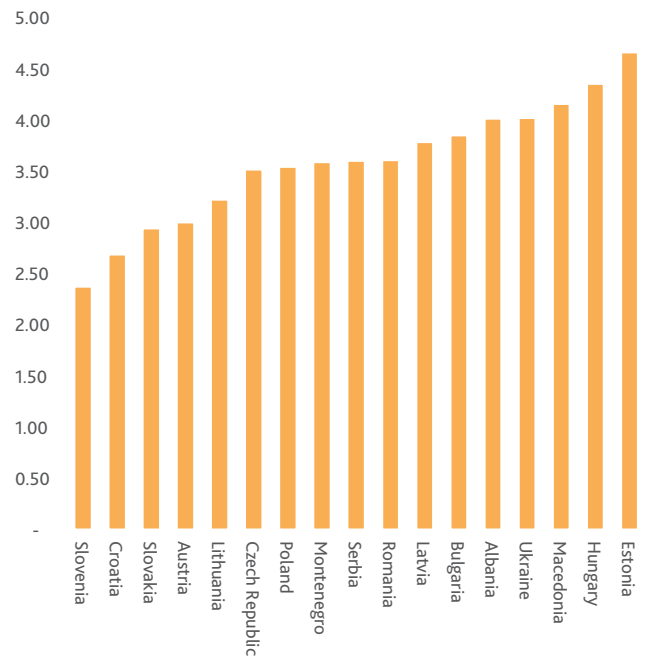
Redundancy Costs (weeks salary)

World Economic Forum Data 2017



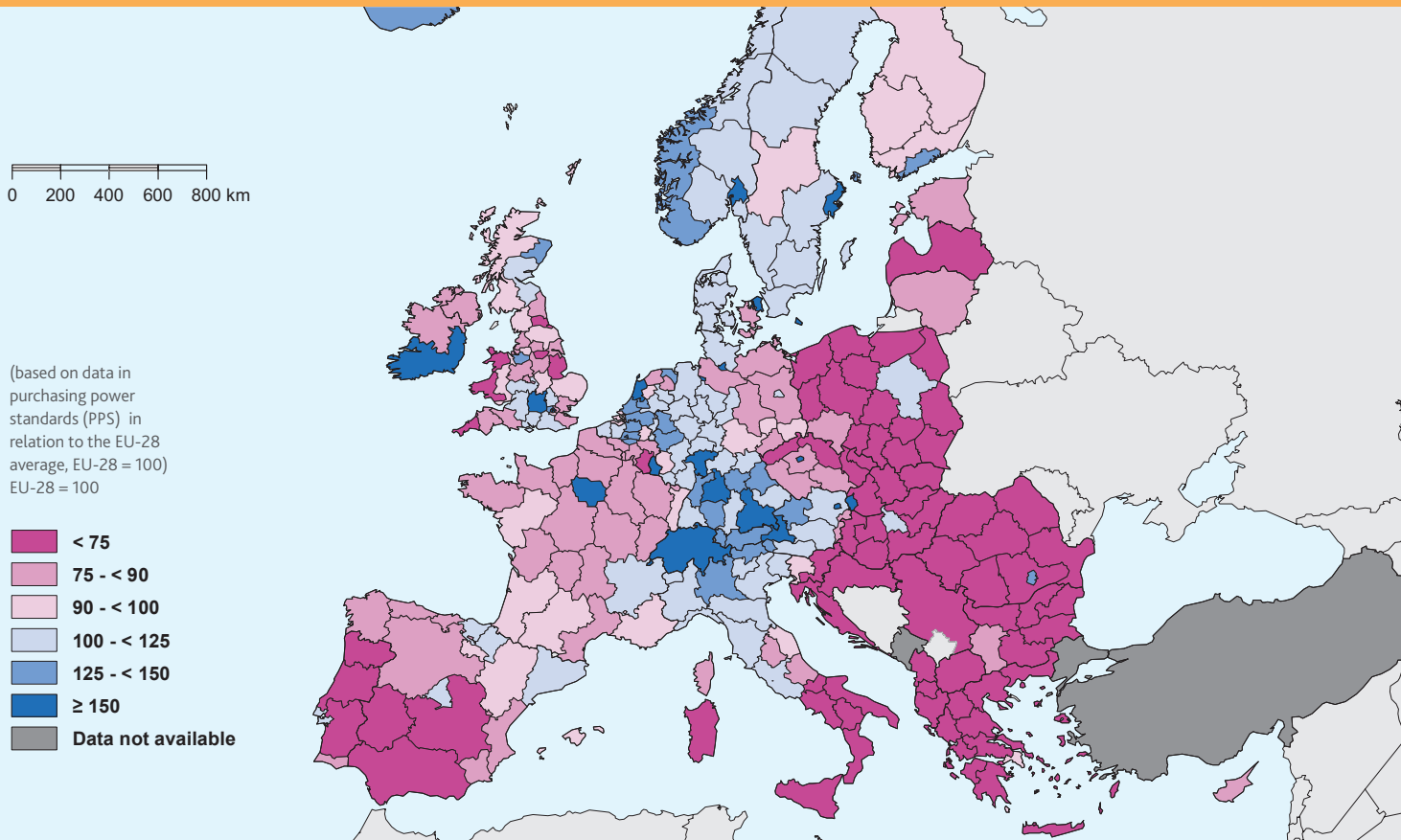
Hiring and Firing Practices

World Economic Forum Expert Survey 2017



Source: (top) Measuring Prevalence and Labour Market Impacts of Occupational Regulation in the EU; EU Directorate-General for Internal Market

(bottom, left & right) Legatum PI



(above) Gross domestic product (GDP) per inhabitant in purchasing power standards (PPS) in relation to EU-28

Source:
Eurostat 2017 data

World Bank data on intermediate poverty levels (defined as those living on less than \$5.50 a day) are notably high in South Eastern Europe and even on nationally defined poverty measures, which may well be better at capturing individual national idiosyncrasy, poverty is clearly an ongoing issue.

EUROPEAN SUB-NATIONAL GDP PER CAPITA

Incomes, both relative and absolute, clearly matter. Over the last decade, less than 20% of the gap in prosperity between Central and Eastern, and Western Europe has been closed. As a result, many people while better off in absolute terms are increasingly disappointed, and they have become impatient regarding the pace of income convergence between different segments of society. These differences are particularly stark when looking at the differences between urban and rural populaces and by education attainment, and also between CEE and Western Europe. Critically, in five countries (Poland, Slovenia, Lithuania, Estonia, Albania), despite improvements, people are less satisfied with their incomes or standard of living than they were ten years ago.

The GINI Coefficient

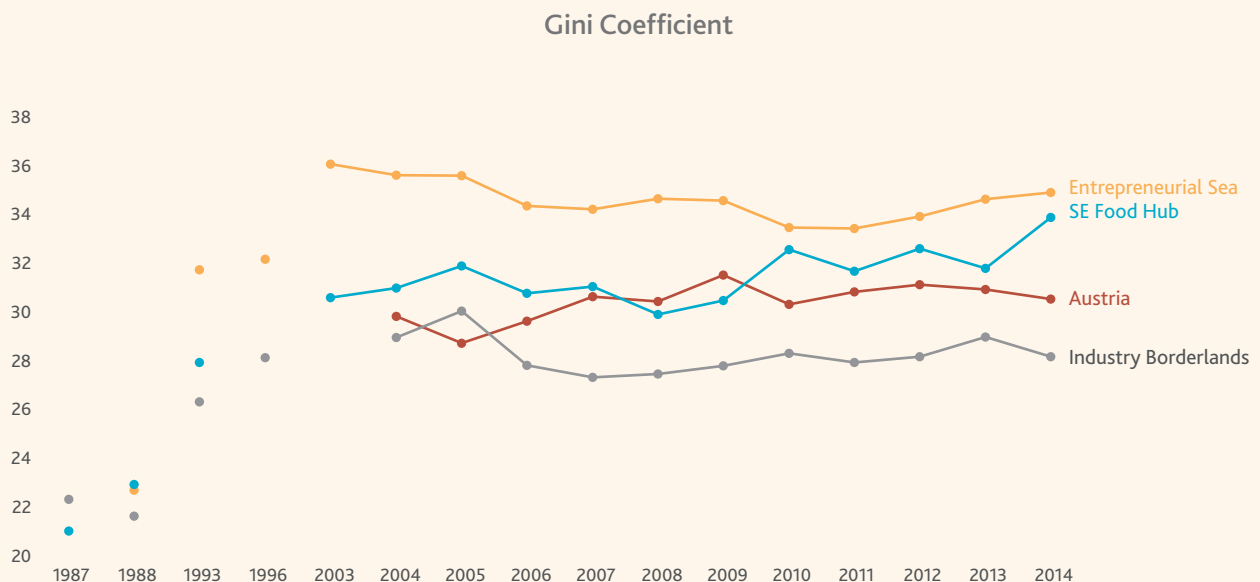
A Gini coefficient is the most common means of measuring income differentials both over time and between countries. A coefficient of one hundred means one person has all the wealth or income of a nation, a score of zero means all wealth or income is evenly distributed regardless of effort, talent or indeed, luck.

When considering income dispersion, the key questions we are trying to answer are: does equality of outcome emerge from a successful economy, or is it a policy objective, achieved through legislation and in any case what is a desirable level of income distribution?

Often commentary on wealth or income dispersion implies, almost regardless of how it is achieved, that the lower a Gini, the better. Clearly there are egregious cases where a high Gini implies that income or wealth are so skewed that it effectively removes incentive from an economy, with many countries in Latin America seeing Gini's above 50. Ultimately not involving a substantial share of a populace in prosperity seriously

impinges on the ability of that society to generate significant aggregate wealth. At the opposite end of the spectrum, low Gini's have different implications. We would argue that Gini coefficients below 30 can be an indicator that there are relatively few entrepreneurial wealth generators within an economy and incentives for personal advancement have effectively been removed usually through high taxation (the UK had such a Gini coefficient in the 1970's, today Gini's under 30 are chiefly found in the Nordics and ex-Soviet authoritarian states).

In the future, very low Gini's are likely to be an indicator that even where prosperity is apparent, the economy is not generating, or being able to accumulate, the levels of wealth necessary to fund wide scale business transformation and investment. The result of this is that highly egalitarian societies are likely to be overly reliant on foreign investment capital to fund any economic growth or development.



Source: World Bank

Looking beyond poverty to the wider issue of income dispersion, the latest World Bank data for 2014 demonstrate that across Central and Eastern Europe there are a wide range of Gini coefficients. The highest, above 37, are both Lithuania and Bulgaria; while the lowest scores, both below 26, go to Slovenia and the Czech Republic.⁷

From the data available, the average Central and Eastern European Gini in 1988 was 22. Such a score may imply everyone was equal: just some were more equal than others. As any middle aged citizen of Central and Eastern Europe could attest, in an economy of shortages, access and privilege replace cash. Economically the difficulty is that such a state mandated egalitarian system was and remains by its very nature unresponsive to market signals and changing tastes and demands of a populace. Such systems have historically often failed to generate prosperity.

DEMOGRAPHICS

The overall population of Central and Eastern Europe is set to fall over the coming decades, the question is the pace of the decline.

Throughout the post-war years, the overall population of Central and Eastern Europe grew by 0.8% p.a. to hit an all-time high of 133 million in 1990. With the fall of Communism this trend was reversed overnight, and the population began to fall by 0.23% p.a. In the early 1980's, each woman in Central and Eastern Europe was having on average 2.1 children. By 1995 this had fallen to 1.4, and from this low it has only slowly climbed to 1.65, still well below the replacement level of 2.1. Polish fertility is now amongst the lowest in Europe at 1.29 children per woman. The UN is forecasting the overall population to continue to drop by 0.45% p.a. through 2050.

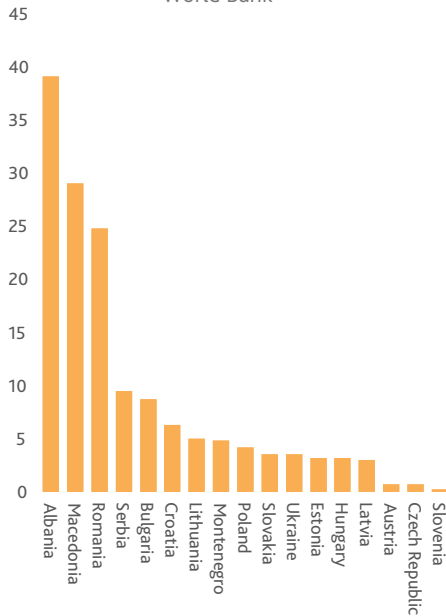
There is an ongoing debate as to what sits behind these trends. Fertility rates depend upon a host of factors from growth of prosperity, to effectiveness of health services, to opportunities for women, to cultural norms. Without doubt the result of the changes being experienced in Central and Eastern Europe there are ever more people dependent upon a slowly shrinking working populace.

Looking just at the long term UN forecasts for the working age population for Central and Eastern Europe over the next century, there is a reasonable amount of agreement between scenarios up until 2050 (naturally given over half the people that are going to be alive then, are alive now) but considerable divergence about what might happen from 2050 onwards. The key here is that by 2050 the number of people entering the working age population is going to be determined not by who is alive today, but by choices made by parents over the coming few years. One set of assumptions sees a continuation of the existing trend downward trend, taking total Working Age Population from today's 85 million to ~30 million, while a more optimistic outlook sees the working age populace of Central and Eastern Europe stabilise around 53 million. Clearly even the more optimistic of these scenarios presents huge challenges to the region. While a rise in the retirement

⁷ This is confirmed by more recent data based on cross measuring income quintiles. Bretan, Juliette; "Income Distribution: Czech Republic is EU's Most Equal State"; Emerging Europe Alliance; April 30, 2018

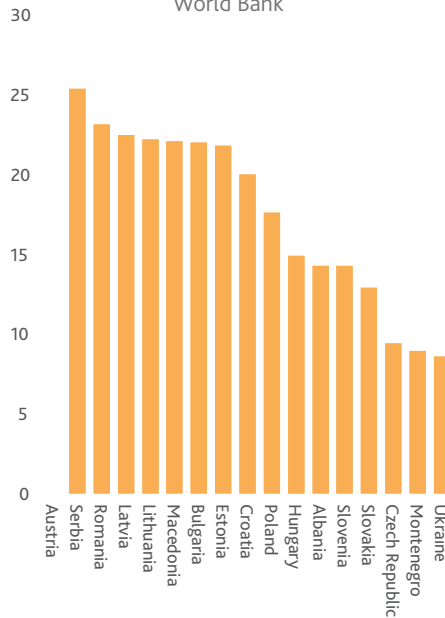
Poverty headcount ratio at \$5.50 a day

World Bank



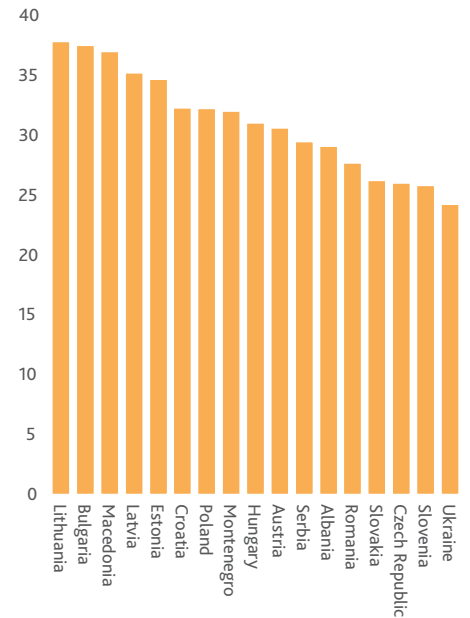
Nationally defined Poverty Level

World Bank



GINI Coefficient

World Bank



age in almost every country will help to address issues around the dependency ratio, this is only part of any long term solution, which must also look at how migrants might be encouraged to return home and how cities within the region could be made more dynamic and attractive to entrepreneurial businesses.

