

EUROPE AND CENTRAL ASIA STUDIES

GREATER HEIGHTS

Growing to High Income in
Europe and Central Asia

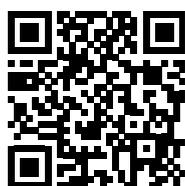
Overview

Leonardo Iacovone
Ivailo V. Izvorski
Christos Kostopoulos
Michael M. Lokshin
Richard Record
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Szilvia Doczi

OVERVIEW

Greater Heights

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This booklet contains the overview and other selected front matter material from *Greater Heights: Growing to High Income in Europe and Central Asia*, doi: 10.1596/978-1-4648-2206-3. A PDF of the final book, once published, will be available at <https://openknowledge.worldbank.org/> and <http://documents.worldbank.org/>, and print copies can be ordered at www.amazon.com. Please use the final version of the book for citation, reproduction, and adaptation purposes.

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Foreword

The countries of Europe and Central Asia (ECA) embarked on a remarkable journey more than three decades ago. In the early 1990s, they began transitioning from planned to market economies, supported by broad and deep structural reforms. This transformation was bolstered by integration into global markets; the emergence of private initiative as the main driver of growth; and, for some of the countries, entry into the European Union. As a result, 10 ECA economies had achieved high-income status by 2024.

Another 20 ECA economies are still middle income, as they and the region face the challenges of accelerating economic growth while creating well-paying jobs. In these middle-income countries (MICs), it has been found that the transition to high-income status requires not only continued foundational reforms but also new transformative measures to unleash business dynamism, nurture talent and reduce its misallocation, and ensure secure and affordable energy.

This report provides a comprehensive assessment of the prospects for ECA countries to reach and maintain high-income status. It offers detailed recommendations about how to escape the middle-income trap. These ECA countries need to undergo not one, but two, transitions. One transition requires a shift from a strategy driven largely by investment to a strategy augmented by the importation and diffusion of global capital, technology, and knowledge (infusion). The other transition is to a stage that adds the dimension of innovation. An emphasis on the overall strategy driven by investment, infusion, and innovation is even more important in countries that have already attained high-income status, because they must avoid becoming stuck in what may be termed “low high-income status.”

Productivity growth among the ECA MICs has lagged. While structural shifts and resource reallocation have contributed to gains, within-firm productivity driven by innovation and technological upgrading remains insufficient. The prevalence of state-owned enterprises (SOEs) and restricted competition have stifled entrepreneurial dynamism and productivity. It is essential to strengthen competition frameworks, attract knowledge-intensive foreign direct investment, and improve capacities and managerial skills. Additionally, incentivizing R&D and addressing credit misallocation are critical steps to enhancing productivity.

Furthermore, intergenerational mobility in education is declining. Younger generations in ECA are now less likely to surpass the educational attainment of their parents. The deterioration in the quality of education poses a significant risk to long-term growth prospects. Addressing these challenges requires strengthening the teaching of foundational skills, revamping vocational education, improving the management and accountability of universities, and integrating research with teaching. Equal access to higher education must be preserved, while emphasizing merit-based graduation. Facilitating the broader participation of women in the labor market and managing talent flows across borders are also crucial.

The ECA MICs have made progress in reducing energy and emissions intensity, but the region remains one of the least energy efficient. Ensuring secure, abundant, and affordable energy presents a significant growth opportunity, but policy, market, and regulatory barriers, along with inefficiencies in incumbent SOEs, are hindering progress. Creating competitive markets and rationalizing energy prices, phasing out fossil fuel subsidies, and introducing carbon pricing are essential measures. Promoting energy efficiency, including in SOEs, while creating new opportunities for workers in affected sectors are vital for a sustainable energy future in the region.

As we look ahead, the ECA region has the potential to continue its remarkable progress. This will not be easy, but by embracing the necessary reforms and leveraging its unique strengths, the region can achieve strong, job-rich growth, ensuring a prosperous future for all its citizens.

Antonella Bassani
Regional Vice President
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Acknowledgments

The report was prepared by a World Bank team led by Ivailo V. Izvorski that included Leonardo Iacovone, Christos Kostopoulos, Michael M. Lokshin, Richard Record, Iván Torre, and Szilvia Doczi.