(above) Poverty

Source: Legatum PI 2017

GOVERNANCE AND THE SINGLE MARKET

European Union membership has made prosperity more achievable for countries in transition

Membership of the EU has opened up opportunities that were unimaginable a generation ago. Great strides have been made, often importing European Union regulations and credibility (e.g. investor protections, ease of resolving insolvency). Over the last 10 years, all Central and Eastern Europe countries, with the exception of Hungary and Slovenia, have seen increases in their Governance score in the Prosperity Index.

Policy areas more dependent upon domestic regulation have shown more mixed results, from the effectiveness of business regulations to anti-monopoly policy, to access to credit and non-tariff barriers. For example, the Central and Eastern European countries on average had weaker Prosperity Index score in 2017 than in 2007 for anti-monopoly, non-tariff barriers and flexibility of regulations covering hiring and firing.

GOVERNANCE

Good government and rule of law remains a key factor in making any sort of advancement. Daron Acemoglu and James Robinson argue in their book “Why Nations Fail” that sustainable development was simply not possible without inclusive institutions, the rule of law and property rights. The challenge is that establishing these institutions can take a prolonged period of time. Countries of Central and Eastern Europe have used their membership of the EU as a method of giving a great deal of regulatory certainty. The stark differential between EU members and those non EU countries of the south-west Balkans where there remains little investor confidence in rule of law, is clear.

The Prosperity Index tracks Governance through a series of indicators:

- **Rule of Law** assesses the confidence in the rules of society: in particular this refers to the law being applied equally to all, and to the quality of contract enforcement, property rights, the police, and the courts.
- **Government Integrity** measures how well government operates in a transparent and predictable manner with minimal corruption. Citizen engagement with the political process further strengthens government accountability.
- **Government Performance** assesses the performance of the civil service and how well the regulation and policy incentivise businesses.
- **Political Participation** looks at whether there is active representation and participation in the political process by everyone.

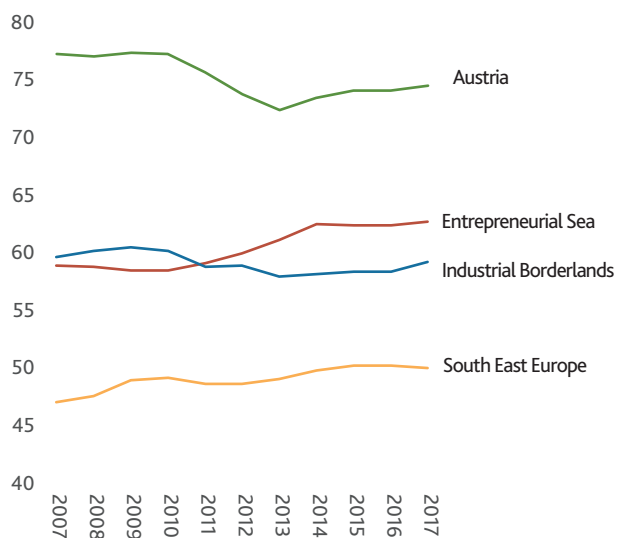
A STORY OF MODEST OVERALL CONVERGENCE, BUT PERSISTENT WEAKNESS IN RULE OF LAW

While EU membership has delivered a significant and rapid advantage, it must be built upon, or else it risks being squandered.

Unfortunately, the ability of EU politicians to squander one off opportunities is well established. For evidence look no further than the establishment of the Euro. Many European Union members had traditionally had a history of high inflation, which led investors to demand high levels of interest to finance debt in these countries. Politicians in these countries used their joining of the EU's Exchange Rate Mechanism to rapidly establish anti-inflation credentials and so enjoy lower debt payments. The initial stages of this process worked extremely well, with 10 year bond rates rapidly falling, in the case of Italy from 6% to less than 0.5%. Unfortunately, political systems remained unreformed and the fiscal room created by lower debt repayments was not used as a once-in-a-generation opportunity to painlessly reduce large government debt stocks, but instead to rapidly expand state spending. Eventually the structural problems of unsustainable levels of fiscal spending and unreformed tax systems reasserted themselves and once again deficits and debt became chronic. Today the levels of debt are higher than ever, and the financial stability and sustainability of many southern European countries government finances remains a significant question.

Looking at the situation in Central and Eastern Europe, the key question is: will

2007-2017 Governance scores for CEE countries



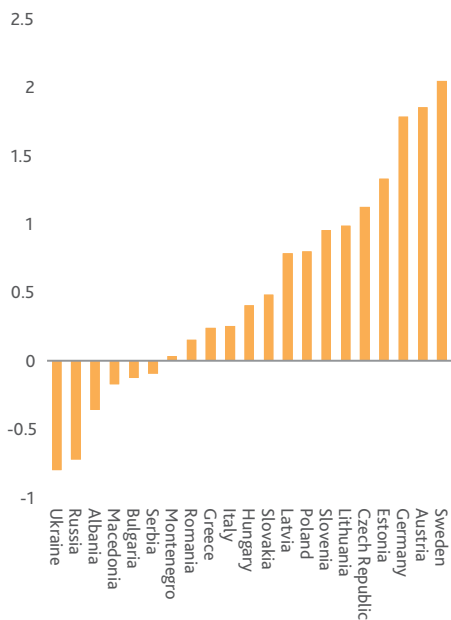
2017 Governance Ranking for CEE countries

Country	Governance	Rule of Law	Government Integrity	Government Performance	Political Participation
Austria	16	18	18	18	13
Estonia	21	22	22	27	38
Czech Republic	31	41	42	29	28
Slovenia	36	49	31	56	20
Poland	37	54	33	38	24
Lithuania	38	46	32	32	48
Latvia	40	50	39	34	68
Slovakia	42	87	45	43	27
Croatia	54	89	51	63	45
Hungary	56	75	58	61	58
Montenegro	65	71	54	78	67
Serbia	67	102	64	65	52
Romania	68	65	52	97	70
Bulgaria	71	92	72	84	63
Macedonia	75	93	56	87	77
Albania	78	115	65	73	65

Source: Legatum PI

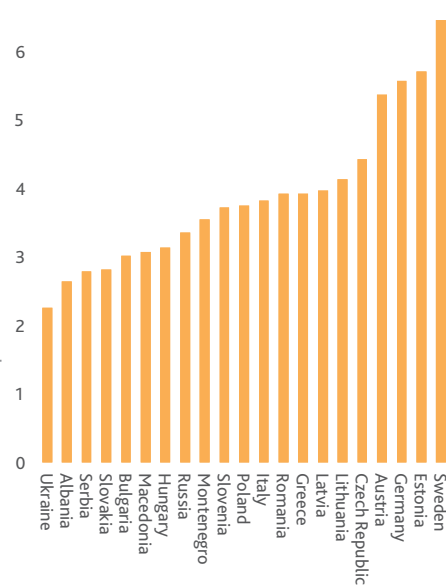
Rule of Law

World Bank Governance Indicators 2017



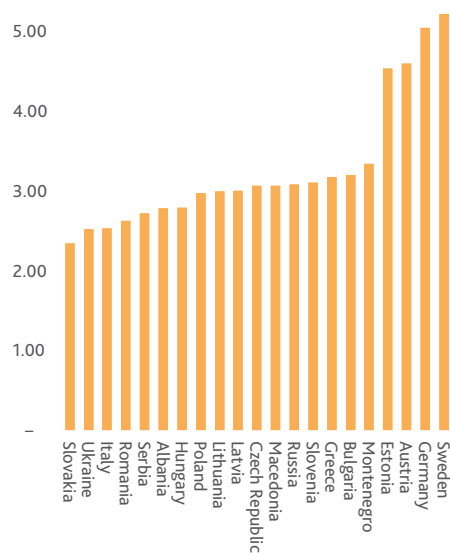
Judicial Independence

World Economic Forum Expert Survey 2017



Ease of Challenging Regulations

World Economic Forum Expert Survey 2017



Source: Legatum PI

the governments of Central and Eastern Europe use the opportunity afforded by adopting EU legal norms to underpin governance structures, or will they use the international trust established by being a part of the EU to seek short-term political advantage? Just as there was (and remains), an investment 'illiquidity premium', that is small countries must offer a greater return on their securities to compensate for the relatively illiquid market, so too there is likely to be a small country jurisdiction regulatory premium. Investors will only learn about and keep track of legal and regulatory developments in a smaller country if the opportunity is exceptional. Where smaller countries legal systems are set within a wider legal and regulatory framework, there are fewer concerns over the future stability of law making, thus there can be greater confidence in making long term investments. The test is to not simply adopt EU rules, but to abide by the Rule of Law, in spirit and in practice; this includes having an independent judiciary and a transparent process under which regulations can be effectively challenged.

A key part of any governance structure is effective dispute resolution and legislative predictability. If legal processes are seen to favour the politically connected, or national over international investors, or disputes take years to resolve, the result is going to be a marked reluctance for investors to become involved and even for domestic companies to be integrated into wider industrial networks. Unlike a European Union regulatory framework, judicial independence is not something that can be simply transferred, it is a cultural norm and takes time to be established and trusted. At one end of the scale, long established and highly developed economies such as Sweden, Austria and Germany enjoy a strong adherence to the rule of law, judicial independence and ease of challenging regulations. At the other end of the scale are those countries where these attributes are largely absent, and in general, so too is prosperity. Even for long standing EU members such as Italy, their score on ease of challenging regulation is demonstrable proof of the difficulty in navigating the Italian legal system.

The scores seen on Legatum's Prosperity Index Governance structures are matched by the data tracking the shadow economy. The size of a shadow economy suggests both the degree of commercial and financial sophistication, as well as the cultural adherence to the rule of law. For most Central and Eastern European nations, there has been a slow and steady improvement in bringing economic activity into the formal economy. The most transparent economies being the likes of Germany and Austria, with 12% or less of their economic activity-taking place in the shadow economy, indeed it is often under 10%; notably both the Czech Republic and Slovakia are close to these developed country norms. It is also notable that many Mediterranean countries have much larger shadow economies, indeed many are similar in scale to those found in Central and Eastern Europe where the shadow economy now accounts for 18% of economic activity, down from 28% in 1991. At the other end of the scale is Russia, which while improving, still sees approximately one third of business activity being conducted through informal channels, although even this is an improvement over the 48% seen in 1997.⁸ Where there is a large shadow economy, not only does the informal nature of the business mean that no tax is paid, more importantly for prosperity, businesses operating in the shadow economy by necessity remain small. Operating in the shadow economy means there are no audited accounts, so access to finance is limited or non-existent. In such situations legal redress becomes impossible and contracts unenforceable. Prosperity does not so much wither, it never becomes established.

LABOUR MOBILITY

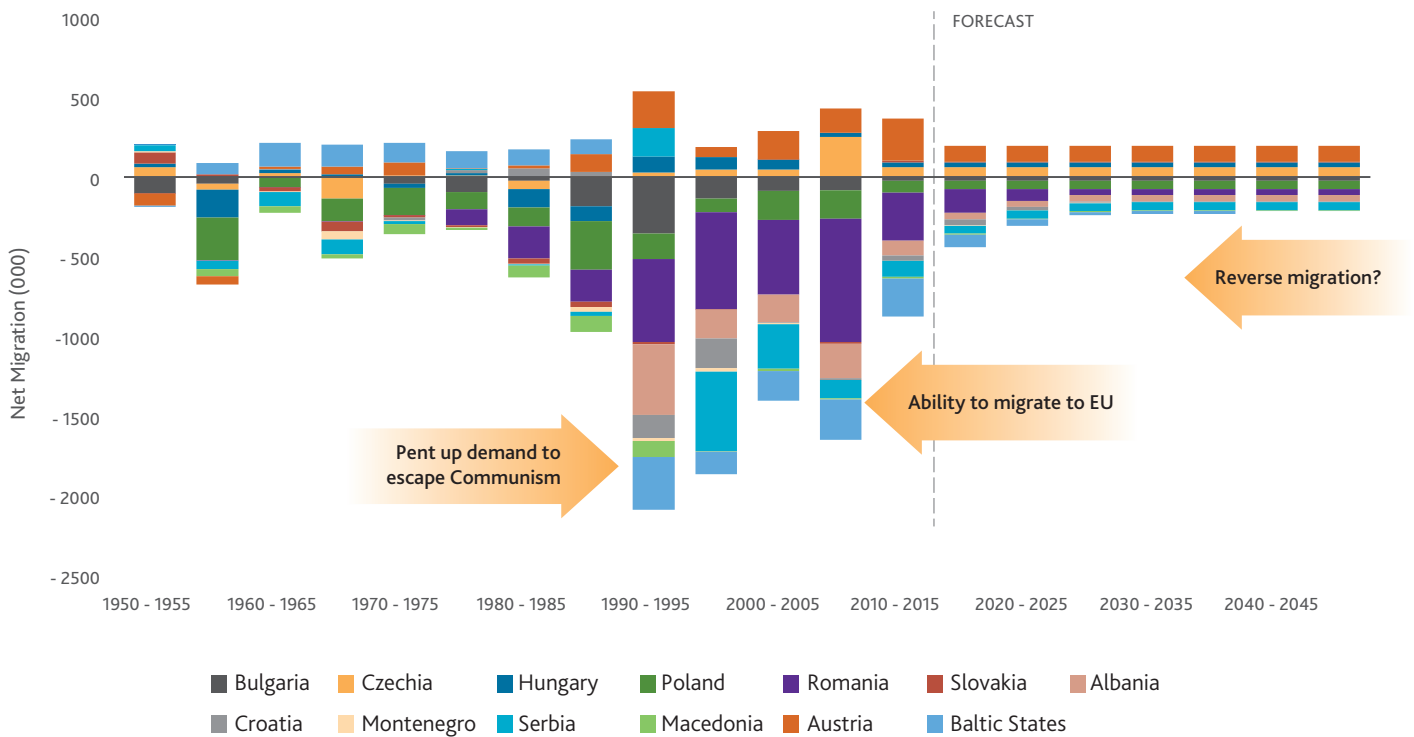
Long-term prosperity is ever more dependent on creating the conditions that develop, attract, retain, and welcome home, highly skilled citizens.

An economic model in much of CEE built on supply of relatively low cost unskilled or semi-skilled labour is coming to a natural end. Such a strategy suited the early stages of convergence, but lower value-adding production will naturally and increasingly shift to less developed parts of the continent and world. For Central and Eastern European nations there are two challenges: attracting (or establishing) higher value-adding businesses and retaining talent necessary for those businesses to compete.

Across Europe, migration has been and looks set to continue to be one of the significant challenges of the coming decade. We are witnessing what seems to be a great human shuffling west, added to which are the migrants, legal and illegal, that are trying to come to Europe from further afield. How these people integrate with existing cultures, what jobs they take, and when might they go home are all-important questions for politicians and citizens alike.

Migration from Central and Eastern Europe has come in two relatively distinct waves, and its future is even likely to be ever more complex. The first wave came directly after the fall of Communism. Here, as there was no immediate or obvious country of destination, but people were determined to leave and they migrated to almost any country that would take them. By the mid 2000's with many of the Central and Eastern European countries accession to the European Union, there came a second opportunity to legally seek much better paid work in at least a few of the EU member states. The result was a renewed surge in migration, which was unexpected by some of the recipient countries.

Drawing out the lessons of the data, the most obvious way to ameliorate and perhaps even counter the net migration trend is to have a successful economy. The Czech Republic has seen its overall population rise due in large part to its thriving economy and the opportunities that has brought. However, even a thriving economy is no guarantee of success. The Baltics have seen considerable economic growth, and they have also experienced high levels of migration; although at least a part of this emigration can be attributed to Russian retirees leaving these countries in the 1990's. Looking at the past decades migration rates from the Baltic States, post the outflow of Russians, the outflows have been less significant, although still negative. What is more encouraging is that the youth in the Baltic nations have shown an increasing reluctance to migrate, with less than 15% of those between 20-39 migrating, well under half the levels seen elsewhere in Central and Eastern Europe.

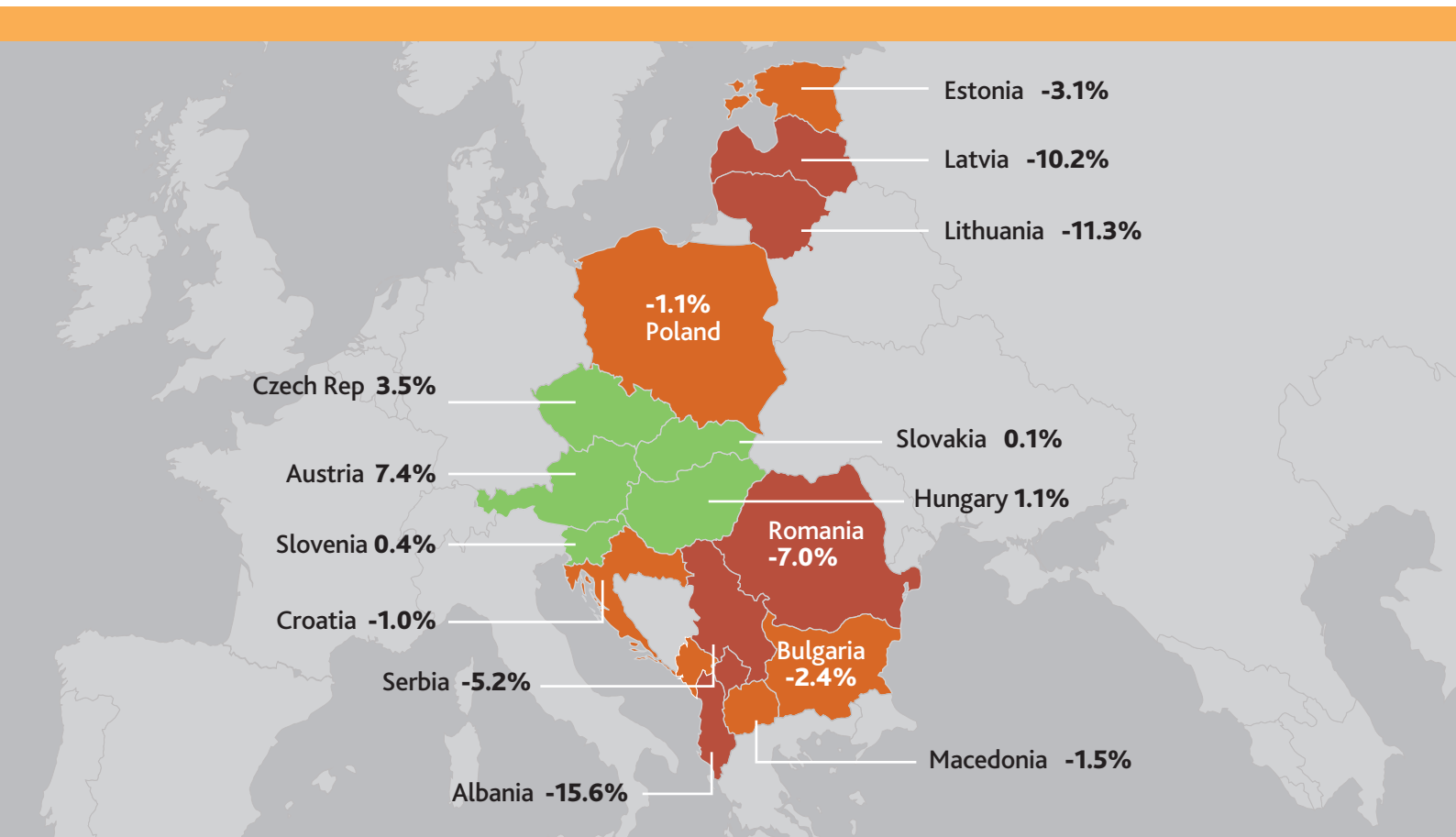


CENTRAL AND EASTERN EUROPE NET MIGRATION

The broader question is what might come in the future? Looking forward, the UN forecasts are for the migration impulse to have been satiated and levels of migration to fall to a slow but steady outward migration. This forecast is supported by the experience of the United States, where there has been a notable decline in inter-state migration. In part, this has been driven by differing skills requirements and cost of living in high growth states excluding those from poorer states. There seems to be little reason that the EU would not experience similar pressures.

(above) Central and Eastern Europe Net migration

Source: UN Pop Database



(above) Central and Eastern Europe Net Migration 2000-2015
Source: UN Pop Database

CENTRAL AND EASTERN EUROPE NET MIGRATION 2000-2015

Net migration figures, while significant, do not tell the whole story. There have been significant outflows to Western Europe, which have in part been ameliorated by inflows from further east. Poland is an obvious example, where significant migration is masked by almost equal amounts of emigration from further east, chiefly the Ukraine. However, even the net migration figures are a concern and Governments across the region are looking at how to attract back emigrants. Both Slovakia and Poland have put in place programs to make it easy for returning emigrants to re-establish themselves, with the result that many Poles in particular have returned to home after years of working abroad.⁹

9 Chaffin, Joshua; "Young Poles leave UK to return home as economy booms"; *Financial Times*; 27 Oct 2017

Case Study: The Irish diaspora returns

Ireland provides some key lessons of how decades of significant migration can be reversed.

Ireland has seen significant emigration for more than a century, most famously during the potato famine of the 1840's. More recently, and of greater relevance, is the example of the post war generation of educated and ambitious Irish men and women who migrated to seek better economic opportunities.

The problem of migration is not just that Ireland had to bear the expense of educating these people, only to lose them as they began to become productive. The real economic challenge was that, it is almost impossible to foster significant or sustainable economic growth, when many of the best and brightest young people, those with the most get up and go, are getting up and going.

Movement between the United Kingdom and Ireland has always been fluid, but the evidence is that the United Kingdom was the net beneficiary of this flow of people and there have long been significant Irish diaspora's in British cities. Nor was it just to the UK, Ireland saw 4.5% of its populace emigrate to the USA between 1947-1979. By the 1960's, the Irish Government was not merely well aware of the problem, but also determined to do something about it. They introduced a series of reforms designed to make Ireland more attractive, from cutting tax payable by artists, through to radically lowering corporation tax to 10%, a successful effort to attract businesses in the growing high tech sector.

What is critical to appreciate is that the right policies alone would not have been sufficient for ultimate success. It is too much to expect of any political or economic policy to lead to a business uprooting its existing operations, including potentially complex supply chains, existing legal agreements, not to

mention the disruption demanded of executives personal lives, all for the promise of lower input costs or tax rates. What is needed is a political and economic framework conducive to business, to be in place when a new business opportunity arises. In the Information Technology revolution, Ireland was in the right place at the right time, and it benefitted from the fresh wave of new, primarily IT investment from America, looking to establish a European base.

From an immigration and emigration point of view, this IT investment led to significant demand for highly skilled people in well paid positions, just the sort of offer that proved attractive to the Irish diaspora. As the economy thrived, GDP per capita doubled from €20,000 in 1993 to almost €40,000 just a decade later, and the population mirrored this, growing substantially for the first time in over a century. These highly skilled returning workers proved critical in sustaining the 1990's economic expansion.

The Irish experience highlights four important points:

- A diaspora will return if they see economic opportunities appropriate to their new levels of skills and experiences
- The qualifications and expertise that the diaspora has gained in third countries has to be recognised and relevant.
- It is important that those who return are welcomed back, rather than resented for having left.
- Finally, some sort of ongoing cultural bonding with the diaspora through embassies and consulates may be helpful in maintaining links.

TRADE & COMPETITIVENESS

To foster further prosperity, the countries of Central and Eastern Europe must look beyond existing partners and technologies to either integrate or invent, or best of all, do both.

PRODUCTIVITY AND TRADE

It has often been said by economists, 'productivity is not everything, but in economic terms, it is almost everything'. If this were true in the past, it is becoming steadily less so, particularly if one defines "productivity" as being the process of getting better at what you are already doing. On the other hand, "agility" as the ability to learn or conceive new products and services is becoming increasingly important.

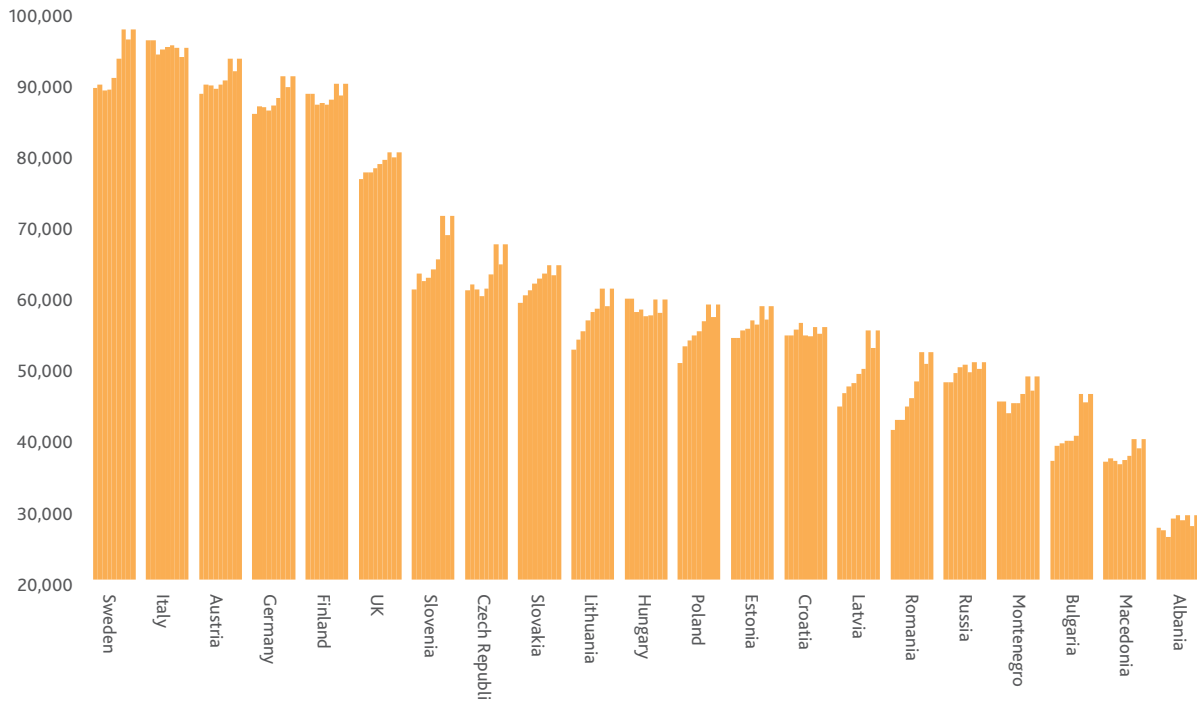
While productivity has stagnated across the developed world in the last decade, productivity in much of Central and Eastern Europe has bucked this trend and has been growing rapidly. Much of this growth is down to effectively playing catch-up, and encouragingly the International Labour Organisation expects the pace of productivity growth to continue across the region for the next five years. While this is good news, there are two caveats:

Firstly, there is a clear advantage to emulating the right competitor, one that continues to stretch expectations and ambitions. Productivity levels vary across Central and Eastern Europe, and the pace of productivity growth is expected to be particularly high in the key industrial hinterland countries and Baltics. Meanwhile the pace of growth in the South East is expected to be more modest, and the gap with the rest of the EU is expected to remain.

Secondly, the Industrial Hinterlands have seen investment driven by automakers seeking to arbitrage lower wages and through technology transfer. They have calculated that with the right investment they can come close to matching individual factory or facility level productivity enjoyed in Western Europe, while paying significantly lower wages that prevail in Eastern Europe. This business model has worked well, but there is a question now about a "middle income trap"; can future productivity increases be sufficient to justify the expected pace of wage increases? If the International Labour Organisation forecast rate of productivity growth holds, this seems possible, but the ILO forecasts are particularly robust and recent history has cast some doubt on these rates of increase being achievable.