The extended team included Matias Belacin, Nicholas David Elms, Tom Farole, Gentian Gashi, Julia Norfleet, and Fabian Alexander Scheifele. Substantial inputs were received from Stefan Apfalter, Donato De Rosa, Zuzana Dobrotkova, Sergiy Kasyanenko, Harry Patrinos, Francis Ralambotsiferana Ratsimbazafy, and Gregor Semieniuk.

The work benefited from the guidance of Antonella Bassani, Vice President of the Europe and Central Asia region; Indermit Gill, Chief Economist of the World Bank Group and Senior Vice President for Development Economics (DEC); and Somik Lall, Senior Advisor in DEC.

The team is grateful for comments, suggestions, and inputs from Elcin Akcura, Asad Alam, Ani Balabanyan, Sudeshna Ghosh Banerjee, Roberta Bassett, Gunhild Berg, Manuel Berlingiero, Maurizio Bussolo, Pietro Calice, Piotr Charewicz, Alexandru Cojocaru, Charles Cormier, Rafael de Hoyos, Rocco De Miglio, James Foster, Katharina Gassner, Koen Geven, Mariano Gonzalez, Joern Hunteler, Jonathan Karver, Tatyana Kramskaya, Nathalie Lahire, Alan David Lee, Luis Felipe López-Calva, Magda Malec, Lukasz Marek Marc, Silvia Martinez Romero, Farah Nadeem, Naveed Naqvi, Claire Nicholas, Sergio Perilla, Claudio Protano, Miguel Purroy, Angelica Rivera-Olvera, Michal Rutkowski, Maksud Safarov, Gulnaz Sharafutdinova, Maria Vagliasindi, and Sameh Wahba.

The team is grateful for the guidance and comments provided by a group of advisors, including Ufuk Akcigit (University of Chicago), Vache Gabrielyan (American University of Armenia), André Sapir (Bruegel), and Kori Udovički (Center for Advanced Economic Studies, Serbia). The report benefited from the presentations and discussions organized by Peter Berkowitz at DG REGIO and Alexandr Hobza at DG RTI, both at the European Commission; Jesus Crespo of the Department of Economics at Vienna University of Economics and Business; Jan Hagemeyer at the Center for Social and Economic Research; Mario Holzner from the Vienna Institute for International Economic Studies; Robert Jeszke from the Centre for Climate and Energy Analyses in Poland; Piotr Lewandowski at the

Institute for Structural Research in Poland; Professor Piotr Maszczyk and Professor Mariusz Próchniak at the Warsaw School of Economics; André Sapir and Nicolas Veron at Bruegel and the Center for Advanced Economic Studies, Serbia; and Julia Woerz from the Austrian National Bank.

Special thanks go to the National Statistics Office of Georgia (GEOSTAT), the Bureau of National Statistics of Kazakhstan, the Kosovo Agency of Statistics (KAS), the National Statistical Committee of the Kyrgyz Republic, the Statistical Office of Montenegro (MONSTAT), the Statistical Institute of North Macedonia, Statistics Poland, the Ministry of Finance of Romania, and the Statistical Office of the Republic of Serbia for their collaboration in providing access to firm-level data.

The communications strategy was led by a team comprising Indira Chand, Nicole Frost, Aaron Wesley Korenewsky, Marcelo Gonzales Montoya, and Nina Vucenik.

A team at Communications Development—led by Bruce Ross-Larson and including Joe Caponio, Mike Crumplar, and Chris Trott—edited the report. Robert Zimmermann copyedited the report. Special thanks are extended to the World Bank’s Formal Publishing Program, including Cindy Fisher, Patricia Katayama, Devika Seecharran Levy, and Stephen Pazdan. Ekaterina Ushakova coordinated the full preparation and publication of the report. Suzette Dahlia Samms-Lindsay provided continued support.