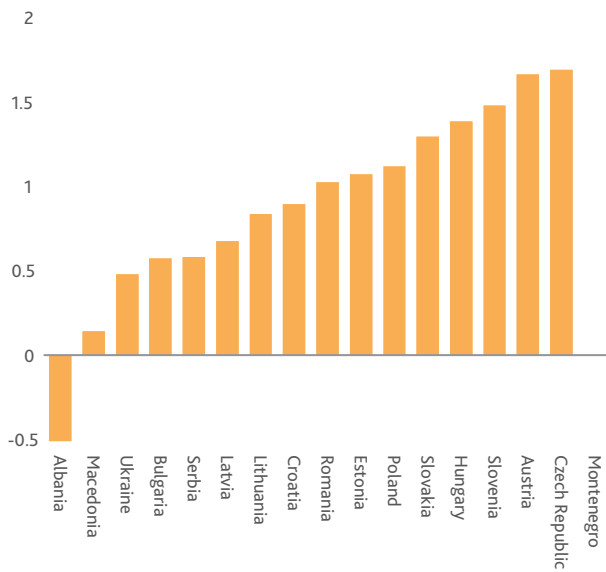
Given our contention that productivity and agility matter, it is important to discern the catalysts to these trends. Trade is one of the most powerful tools of development. Trade enhances consumer choice, promotes competition and opens opportunities for business and individuals alike. Harvard University's Atlas of Economic Complexity allows trade data to be easily visualized and for global trade flows across markets to be tracked over time. The Atlas places the industrial capabilities and knowhow of a country at the heart of its growth prospects, where the diversity and complexity of existing capabilities heavily influence how growth happens.

Productivity—Output (\$) Per Worker 2010-2018



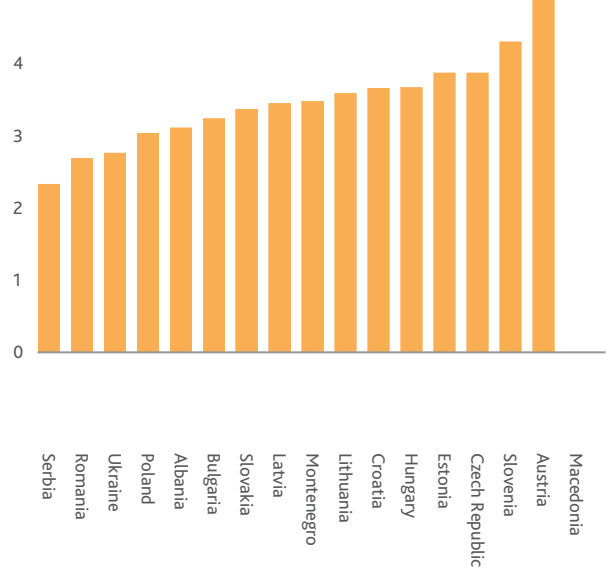
Economic Complexity Index

Harvard CID



Competitive Advantage

WEF Survey



Source: (top) ILO (bottom, left & right) Legatum PI 2017

Case Study: European Automotive Market

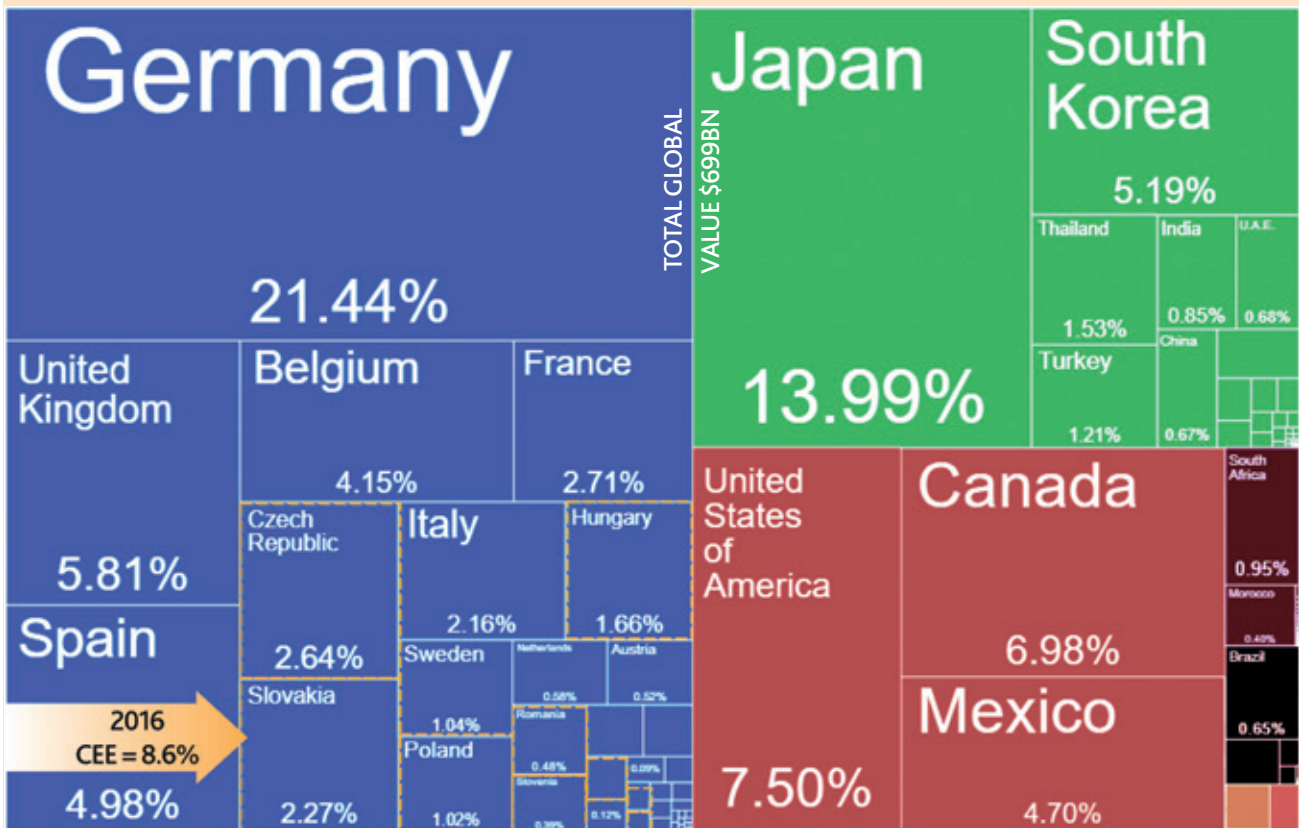
The world's most traded product faces a range of challenges and opportunities, from electric and self-driving cars, to meeting the demand from developing countries consumers. How the workers and firms of Central and Eastern Europe can be a part of this next generation of manufacturing will be a key question in the coming years.

Trade in automobiles is worth some \$1.35 trillion, or 4.9% of global exports.¹⁰ It is also a highly competitive market and Original Equipment Manufacturers are constantly seeking ways to meet consumers' demands for lower costs without compromising on quality.

Global Automotive Exports

Even under Communism, a number of Central and Eastern European countries had a significant industrial base, and much of it was then, as now, geared towards the automobile industry. The collapse of Communism allowed for the countries of Central and Eastern Europe, particularly those bordering the heart of much of Germany

industry, to integrate and upgrade their technology and industrial offerings. For the countries concerned this was a substantial opportunity, and one that has turned out to be a significant driver of prosperity. However, this desire for modernisation would have been much more difficult had there not been a co-incidental need of the European auto industry to address its high cost base. Here two factors have been crucial. Automobile manufacturers have been extremely adept at technology transfer, either through establishing new operations, or through extensively revamping existing facilities. These new operations have been able to come close to matching levels of western European productivity at the plant level, while paying



Source: Harvard Centre for Intl Development

10 "These are the world's most traded goods"; World Economic Forum; 23 Feb 2018

Case Study: European Automotive Market cont...

workers in Central and Eastern Europe what are good wages locally, but still well below the prevailing levels seen in Germany and elsewhere. Secondly, the geographic proximity of Industrial Hinterland facilities allowed them to be incorporated into wider 'just in time' logistics supply chains. The result is that Central and Eastern Europe now accounts (2016) for 8.6% of global car exports, by value,¹¹ approximately 90% of which originates in those countries close to the heart of German manufacturing. And this is before parts supplied into autos assembled in other countries are counted. The impact of this investment cannot be underestimated; there was no other opportunity that could conceivably have brought as much sustainable prosperity to such significant numbers of people in such a relatively short time.

Slovakia in particular has established itself as a major centre for automotive assembly; the industry represents 43% of the country's total industrial production and 35% of industrial exports, worth some €17 billion. The industry employs, directly or indirectly, some 200,000 people, out of a population of 5.4 million. All of this is to the good, yet of the 40 largest auto suppliers to the automotive sector, only two are Slovakian owned, with German suppliers being by far the most important investors.¹² While there remains a good mix of tier one (entire systems for inclusion in the final product) and tier two (individual parts supplied to either tier one suppliers, or the original equipment manufacturers) the days of competing on cost alone are rapidly fading.

The key question now is where to go from here? According to a 2015 BCG report,¹³ Global Emerging Markets automakers are on the brink of surging ahead in terms of total production. The impact of this on industrial hinterlands manufacturers is likely to be mixed. On the one hand, although much of the surge in auto production in developing countries will be absorbed in those countries themselves, German exports will undoubtedly be hit, with knock on effects for their suppliers. On the other hand,

cost pressures are likely to make the German OEM's even more tempted to utilise lower cost production available in the industrial hinterlands. This question is further complicated by Chinese leaders discussing legislation that, by 2025, would ban internal combustion engine vehicles in tier one cities. European countries are having similar discussions, looking to ban fossil fuel only cars but only from 2040.¹⁴ Such fundamental changes to the entire manufacturing process will clearly have a huge impact on carmakers around the world, and to date European manufacturers have been behind others in developing electric cars (although the Czech Republic is actively encouraging investment in this sector). What any change of this magnitude is going to entail is an entirely new business model, one where considerations of the productivity of the Industrial Hinterlands, the "middle income trap" and the need for capital markets.

Key lessons:

The next stage of automotive technology from electric to autonomous cars, will entail revolutionary redesign and considerable retooling of many aspects of production. Firms in CEE must ensure they remain highly competitive in order that they are selected to continue to be the manufacturing location of choice within a global supply chain.

Artificial Intelligence is most likely to be deployed in advanced manufacturing generally and the auto industry specifically. This gives CEE businesses the opportunity to be at the cutting edge of emerging technology, firms should seek to deploy this expertise into as wide a range of manufacturing processes as possible.

Key to any competitive positioning will be a highly skilled and adaptable workforce. Governments can help with facilitating worker retraining and life-long learning; actions range from tax incentives to allow custom tailored retraining, to expansion of further education colleges and schools.

11 Harvard Centre for International Development

12 "Automotive Sector in Slovakia"; Slovak Investment and Trade Agency; 2016

13 "The Shifting Competitive Balance in the Automotive-Supply Industry" BCG; 24 June 2015

14 "China moves towards banning the internal combustion engine"; *The Economist*; 14 Sept 2017

Clearly, the economic complexity index essentially reflects what might have intuitively been expected. The countries of the industrial hinterlands score well, while the more agricultural and less integrated countries of South Eastern Europe are grouped at the bottom. Looking to the World Economic Forum's Competitive Advantage survey, we find a similar pattern, although less stark divergences across the region. The immediate question is how might those countries of the South East food hub increase their prosperity, and how might those of the Industrial Hinterlands continue to build upon their advantages? The answer for both is careful investment. It is unlikely that the Governments of Central and Eastern Europe are going to be any better at "picking winners" than the governments of Western Europe have been. However, non-company specific investment to improve infrastructure offers far more scope for fostering development. Improving logistical linkages, through to improving communications links, are going to be useful no matter what businesses develop.

INDUSTRIAL HINTERLANDS—THE CHALLENGE OF REINVENTION AND DIVERSIFICATION

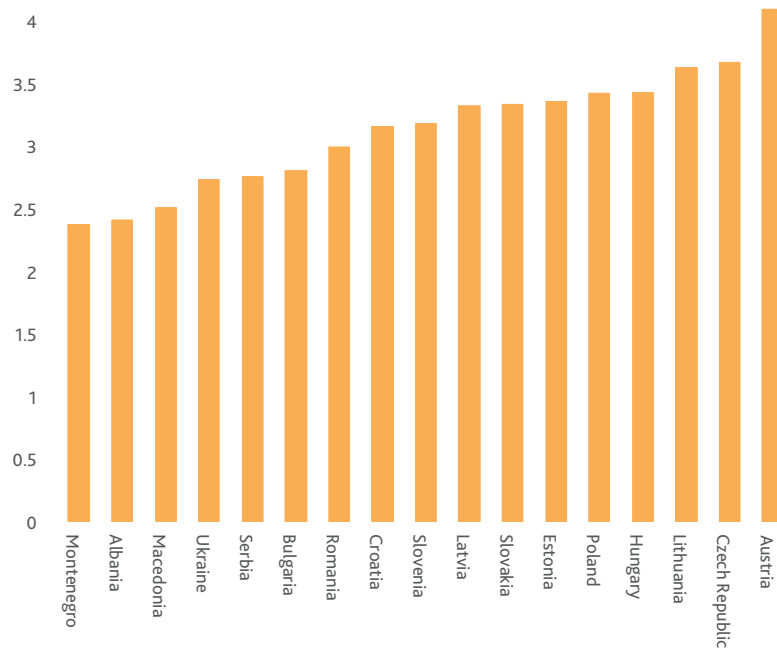
The Czech and Slovak Republics are at the core of what we have termed the "Industrial Hinterlands", an area in which we also include Slovenia, as well as parts of southern Poland and northern Hungary. It is notable that the "Industrial Hinterlands" are all in the top half of our Logistical Performance Index, indeed such connectivity would seem to be a prerequisite to be incorporated into the wider European industrial supply chain. But looking at Legatum's Prosperity Index, it is not just physical linkages or the geographic proximity to Germany and Austria that defines this area, the key is the economic, industrial, social and institutional mix.

Given the choices that this region faced in the aftermath of the collapse of Communism, integrating into the broader industrial heartlands of Europe was both obvious and has been a notably successful strategy. The question is, will this strategy of industrial integration continue to be the success in the future that it has been in the past?

The economic challenge is that being the location for relatively low cost, reasonably high skill, production and engineering does carry a risk. Certainly, it is true that there is a significant benefit from having a well-paid populace. Moreover, this was a tide that lifted if not all, then certainly many, boats. Income differentials have declined as increasing number of people found well-paid positions. As a measure of this, it is notable that the Gini co-efficient for the Czech and Slovak Republics are respectively 25.9, and 26.1, while that of Slovenia is 25.7.¹⁵

In the case of the Industrial Hinterlands, they have effectively become the near-source home for German and other Europeans engineering and manufacturing. The difficulty merely being the home of production for others is that you have little control over your economic future, depending almost exclusively on the decisions taken by companies based in other countries. There are a host of examples of "rust belt" regions where being the location of manufacturing worked well for a time; but this strategy ultimately left those regions without the natural and necessary ability to weather economic shocks or adapt to necessary changes. A measure of

15 World Bank Data 2016/7



local wealth accumulation might raise a Gini coefficient, but it also would provide a pool of finance and a stronger longer-term regenerative base.