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Main Messages

Chapter 1: Transitioning to High Income—or Not

- Since 1990, 27 countries across the globe have reached high-income status; of these, 10 are in the Europe and Central Asia (ECA) region and have joined the European Union. Another 20 ECA countries have become more prosperous since the 1990s. However, these middle-income countries (MICs) have found that their prospects for growing to high income have become troubled. This partly reflects the slowing pace of progress on structural reforms at home. The challenges are also partly linked to the deteriorating global environment.
- Concern is growing that many ECA countries may have become caught in a middle-income trap, a development phase of repeated growth slowdowns, with per capita incomes systematically below the high-income threshold. On current trends, it is unlikely that any of the ECA MICs will cross the high-income threshold in the next few years.
- To ensure that these countries overcome recent growth slowdowns and the challenges associated with the wobbly global environment, policy makers need to focus on two transitions. One transition is from a strategy driven largely by investment to a strategy augmented by the importation and diffusion of global capital, technology, and knowledge (infusion). The other transition is from the latter infusion stage to a stage that adds the dimension of innovation. The emphasis on the overall strategy driven by investment, infusion, and innovation is even more important in countries that have already attained high-income status because these countries must avoid becoming stuck in what may be termed “low high-income status.”
- Unleashing the Schumpeterian forces of creative destruction is essential to the transition to high-income status in the years ahead. In the 1990s, the early years of transition from a planned to a market economy, the forces of destruction dominated the economies of the ECA MICs. For those countries that advanced the most quickly, the forces of preservation were muted, while the forces of creation were emerging. Fast forward three decades. Now, the forces of preservation have the upper hand. Countries must help balance more evenly the forces of creation, destruction, and preservation to reach high-income status and sustain progress.

Chapter 2: Enterprises and Productivity

- The ECA MICs can reach high-income status only if firms are able to grow, innovate, and compete. Within Europe and outside the region, successful transitions to high income have been driven by private sector transformation. Policy makers need to shift from protecting incumbents to enabling business dynamism, rewarding merit, and facilitating innovation. With the proper reforms, the ECA MICs can foster the enterprise-driven growth needed to sustain long-term prosperity.
- Traditional policies centered on supporting small and medium enterprises (SMEs) alone frequently prove misguided because they result in an excess of SMEs and do little to promote cumulative growth in jobs and output. Startups and young firms, rather than SMEs in general, drive job dynamism both in the ECA region and around the world. MICs must abandon overly broad support for enterprises based on size and focus on the value added by supporting dynamic, high-growth firms that create jobs and innovate. The ECA MICs suffer from a “missing large” problem: there are too many small, unproductive firms that do not grow and too few businesses that are industry leaders.
- Domestic competition should be reinvigorated to allow new, dynamic firms to emerge. The enduring presence of state-owned enterprises (SOEs) in the ECA region dulls the impact of market competition on creative destruction. Wherever SOEs are more prominent, the broader economy-wide impacts involve reduced entrepreneurial activity, less business entry and exit, and lower investment. Governments must strengthen competition authorities, discipline SOEs, and help ensure that new entrants are not blocked from gaining access to markets and finance.
- Access to finance, especially long-term credit and risk capital, must greatly improve. Limited access to finance is often linked to lingering macro risks and an uncompetitive financial system reliant on government direction and support. Venture capital and other forms of long-term financing remain underdeveloped in the ECA MICs, limiting the ability of firms to invest in innovation and scale up. Governments should facilitate access to risk capital, deepen financial markets, and reduce distortions caused by state-directed lending that often benefits less productive firms.

Chapter 3: Talent and Social Mobility

- The shortage and misallocation of talent are becoming a binding growth constraint on ECA countries. This limits the ability of firms to invest; to infuse technologies, capital, and expertise from abroad; and to innovate.

- Social mobility is the most important measure of the extent to which the talents of children are utilized well and, thus, whether societies have embraced a pro-growth focus. The expectation of social mobility matters because it confirms the possibility of progress and dynamism and ultimately fosters public support for structural reforms, including in education. Social mobility has been declining among younger generations in the ECA region. The probability that children are more highly educated than their parents is lower today than in the past. Family circumstances are now playing a larger role in determining children's educational attainment.
- The quality of education across the ECA MICs has deteriorated substantially in recent decades. Over the past decade, lower education quality has meant that children have lost the equivalent of a full year of schooling. One of the most pressing issues in the region is the effectiveness of vocational education and training (VET). While VET programs are often touted as a viable pathway to enhancing employability, they frequently fail to equip students with the skills to thrive in a rapidly evolving job market. The picture is even gloomier at universities. Obtaining a diploma has become more important than receiving knowledge or acquiring skills. Academic capture, inadequate funding, outdated curricula, a lack of modern infrastructure, and the proliferation of tertiary institutions are among the leading causes of the poor quality of tertiary education.
- To bolster social mobility and foster innovation, ECA countries must dramatically overhaul education systems, particularly vocational and university education. Vocational education should be deeply reformed by delaying the placement of students in separate academic tracks, boosting links with the private sector for relevance, and ensuring that foundational skills are also learned. Universities should be consolidated, research centers should be integrated into universities, and graduation on merit should once again become entrenched in the practice of education.