That said, the Industrial Hinterlands have already weathered one set of post Communism changes with remarkable skill. Consumer white goods were for a time produced in large quantities in the industrial hinterlands. The problem was that white goods manufacturers could not justify wages on a scale similar to those involved in the automotive industry. The result was that white goods manufacturers had difficulty recruiting workers, eventually relocating production to Asia. If the industrial hinterlands are to maintain their economic and industrial agility and competitive advantage in engineering, they must meet the next set of challenges of increasingly competitive and sophisticated manufacturing such as 3D manufacturing and take advantage of dramatic opportunities to reduce labour input costs into engineering processes.

Finally there is the entrepreneurial challenge, which the Industrial Hinterlands have in common with almost all of Europe. As with any challenge, there is also more than one solution. It is unrealistic to advocate the entrepreneurial model and approach of the Baltics, heavily reliant on new companies and high tech start-ups, to the industrial hinterlands. What is needed in the Industrial Hinterlands is to work with the great industrial and engineering successes, both fostering the expansion of local engineering firms and critically helping existing firms to broaden and diversify.

(above) Logistics Performance Index

World Bank Development Indicators 2017

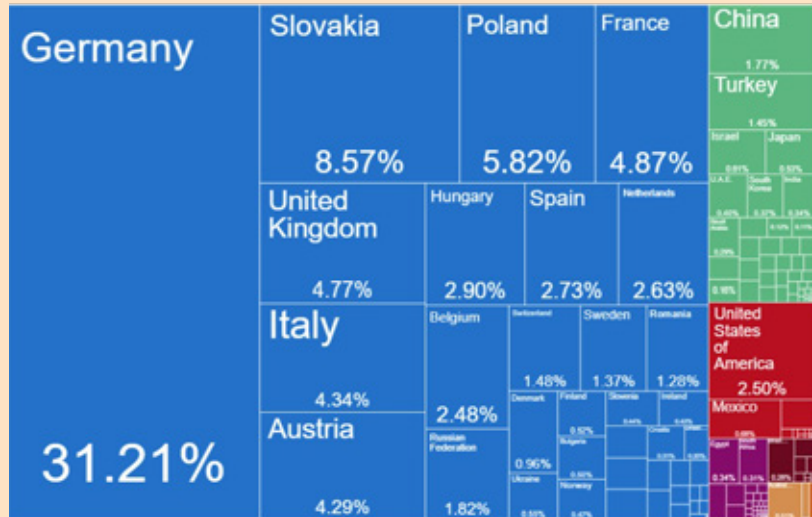
Source: Legatum PI 2017

Case Study: Czech and Slovak Republics

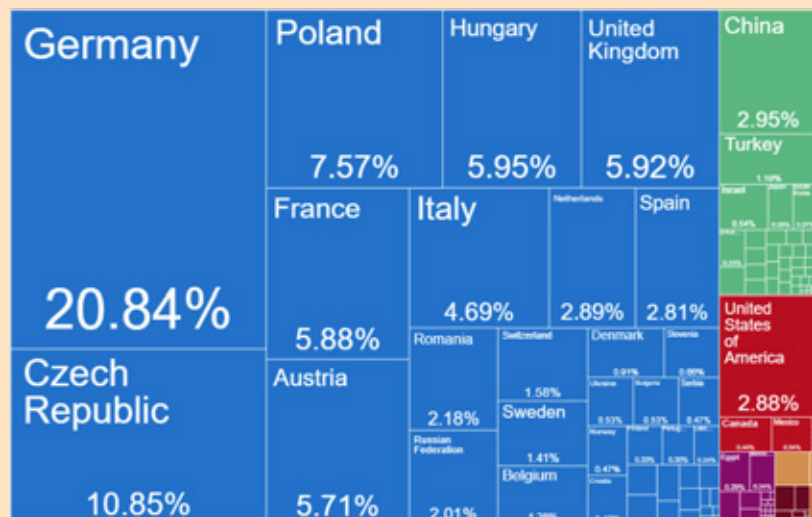
Decisions made a generation ago have brought significant prosperity, but it is time to look at the next set of strategic choices. Industrial and geographic diversification should be key priorities.

While the “velvet divorce” resulted in the breakup of Czechoslovakia, there are according to the Legatum Prosperity Index, no two Central and Eastern European countries that have more in common than the Czech and Slovak Republics. Both have a heavy reliance on the automotive sector, they are each other’s second most important export destination (for both, Germany is the most important trading partner). Both countries score well in terms of logistics, a factor that has been so helpful in their being incorporated into the wider framework of the ‘industrial hinterlands’. While on most scores, the Czech Republic is wealthier, both countries have demonstrated good fiscal discipline and Slovakia has a low budget deficit. Both have low debt to GDP ratios, both have low tax take as a percent of GDP. Both countries score poorly on perception and reality of starting a business; and tend to have restrictive labour market regulations. The Czech Republic has a rich and complex set of exports. Indeed, the scale and complexity of exports from the Czech Republic is more complex than those of Austria and twice as much as a percent of GDP. It is notable that the

Czech Republic Exports
Total Global Physical Export: \$160bn



Slovakia Exports
Total Global Physical Export: \$77.7bn



Source: Harvard Centre for Intl Development

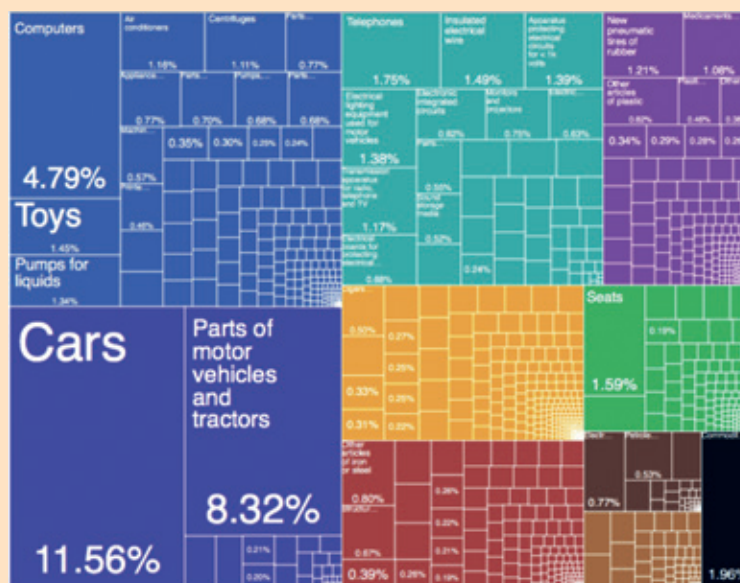
Case Study: Czech and Slovak Republics

Czech Republic is now seeking to diversify their export base in a manner similar to the successful diversification they undertook after the fall of Communism. To facilitate this the government is opening a series of new embassies and trade missions from San Francisco to Seoul.

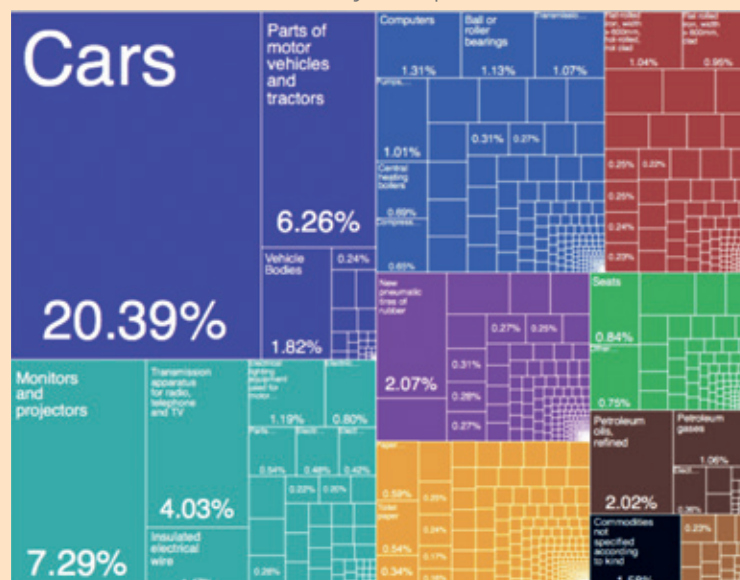
Looking at how socially and economically inclusive the Czech and Slovak Republics are is an interesting contrast between cultural affinity with their near neighbours, and legacy of their Communist past. Just looking at the Legatum Prosperity Index scores, the Czech Rep comes in at 31st, while Slovakia trails not far behind at 37th. Both countries have admirably small and gradually shrinking shadow economies, in both countries' cases down by almost half since 1992.¹⁶

Yet both countries are particularly weak on social capital, a clear legacy of their Communist past. The Czech Republic relatively good on rule of law in the context of Eastern Europe—but still notably behind Germany and Austria. Slovakia is weaker still on Rule of law, while neither country scores well on Public sector corruption and transparency of policy-making. Both are middle of the European pack on Government Performance. As with much of industrial Europe, there are significant amounts of labour market rigidities, although in neither case has this resulted in high unemployment.

Czech Republic Exports
Total Global Physical Export: \$160bn



Slovakia Exports
Total Global Physical Export: \$77.7bn



Source: Harvard Centre for Intl Development

Case Study: Czech and Slovak Republics

Key lessons:

Diversified savings base closer to the Anglo-Saxon model of individual equity savings should be accumulated in order to foster the ability to domestically fund economic and business investment.

Liberalisation of labour markets should be embarked upon now when high employment means the opposition will be minimal.

“Creative adaptation” could be fostered through the corporate tax code, allowing venture capital style tax reliefs to enhance the returns from diversification.

Similar to Ireland, a national program seeking to foster links with Czech and Slovak diaspora’s is desirable to attract talented workers.

The next stage of development is going to require the build of digital and physical infrastructure to support all their endeavours.



Image credit: Herrndorff / Shutterstock.com

SOUTH-EASTERN EUROPEAN FOOD HUB: SCARCE TOWNS, SMALL FARMS

Fostering urban clusters and a prosperous countryside

The population of South Eastern Europe is less prosperous, less urban and less productive than in the rest of Central and Eastern Europe. South-eastern Europe has the potential to be a major agricultural resource for the whole of the EU, although it has to be recognised this has to be a long term ambition.¹⁷ Encouraging and enabling migration to urban centres will help both productivity and prosperity. Key to achieving this is raising the capital intensity in the countryside, while raising the productivity of human capital in urban centres.

A quick glance at a map confirms most people's intuitive understanding: South Eastern Europe is predominantly agricultural. It is notable that the three countries with the highest concentration of very small and small farms are, in order: Romania, Hungary and Bulgaria. Indeed Romania accounts for 33.5% of all farms by number in the EU.¹⁸ What becomes apparent is that these very small farms are also extremely inefficient and, according to the Prosperity Index, as many as 25% of the farmers in Romania are living on World Bank's definition of interim subsistence of \$5.50 a day. Even factoring in a substantial degree of production being missed by official statistics, these farmers are going to be poor.

It is also useful to note that many countries have a nationally defined poverty level. While making comparisons between countries more difficult, such national measures can understand and account for local circumstances. Under local measures, we can see the Baltics faring more poorly than international data would suggest due to rapid rises in their cost of living, while Albania, with its very low cost of living, has fewer people in locally defined poverty than international comparison might suggest. That said, poverty is still a huge challenge and Serbia, Romania, Macedonia, Bulgaria and Croatia; all see, according to local measures, more than a fifth of their populations living in poverty.

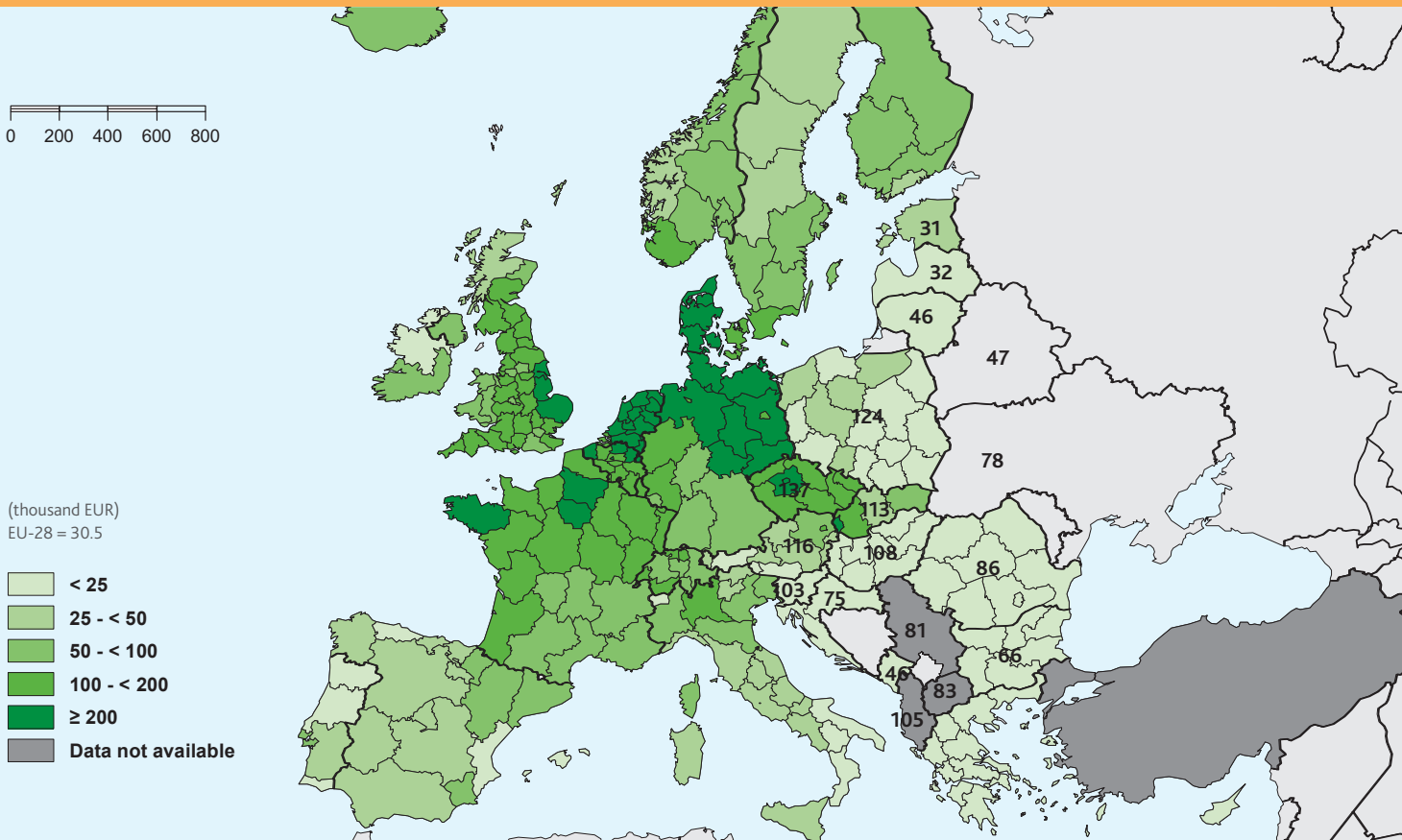
AVERAGE ECONOMIC SIZE OF FARM HOLDINGS

There has been substantial academic research over the years relating farm size to resulting productivity. Some argue that small farms should be preserved and that the Common Agricultural Policy should seek to make small farm holdings viable. However, successive EU agricultural reforms have moved away from this approach, and a wider range of considerations, from environmental sustainability to preservation of rural employment, now influence agricultural support programs.