Chapter 4: Energy

- The ECA MICs are on the verge of decoupling energy intensity and growth in emissions from growth in output, a feat accomplished thus far mostly by high-income countries. Nonetheless, ECA remains the most energy-intensive developing world region, with a substantial prevalence of SOEs and some of the world's highest energy subsidies.
- The transition to lower energy intensity and lower emissions can become a transition to high-income status, but this link is not automatic and will require deliberate, well-sequenced steps. Reaching and sustaining high-income status depend crucially on the ECA countries tackling substantial energy inefficiencies,

reducing energy intensity, and adopting lower-cost energy production. As an important step, countries need to discipline the incumbent SOEs that control 100 percent of transmission, more than 80 percent of fossil fuel power generation (double the global average), and more than 65 percent of electricity distribution. A large share of the ECA SOEs are loss making, preventing them from upgrading their infrastructure and infusing global knowledge and expertise.

- Transmission networks urgently need to be upgraded, and adequate battery storage created so that the energy generated by the new entrants to the market is not wasted. A large majority of private companies deem grid access a high or remarkably elevated risk. They expect most ECA countries to encounter issues in integrating the planned solar and wind volumes if these countries do not also undertake substantial investment in transmission and distribution networks.
- The ECA MICs need to establish the proper price signals, make sure energy markets work, and ensure that startups can connect to the transmission grid and not be blocked by incumbents. Energy prices should reflect economic and social costs. Realizing this adjustment requires the elimination of energy subsidies and the introduction of carbon taxes to internalize externalities. Economic merit dispatch needs to be observed. Energy efficiency standards also need to become appropriately stringent.
- The transition to more efficient and lower carbon emissions creates losses among consumers, workers, and businesses and, so, encounters resistance. Affected groups will push back against well-intentioned reform. Addressing such political economy concerns requires careful policy sequencing so that reforms impose no unbearable burdens on any group. But focusing only on low-hanging fruit that is unlikely to create a backlash may not lead to the emergence of new firms and the destruction of inefficient practices and enterprises. Reductions in fossil fuel subsidies among vulnerable groups can be balanced by targeted income support, and money can be saved.

Abbreviations

BOS	businesses of the state
ECA	Europe and Central Asia
ETS	emissions trading system
EU	European Union
GDP	gross domestic product
GNI	gross national income
HIC	high-income country
IEA	International Energy Agency
LIC	low-income country
LMIC	lower-middle-income country
MIC	middle-income country
NACE	statistical classification of economic activities in the European Community
OECD	Organisation for Economic Co-operation and Development
PISA	Programme for International Student Assessment (OECD)
PPP	purchasing power parity
R&D	research and development
SD	standard deviation
SMEs	small and medium enterprises
SOE	state-owned enterprise
TFP	total factor productivity
UMIC	upper-middle-income country
VET	vocational education and training

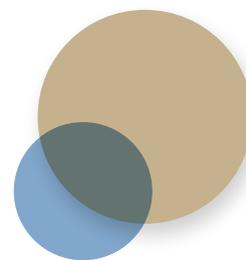
Country Classifications Used in This Report

Europe high-income countries (Europe HICs): Andorra, Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, Liechtenstein, Luxembourg, Monaco, Netherlands, Norway, San Marino, Spain, Sweden, Switzerland, and United Kingdom.

Convergers: Croatia, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovak Republic, and Slovenia.

Europe and Central Asia high-income countries (ECA HICs): This is a subset of the Convergers and includes the three HICs in Europe that are World Bank member countries, that is, Croatia, Poland, and Romania.

ECA middle-income countries (ECA MICs): Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakhstan, Kosovo, Kyrgyz Republic, Moldova, Montenegro, North Macedonia, Russian Federation, Serbia, Tajikistan, Türkiye, Turkmenistan, Ukraine, and Uzbekistan.