If small farms are seen as being inefficient and the root cause of both poverty for many farmers and poor productivity on a wider scale, how rapidly might the agricultural sector

¹⁷ It is often said the best time to plant a tree was 20 years ago, the second best time is right now.

¹⁸ Eurostat Statistics explained; "Small and Large farms in the EU—statistics from the farm structure survey"; p2; 26/10/17



(above) Average economic size of farm holdings, by NUTS 2 regions, 2013(thousand EUR)

Source: Eurostat, World Bank

Number is 2016 population density per KM

Note: Germany and London (UKI): NUTS level 1. Slovenia: national data. Iceland, Switzerland and Montenegro: 2010. Source: Eurostat (online data code: ef_kvecsleg)

be reformed? Could farm sizes be increased to allow for more efficient farming methods to predominate and therefore for the sector as a whole to add to the prosperity of the region, indeed to all of Europe? Increased specialisation in high margin food-stuffs, which may also entail more local processing, could well result in viable smaller size farms, albeit these farms would certainly still be larger than many found in the South East Food Hub today.

Looking at the UK, where there is considerable historic data, the number of small British farms (5-20 acres) fell considerably in the last 150 years, but this decline was far from steady. In 1870 there were some 125,000 small farms, and numbers were generally reasonably stable until the early 1930's at which point the number of such farms declined precipitously (apart from a blip during the Second World War) to approximately 30,000 small farms in 1983. The number of medium sized farms declined as well, although this decline came only after the Second World War and was far less dramatic, while the number of large farms, over 300 acres, has slowly risen over that time. Throughout this time, the amount of land devoted to farming has been reasonably steady.¹⁹ If a similar pattern is replicated across South Eastern Europe, it is quite possible the reforms will be seen over a more rapid timeframe, albeit it will still take a generation

19 Grigg, David; "Farm size in England and Wales from early Victorian times to present"; *The Agricultural History Review*; Vol. 35, No. 2 (1987), pp. 179-189.

Case Study: Croatia

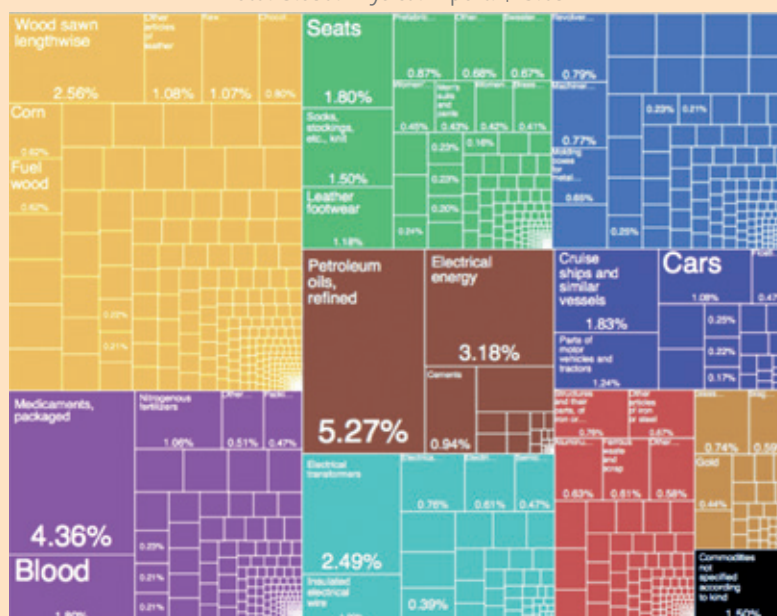
Croatia is working to overcome poor logistical infrastructure and the legacy of war. Leveraging their tourism industry is going to be key to creative adaptation.

While Croatia is the most prosperous South Eastern European nation in Legatum's Prosperity Index, it still ranks only 43rd overall. This places Croatia below the Baltics and all the nations of the Industrial Hinterlands, except Hungary. The challenges facing Croatia are manifest: in terms of an Open Economy, it is ranked 83rd and is particularly weak in its business environment, with a poor perception of it being a good place to start a business and a high cost of doing so. Not only is finance hard to arrange, labour market regulations are numerous and there is a high degree of occupational licencing.²⁰ There is also a high cost to registering property and low ease of resolving insolvency, a particular concern of many providers of venture capital. Croatia suffers from relatively high levels of unemployment and fares poorly in providing an inclusive society, ranking only 50th globally, plagued by weak social capital and weak rule of law. Given the relatively recent civil war, Croatia is unsurprisingly concerned about safety and security.

While Croatia might in theory have an easier time than other former Yugoslav Republics (excepting

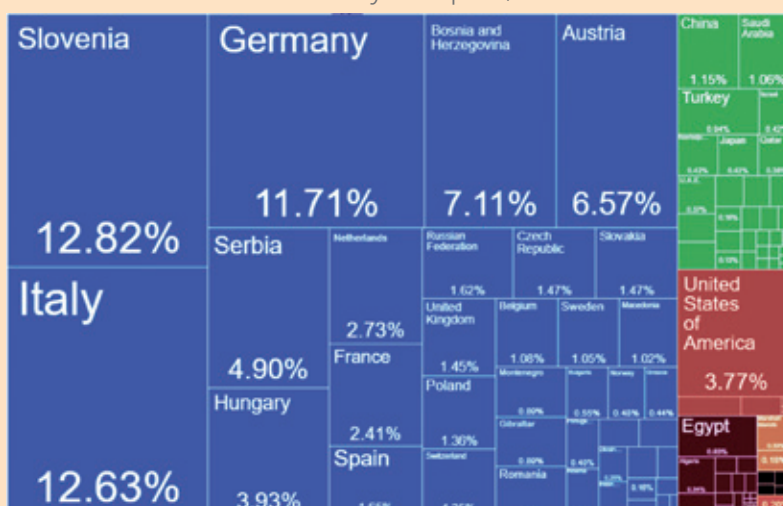
Croatia Exports

Total Global Physical Export: \$13.6bn



Croatia Exports Destinations

Total Global Physical Export: \$13.3bn



Source: Harvard Centre for Intl Development

20 Dr Maria Koumenta and Dr Mario Pagliero; "Measuring Prevalence and Labour Market Impacts of Occupational Regulation in the EU"; European Commission, Directorate-General for Internal Market; 2015

Case Study: Croatia cont...

Slovenia) in terms of being integrated logistically into the industrial heartland of Europe, the program of infrastructure building, chiefly road and air links, is only just being completed and has yet to bear fruit.²¹ As a result physical exports have been constrained, amounting to just over \$13 billion. For comparison this is one-third the level seen in better integrated countries such as the Czech Republic.

The one area of Croatian economic success is tourism, in particular Croatia's Dalmatian coast which, according to Eurostat, is the only area of all of Central and Eastern Europe that sees tourism (nights in hotels) on a level with other high tourist areas such as north Italy, the south of France, Mediterranean Spain, Bavaria and south coastal Britain. Capitalising on this natural advantage to foster greater "creative adaptation" with local firms using their cash flows to borrow and invest in economic diversification has the potential to give Croatia an enviable competitive advantage.

Key Lessons:

As with other nations in Central and Eastern Europe, a diversified base of individual savings should be accumulated in order to foster the ability to domestically fund economic and business investment.

Agricultural areas should be encouraged to develop higher margin food processing capabilities, meeting the increasing demand from Northern and Western European consumers for convenience foods.

"Creative adaptation" could be fostered through the corporate tax code, allowing venture capital style tax reliefs to enhance the returns from diversification or moving up the industrial and agricultural value chain.

To retain and attract talented workers, there needs to be an ongoing program seeking to foster links with the Croatian diaspora.



Shutterstock.com

²¹ Eurostat Data, *Motorway Networks* by NUT2 Regions

or more, rather than a century. What is even more likely is that reform will not be gradual, but subject to periods of near stagnation, followed by rapid change, in part this volatility will be driven by the uneven application of rules allowing or encouraging consolidation of farmland and foreign direct investment into the sector.

Alongside agricultural reforms is the need to enable movement from the countryside to the cities. This is a challenge for all of Central and Eastern Europe, and it is probably most acutely felt in South Eastern Europe where there is less urbanisation and where existing urban centres are less ready to absorb significant migration. There is however some good news. The Global Talent and Competitiveness Institute ranks²² those urban centres of the world best able to attract and hold onto talent. While no Central and Eastern European city ranks in the top 25 cities globally, six are in the next 25 (headed by Prague) and all Central and Eastern Europe countries, barring Albania and Macedonia, have at least one city in the top 70, with non-capital cities such as Krakow and Brno also making the grade. This is in marked contrast to many other emerging economies around the world, where there are no cities of note. Clearly, the attractiveness of cities across Central and Eastern Europe is an advantage that should be built upon.

22 <https://gtcistudy.com/special-section-gtci/#gtci-rankings-table>

ENTERPRISE AND DIGITALISATION

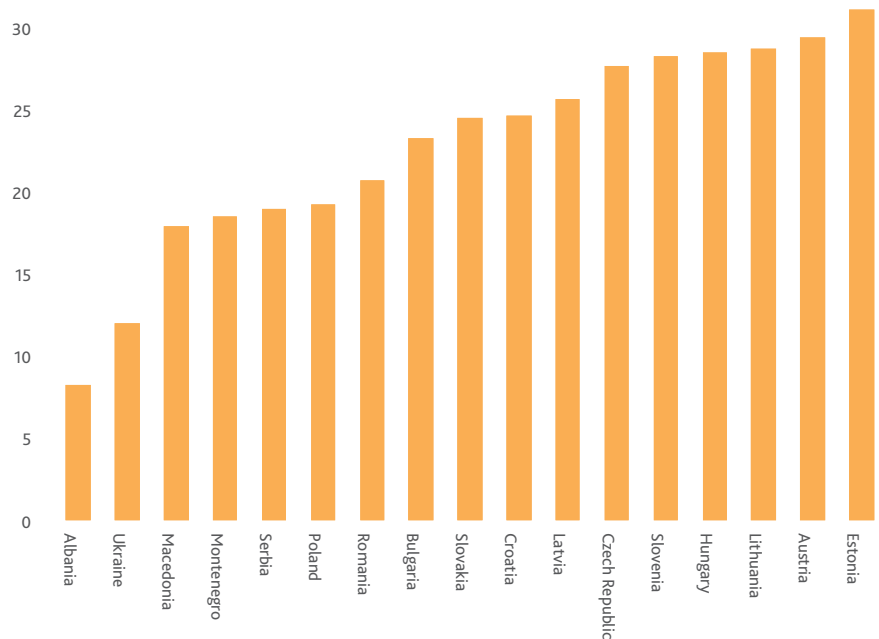
The digital and information age puts the need for “creative adaptation” at the heart of business transformation

The digital and information revolution has already begun to transform the economies across Europe and this revolution is going to put further pressure on Central and Eastern European countries. While Central and Eastern European countries have undergone a degree of digitalization, there is still much to do. The countries of the Entrepreneurial Sea rank on average 29th in the world for broadband connections, whereas the Industrial Hinterlands rank at 36th, with the South East at 49th.

THE ENTREPRENEURIAL SEA

The waters of the Baltic Sea may well be something special. While much of Europe languishes in the bottom quartile of global entrepreneurial activity, the Baltic nations

Fixed Broadband Subscriptions
World Bank Development Indicators 2017
Source: Legatum PI 2017



Measuring Entrepreneurship

How might we measure entrepreneurship and how is it changing around the world? In terms of measuring entrepreneurship, one of the best data sets is collected through the Global Entrepreneurship Monitor (GEM), put together by an alliance of leading business schools from around the world.²³ The chart below shows the number of people working in an entrepreneurial start-up, that is a business less than three years old.

What is very apparent from the data is that the state of global entrepreneurship has gone through a revolution in the last twenty years. Since 2001 (when the data was first collected) the number of people involved in an entrepreneurial start-up has grown by five-fold. Take for example the highly entrepreneurial United States, where in 2001 approximately 12% of people were involved with a start-up company. At the time, this was a good score and placed the United States in the top half of the global rankings. Today 15% of Americans are involved in a start-up and a score of 12% is seen in countries such as the United Kingdom.

However, just examining the United States, or indeed the developed world does, not begin to tell the whole story. The 2016 dataset shows the full range of global

entrepreneurial activity, and there have emerged three overlapping drivers of this activity. At the one extreme, the most entrepreneurial in the world, are Zambia and Nigeria (with ~40% of their populaces describing themselves as entrepreneurs). These places are prime examples of “factor driven” entrepreneurship, which says that for many people in these countries there is little effective choice: either start your own business, or be unemployed. Further down the scale we find “efficiency driven” entrepreneurship. Here people are providing a range of necessary goods, but often as not these services have yet to achieve effective scale. Only when you move further down the scale do you find what is termed “innovation driven” entrepreneurship. People starting firms out of choice, many certainly for lifestyle reasons, but many firms are started by people determined to provide a better service, or to exploit some new innovation.

Within ‘innovation driven’ entrepreneurship we can see a wide range of results, from the leaders such as the United States and the Baltic States with over 15% of the populace working for a firm less than three years old, to Italy and Japan where respectively 4.4% and 3.8% of people are involved in a new company.