Overview

Introduction

Twenty-seven countries across the globe have reached high-income status since 1990. Ten of these countries are in the Europe and Central Asia (ECA) region, and all of them have joined the European Union (EU). These countries saw their economic growth peak in the 2000s because of the transition from a planned economy to a market economy that began in the early 1990s, the accompanying broad and deep structural reforms, and the emergence of private initiative as the main driver of growth. The success of these countries in their embrace of EU-integrated markets, robust institutions, and reformed and realigned production structures resulted in the transition to high-income status (refer to figure O.1).¹

Another 20 ECA countries have become more prosperous since the 1990s, but their transition to high-income status has been delayed. These middle-income countries (MICs) have found that their prospects for achieving high-income status have become more complicated since the global financial crisis in 2007–09. The problems have arisen partly because of slow progress in advancing domestic structural reforms, notably, in reducing the role of the state in the economy and establishing effective competition policies to support the emergence and growth of efficient, innovative enterprises.² Another factor is rapid population aging and the dramatic declines in birth rates in most of these countries, except in Türkiye and in Central Asia, combined with large outward migration, that have resulted in reductions in the size of working-age populations and downward pressure on economic growth. The deteriorating global environment has also played a role. These countries have been battered by a succession of crises, including the global financial crisis, the European debt crisis, the COVID-19 pandemic, and Russia's

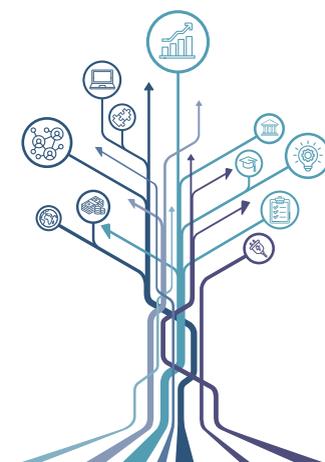
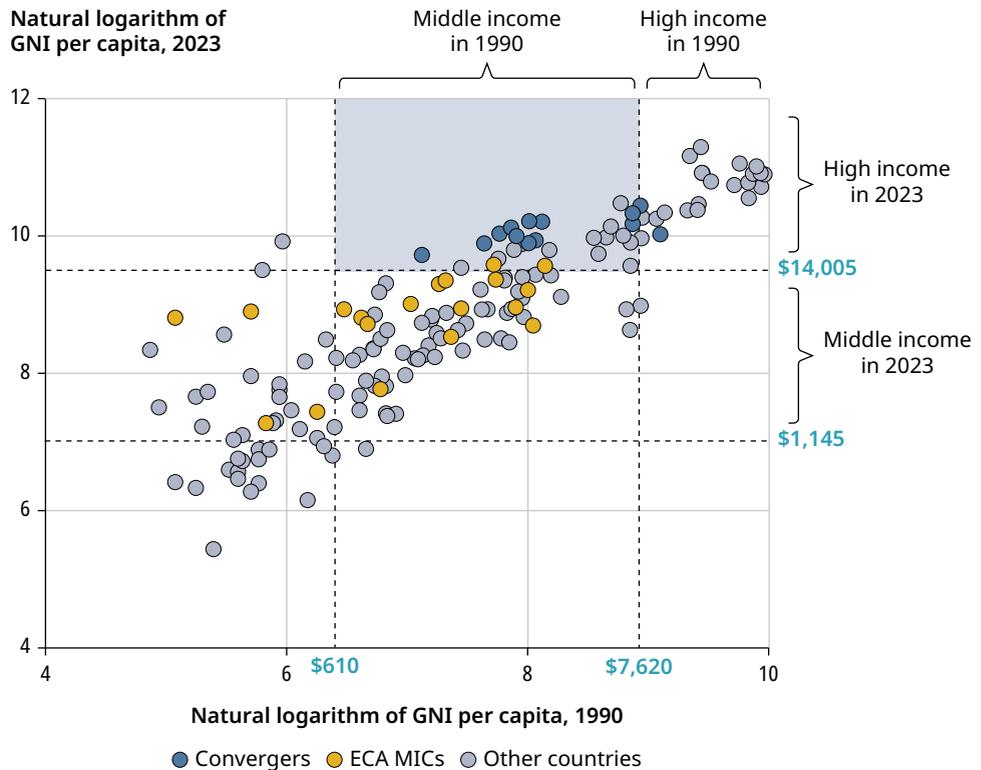


FIGURE O.1 Ten ECA countries have achieved high-income status since 1990

Source: WDI (World Development Indicators) (dashboard), World Bank, Washington, DC, <https://datatopics.worldbank.org/world-development-indicators/>.