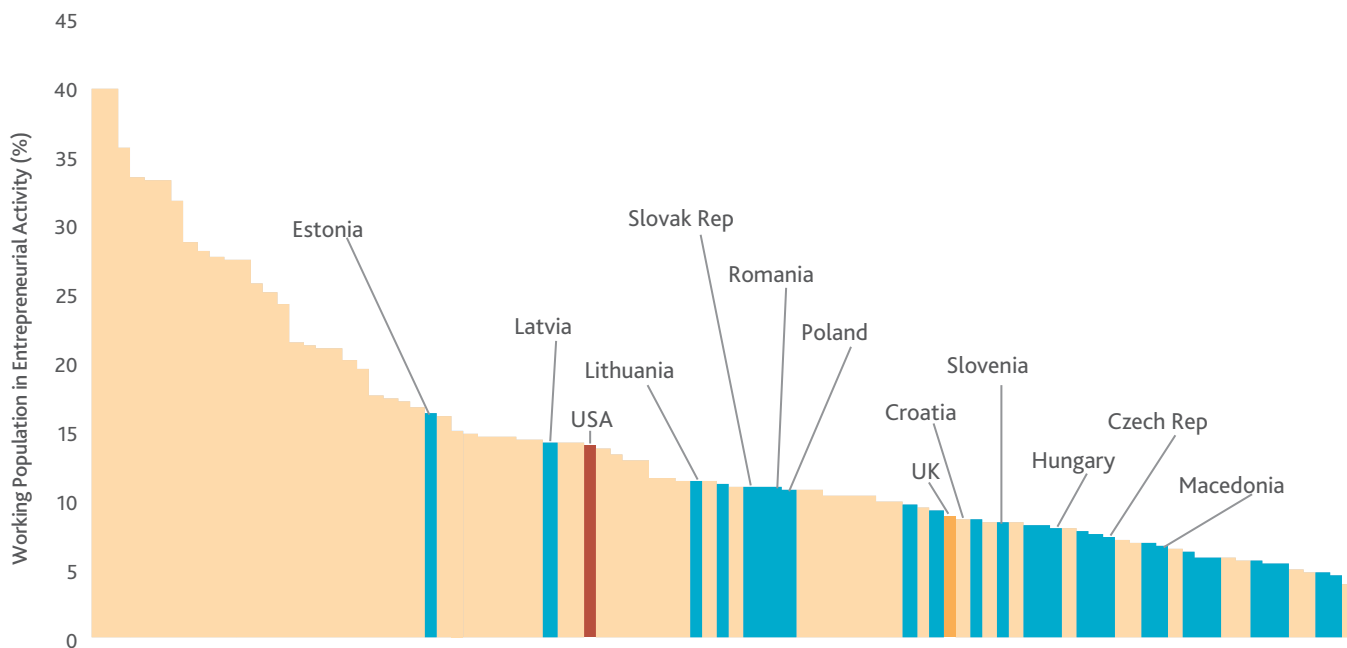
have shown that high degrees of social provision can be successfully combined with significant degrees of entrepreneurial business agility and large doses of radicalism.

Europe as a whole has fared poorly in developing innovative new entrepreneurial start-ups. Central and Eastern Europe countries (coloured light blue in the table below), clearly show a wide variance in the degree of entrepreneurial activity. The data confirms what might have intuitively been expected, that the Baltic States score particularly well. The Industrial

Hinterlands are less obviously entrepreneurial and conform to the pattern set by more long-standing EU states, while the South East shows a significant degree of variation, from Romania with approximately 11% of workers involved in a start-up, to Macedonia where less than 7% of people are similarly entrepreneurial.²⁴ It should be noted that for much of the South East, levels of entrepreneurship might place them amongst the innovation driven nations, but closer examination of the data reveals they are low scoring efficiency driven economies.

23 <https://www.gemconsortium.org/>

24 There are some gaps, both Albania and Bulgaria have no reported data.



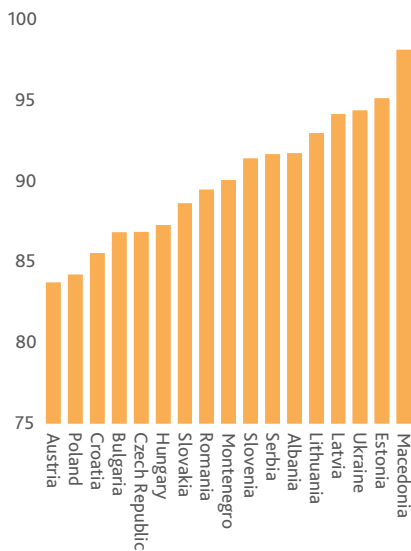
(above)
Entrepreneurial
activity. EU
countries
are in blue.

Source: Global
Entrepreneurship
Monitor.

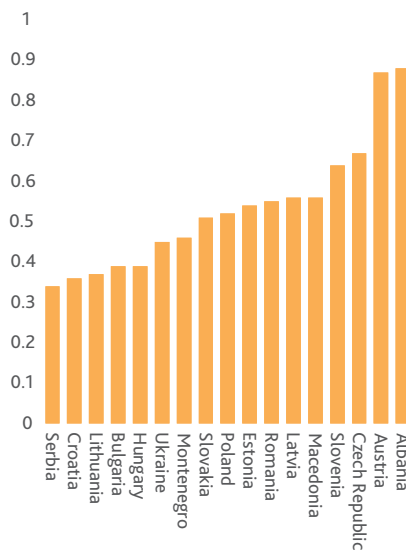
GLOBAL ENTREPRENEURSHIP: 2016

It goes without saying that the ability to start a business is not a sufficient incentive to actually do so. In truth the fostering of entrepreneurship seems to depend on a host of attributes. These range from wider social attitudes, which is why the Prosperity Index tracks varying measures from the ‘ease of starting’ a business, to ‘thinking it might be a good idea’, to ‘respecting those who start a business’; but again, positive responses—however welcome—are not a guarantor that people will actually start a business. Also critical are issues such as having a clear rule of law, encouraging a sympathetic ecosystem of services such as legal advice, providing core infrastructure such as broadband, sympathetic bankruptcy procedures making it easy to fail and try again. Ultimately while success cannot be guaranteed, opportunity does have to be open to all those want to try. The nations surrounding the Entrepreneurial Sea have been notably successful in fostering each of these attributes.

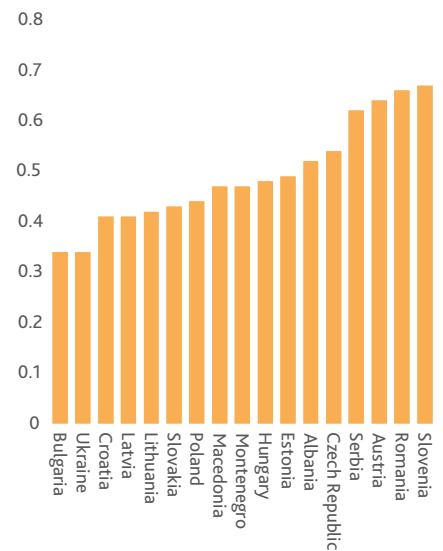
Ease of starting a business
World Bank Doing Business Index 2017



Perception of working hard getting one ahead
Gallup World Poll 2017



Perception of good place to start a business
Gallup World Poll 2017



CREATIVE ADAPTATION

It is inconceivable that many societies in either Western or Central and Eastern Europe would allow or condone a Schumpeter-esque “creative destruction”²³ of companies, even if they were confident that a new cadre of vibrant firms would grow up in their place. What is needed therefore is a system which fosters and encourages not creative destruction, but “creative adaptation”. This involves existing companies and their employees adapting what they are doing, and to do so by considering new areas of activity well beyond the traditional confines of the existing goods and services they have been producing.

Business transformation as a method of entrepreneurship is not as unusual as might be imagined, and more evolutionary business structures can clearly deliver prosperity. There are a series of examples of corporate transformations from around the world that show just how corporate renewal can be achieved.

Firms such as Finland’s Nokia have moved over the years from being a paper mill, to manufacturing rubber products, to telecoms, to ultimately failing to capture the final twist in their fast changing industry and as a consequence being absorbed into another firm. But, over their years of spectacular growth they (and their Swedish competitor Ericsson) spurred

Source: Legatum PI 2017

23 Austrian economist Joseph Schumpeter advocated creative destruction of firms as a method of business renewal and economic vibrancy.

on the establishment of an entire Nordic eco-system of technology and communications firms.²⁶ This is a legacy that has lived on and continues to deliver prosperity to the region today.

Often business transformation is a result of an ancillary line of business doing so well, it becomes the obvious place to focus to achieve revenue growth. The American giant IBM went from being a manufacturer of computers, to a consultant as to how to make Information Technology systems work efficiently. This transformation was undertaken by a new CEO, from outside the firm, who had the strategic vision to see how the industry was developing and how to meet the challenge of declining manufacturing margins, while exploiting the growing demand for IT consulting.²⁷

The Peugeot family has long shown a great degree of innovation, they came to car manufacturing through milling, manufacturing of steel tools, through bicycles, to salt and pepper grinders. In 2012 the firm utilised its design expertise, forming a design lab which is open to non-automotive customers.

Berkshire Hathaway, which before it became arguably the world's most successful investment firm, originally made men's shirts. Warren Buffett thought the company was both undervalued and had a future in textiles. Taking a controlling interest in 1965, he began by looking for investment that would help to diversify and stabilise the company's volatile revenues, only eventually concluded that the best way forward was to exit the shirt business altogether in 1985 and focus the firm onto something that created value.²⁸

Each of these transformations has a host of unique factors and all involve large companies, and some common themes applicable to firms of any size do emerge. These transformations were all characterised by leaders who recognised the need to think strategically and who grasped opportunities, even if it was not the opportunity they were initially expecting. Often the leaders were outsiders, less constrained by a corporate memory and so more willing to make the necessary hard decisions. These leaders also had permission, legally and from their stakeholders, to drive through these changes: there was a widespread realisation the choice is change or die. Finally, and this applies for small businesses as much as large ones, these companies used their existing cash flows to finance the transformation.

In an economy such as that that prevail in Central and Eastern Europe where bank debt is the most common form of financing (see next section), using existing cash flows to raise the necessary investment is likely to be the only realistic path to restructuring and long term viability for many companies. Such a path is going to need flexibility from bankers, but the rewards and potential of agility in this area remain considerable.

"Creative adaptation" has the potential to be key to enabling economic change and promoting businesses agility. Political leaders should consider prioritising incorporating such an approach into policy making and encourage the existing infrastructure of firms, from banks, to legal firms, to accountants and other services, to see "creative adaptation" as a natural part of the way of doing business.

26 "Our history"; www.nokia.com

27 "History 1990's"; www-03.ibm.com

28 "History of Berkshire Hathaway"; www.warrenbuffett.com

Case Study: Estonia

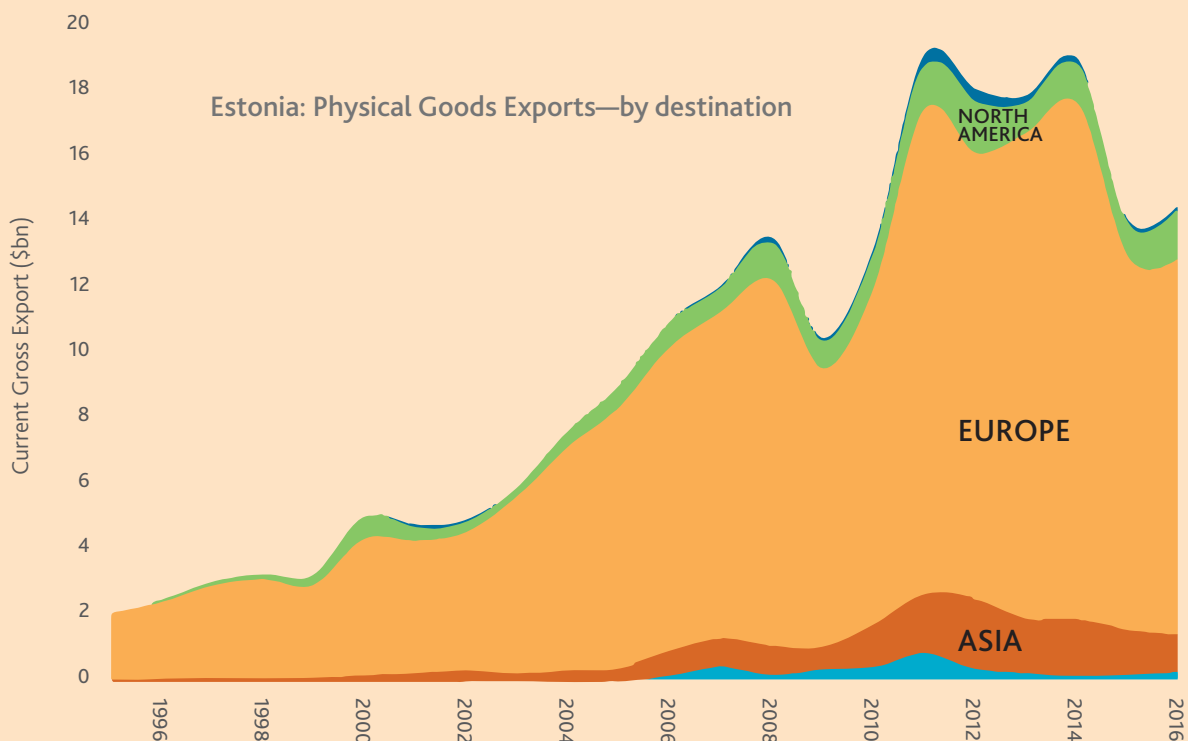
Embracing innovation from e-government to entrepreneurship has not only boosted exports, it has stemmed emigration.

In many ways, Estonia is one of the most remarkable success stories to emerge from Central and Eastern Europe. Since 1993 GDP per capita has grown in real terms, from less than \$2000 to more than \$18,000. Even more remarkable is that this has been achieved without resorting to unsustainable levels of government spending; indeed government debt levels are less than 10% of GDP. This has propelled Estonia to 27th in the Legatum Institute Prosperity Index.

Estonia's banking system is sound and credit is affordable. Like its Baltic neighbours, there is a strongly pro-business atmosphere, they rank 13th globally for ease of starting a business. There is a flexible labour market (although redundancy

costs are high) and minimal levels of occupational licencing, with the result that unemployment levels are reasonably low. Estonia is the most entrepreneurial country in the entire Central and Eastern European region, and unsurprisingly this has attracted a significant amount of Venture Capital.

Estonia's export base is heavily dependent on Europe in general and their Baltic neighbours in particular. One third of exports go to other Nordic countries, almost half that going to Sweden, with Finland following closely behind. Many of these exports undoubtedly end up in goods which are then re-exported to the rest of the world, so the dependence on Europe as a final consumer is almost certainly overstated. Domestically Estonia ranks 24th globally for



Source: Harvard Centre for Intl Development

Case Study: Estonia cont...

broadband subscription rate. Telephone equipment is the single largest category of exports, over three times the size of the next largest category of exports. The explosive growth of the telecoms market is showing signs of maturing and finding the next rapidly growing area, and or technological diversification is going to be necessary to enjoy rapid above trend growth in future.

Like all former Communist countries, Estonia suffers from relatively weak Social Capital, although the country has done more to overcome many of the other negative legacies of Communism than other Central and Eastern European nations and has reaped the rewards.

Estonia is strong in Governance, rule of law, and its independence of judiciary is the strongest in Eastern Europe. They enjoy high levels of intellectual property protection and are very strong on government integrity and transparency, and ability to deliver good policy.

Key Lessons:

As with other nations in Central and Eastern Europe, a diversified base of individual savings should be accumulated in order to foster ability to domestically fund economic and business investment.

To retain and attract talented workers, there needs to be an ongoing program seeking to foster links with Estonian, or wider Baltic State, diaspora is desirable.



Image credit: Shutterstock.com

GROWING SMALL AND MEDIUM ENTERPRISES

Looking at top line macro-economic figures such as GDP masks the dual structure of the Central and Eastern European economies. Multi-nationals have indeed done well, and their investment is more often than not highly profitable, but there is also a growing divergence between performance and productivity these larger multi-national firms and that of domestic Small and Medium Enterprises. Often Central and Eastern European SMEs are focused on providing services, such as food retail, which in more developed economics were long ago subjected to corporate consolidation. While there is no particular pattern in the number of SME's in Central and Eastern Europe compared to the rest of the European Union, Poland, Slovakia and Romania have relatively few SMEs, around two enterprises per 1000 inhabitants. In contrast the Baltics have a good number with over four enterprises per 1000 inhabitants. That said there is an equally wide range of outcomes amongst western European economies, with Germany being similar to the Baltic States and France being more like Romania in having relatively few SMEs.²⁹

Fostering SME growth is a key priority for the region, and while SMEs employ significant numbers of people, many of these smaller firms are relatively unproductive, so unable to pay significant salaries. For example in Poland the value added by SMEs is only 68% of that for larger firms.³⁰ Economic governance and regulation is also an issue. Many larger firms can cope with bureaucracy and if necessary negotiate exemptions, but for SMEs and overall economic health, such 'over bureaucratisation' is a serious hindrance to fostering widespread prosperity. Many companies have concluded that they need to avoid bureaucracy wherever possible; and the result is a still significant, although shrinking shadow economy. The effect of this goes well beyond the impact of tax revenue for the government; SMEs are all too often incentivised to stay small to avoid coming to the notice of the bureaucracy. This approach naturally discourages investment and indeed two thirds of SME investment can be met from retained funds.

29 Adam Czerniak, Maciej Stefański; "Small and medium enterprises in Poland—obstacles and development"; *Polityka Insight*; 2015

30 "Small and Medium Size Enterprises in Poland" Polish Agency for Enterprise and Development (PARP); 2017

FINANCE AND INVESTMENT

When looking to enable change, to foster entrepreneurship, to encourage business adaptation, the availability of financing rapidly becomes a critical factor. While all forms of finance are welcome, not all forms of finance are equally appropriate in fostering all kinds of business expansion. Factors such as cash flow, perceived risk, access to global capital markets, and an effective regulatory environment all play critical roles in determining the size and shape of the financing that may be available.

For all three regions of Central and Eastern Europe, there are four pools of potential capital, and these pools are likely to be of varying degrees of use to companies seeking finance to build future prosperity in Central and Eastern Europe.

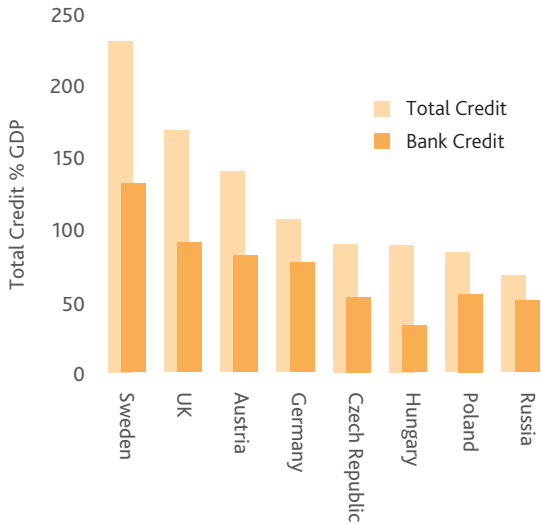
Bank debt—This type of financing has historically been the most dominant across almost all of Europe, and there seems every reason to assume it will remain so in future. Bank debt above all requires companies to have, or rapidly develop, a cash flow to service repayments. This does obviously limit the role of bank debt in start-up companies where sustainable revenue may take some time to develop. A sustainable domestic bank debt market also requires savings and in general countries the savings rates of Central and Eastern Europe have averaged a healthy 20% over the last decade. What would be of great benefit to all of Central and Eastern Europe is a degree of flexibility from borrowers and lenders alike. Companies using their cash flows to borrow and facilitate “creative adaptation”, while bankers responded with a degree of flexibility in structuring loan agreements.

Equity Financing—This is a crucial element of financing in much of the Anglo-Saxon world, but of much less significance in financing the Germanic business world. The equity capitalisation of the United States is almost 150% of GDP, while for Germany, it is just 50%.³¹ Thus while public equity financing may be useful to some larger companies in Central and Eastern Europe, it is unlikely to be a major source of finance for most companies and no use whatsoever for smaller firms. Moreover, the legal structures and business culture, not to mention the specialist investment banking skills required to enable large scale equity financing are absent in Central and Eastern Europe and are unlikely to emerge in the short or medium term.

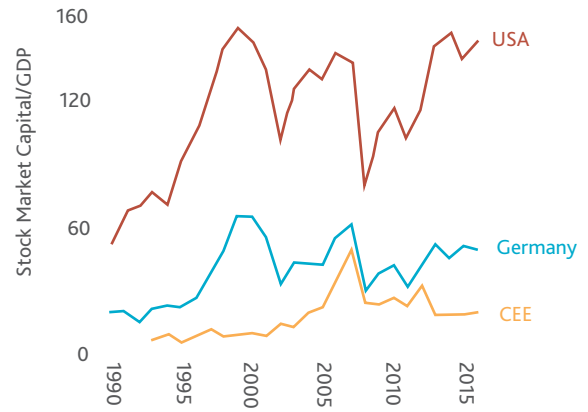
Venture Capital—Venture capital can be vital for entrepreneurial start-ups, but such capital is also extremely demanding; demanding of both the companies it finances (venture capital providers expect significant returns and set high hurdle rates) and demanding of the institutional framework in the jurisdictions in which they are willing to make meaningful investments. Venture capitalists are acutely aware of issues such as resolving insolvency; they know however hard they try, many of their ventures are going to fail. For a good number of countries, the scale of legal adjustment required to make domestic markets attractive to venture capitalists are unlikely to be politically justifiable.

31 World Bank data 2016

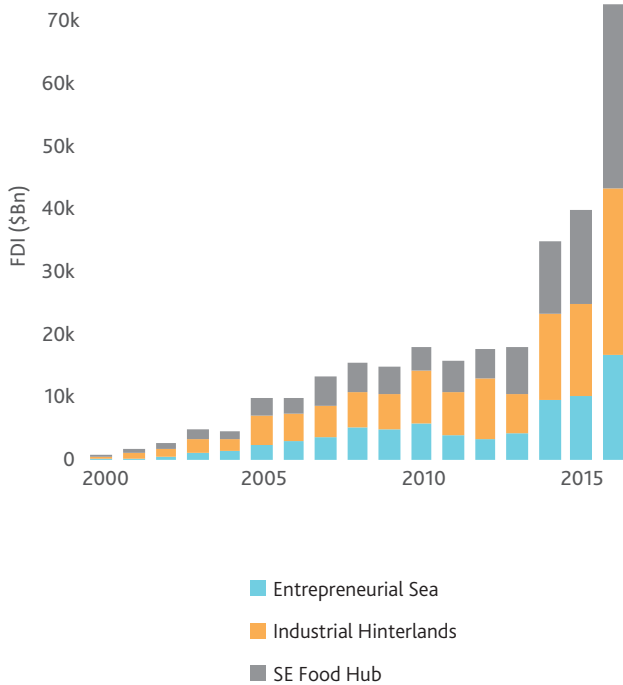
Total Credit



Public Equity Market Capitalisation



Foreign Direct Investment Net Inflows



Venture Capital

COUNTRY	RANK/TREND	COUNTRY ATTRACTIVENESS INDEX
United States	1	100
United Kingdom	2	94.4
Germany	8	87.7
Austria	22	76.9
Poland	26	72.4
Czech Republic	33	65.7
Russian Federation	39	63.5
Estonia	44	60.2
Lithuania	45	59.5
Romania	47	59
Latvia	49	58.2
Hungary	52	57.7
Bulgaria	56	57.1
Slovenia	59	54.7
Croatia	68	51.8
Slovakia	71	50.5
Macedonia	80	45.3
Serbia	82	44.9
Montenegro	85	42.5
Albania	103	27.9

Source: BIS, World Bank, World Bank, Eurostat

Foreign Direct Investment (FDI)—There have been considerable inflows of Foreign Direct Investment into Central and Eastern Europe, peaking in 2010 and almost reaching similar heights in 2015. But, as is readily apparent when examining the data, such investment is extremely volatile. That said, these are investment inflows, and while the amount of money going in may vary, FDI does have the benefit of requiring long term commitment, so once the investment is made, it tends to stay.

The question is what sort of financing is realistically going to be available to help businesses across Central and Eastern Europe in future. The answer is clearly bank debt and foreign direct investment will continue to be of primary importance, with venture capital and public listed equity present, but of less importance for most economies and businesses. In the longer term the European Union's plans for a Capital Markets Union envisage a more diverse range of funding sources becoming available; such sources of funding depend on a range of factors from transparent accounting standards to business custom, all of which will take time to become established.

The Legatum Prosperity Index data on the soundness of banks follows a predictable pattern, with Czech Republic, Slovenia and Estonia topping the list. As any experienced banker could tell you, the ultimate health of a bank depends on its ability to undertake sound lending. But the ability to lend is reliant on a pool of savings and preferably domestic savings. For almost all of Central and Eastern Europe savings rates are high and are resulting in the accumulation of a significant stock of wealth. The habit of high savings rates is long established, although high savings under Communism was arguably as much a reflection of a lack of consumer choice as it was a desire to save. Moreover, given savings prior to 1990 could not be effectively invested, the result was there was no stock of private wealth. However, this good rate of savings, which the IMF expects to continue in the future, has now led to an accumulation of wealth, already estimated by the Legatum Institute to amount to \$3000 per head across the region, and as such provides a sound base for banking into the medium term.

Finally, for individual and corporate savers alike, there is significant benefit from a greater diversification of investments. It is one of the cast iron truisms of finance that capital which is accepting of greater risk, can expect greater long run returns. There may be bad years, but being tied to the overall success of the economy has a long track record of significantly enhancing wealth. For evidence look no further than individual UK savers, where equity fund investments are commonplace, the average Briton has accumulated on average \$140,000 in financial assets. Germans savers, who have higher incomes than the British and save a greater proportion of their higher incomes, have accumulated just under \$90,000 in financial assets.³² Where prosperity is widespread across the economy it is invariably more sustainable.

A programme where savers were encouraged and incentivised to diversify their reliance on pillar one (state) and to look to develop pillar two (employer) pensions and pillar three (individual) pensions would be very welcomed. These new pools of long term savings would ideally be invested in equity helping to develop and diversify local capital markets where stock market capitalisation to GDP is only 20% of the level seen in the USA.

32 OECD National Accounts, *Household Financial Assets*, 2016

METHODOLOGY

The *Legatum Prosperity Index™* is a framework that assesses countries on the promotion of their citizens' flourishing, reflecting both wealth and wellbeing. It captures the richness of a truly prosperous life, moving beyond traditional macro-economic measurements of a nation's prosperity, which rely solely on indicators of wealth such as average income per person (GDP per capita). It seeks to redefine 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.

In moving to "GDP and beyond", to cover both wealth and wellbeing and not just one or the other, the Prosperity Index faces the challenge of finding a meaningful measure of national success. We endeavour to create an Index that is methodologically sound. This is something that the Legatum Institute has strived to achieve with academic and analytical rigour over the past decade.

The Index captures the breadth of prosperity across nine pillars of prosperity using 104 indicators. We ensure that all indicators displayed a statistically significant and meaningful relationship with at least wealth or wellbeing. The 2016 edition of the Prosperity Index covered more countries and more variables, added a new pillar on the Natural Environment and reflected new sources of data.

A country is given a score for each pillar. This score is based on that country's performance with respect to each of the indicators in that pillar, and the level of that importance—the weight assigned to each indicator—which is discussed in the methodology report. Finally, the pillar scores are averaged to obtain an overall prosperity score, which determines each country's rank. Each pillar contains around 12 indicators, which are also aggregated into sub-pillars, to capture an intermediate perspective. While the Index score provides an overall assessment of a country's prosperity, each pillar (and sub-pillar) score serves as a reliable guide to how that country is performing with respect to a particular foundation of prosperity.

For the 2016 issue, the Prosperity Index was refreshed following a two-year methodological review, with the input of academic

Pillars



The **Economic Quality** pillar measures countries on the openness of their economy, macro-economic indicators, foundations for growth, economic opportunity and financial sector efficiency.



The **Business Environment** pillar measures a country's entrepreneurial environment, its business infrastructure, barriers to innovation and labour market flexibility.



The **Governance** pillar measures a country's performance in three areas: rule of law, effective governance, and democracy and political participation.



The **Education** pillar measures access to education, quality of education and human capital.



The **Health** pillar measures a country's performance in three areas: basic physical and mental health, health infrastructure and preventative care.



The **Safety & Security** pillar measures countries based on national security and personal safety.



The **Personal Freedom** pillar measures national progress towards basic legal rights, individual liberties and social tolerance.



The **Social Capital** pillar measures the strength of personal relationships, social network support, social norms and civic participation in a country.



The **Natural Environment** pillar measures a country's performance in three areas: the quality of the natural environment, environmental pressures and preservation efforts.

and policy expert advisors. The objective of the review was to get closer to a measure of prosperity that is transparent and policy-relevant, constructed by combining established theoretical and empirical research on the determinants of wealth and wellbeing. We also continuously monitor the quality and availability of global data, which is not constant; and consequently, we make minor revisions to the index each year—although these revisions have had negligible impact on overall rankings.

We publish a full methodology document to provide the reader with all the information required to understand the *Legatum Prosperity Index*TM in a way that is transparent, useful, and informative. For more information on the methodology, please refer to the Methodology Report published at www.prosperity.com.

ABOUT THE AUTHOR

James Sproule

James is a Senior Fellow of the Legatum Institute. Prior to joining the Institute, he was Chief Economist and Director of Policy at the Institute of Directors from 2014 to 2017 where he became a regular commentator on UK and European economic matters and business trends. Prior to the IoD he was with Accenture, where he led their UK Research team. He started his financial career as a merchant bank economist working with Bankers Trust, Deutsche Bank and Dresdner Kleinwort, and eventually helped to found the boutique bank Augusta and Company. Before embarking on a career in finance, James was a signals officer in the Royal Navy, where he remains an honorary Commander. James Sproule sits on the European Advisory Board of LEK Consulting and he stood for Parliament at the 2005 general election and was for seven years a visiting fellow in the Department of Management Economics at the London School of Economics.



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