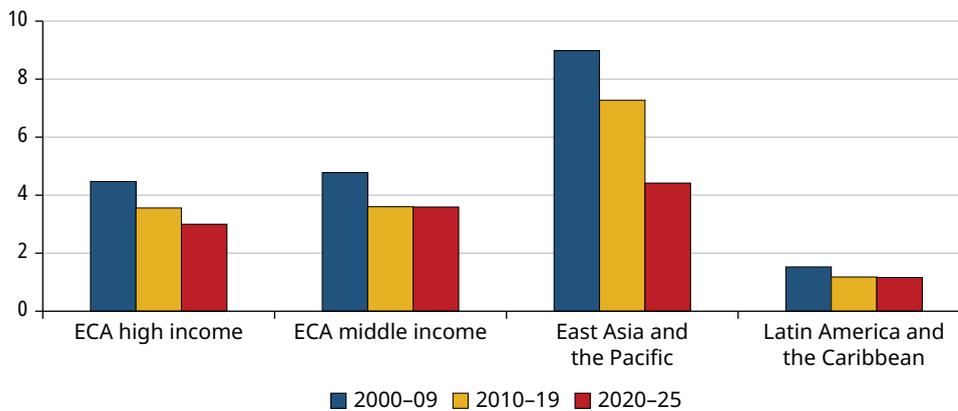
Note: The shaded area indicates countries that transitioned from middle-income to high-income status in 1990–2023. The countries of the ECA region in 1990 are shown in dark blue. GNI = gross national income; MICs = middle-income countries.

invasion of Ukraine. Global economic growth is weaker today than it has been since the mid-1990s. The pace of economic expansion in the EU, the largest trading and investment partner of the ECA countries, has dropped significantly. Global value chains are becoming more fragmented as geopolitical tensions have increased. Populism and protectionism have acquired more support, resulting in a shift away from an outward-looking focus in many countries.

With these challenges, per capita economic growth in the MICs in the region weakened from an annual average of 4.8 percent during 2000–09 to 3.6 percent during 2010–19 and 2020–25, about one percentage point less than in East Asia and the Pacific (refer to figure O.2). Average gross domestic product (GDP) per capita in purchasing parity prices in the ECA region increased from 22 percent of the US level in 1999 to more than 33 percent by 2009, but only rose to 38 percent by 2022. Thus, the income convergence of the MICs in the region with the

FIGURE 0.2 Economic growth in the middle-income countries of ECA has stagnated, 2000–25

Percent, period average



Source: WDI (World Development Indicators) (dashboard), World Bank, Washington, DC, <https://datatopics.worldbank.org/world-development-indicators/>.

Note: ECA high-income countries include Croatia, Poland, and Romania.

high-income countries (HICs) slowed, and diminishing returns appeared to have become the norm. Although the slowdown mirrored global trends, and the average ratios to the United States were higher in the ECA countries than in other countries, the slowdown in the ECA region was much steeper. Based on average 15-year per capita growth rates, only a couple of MICs in the region seemed likely to reach the high-income threshold (currently \$14,005) by 2040.

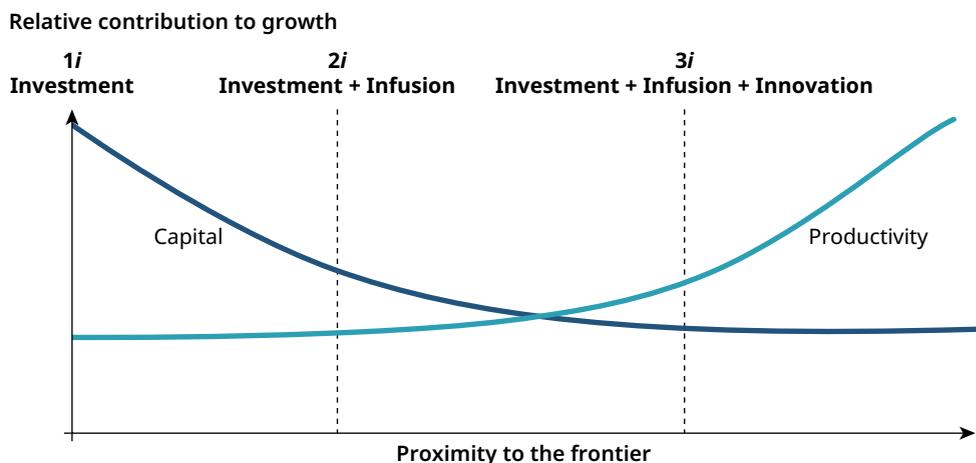
The concern is growing that many ECA countries may have become caught in a middle-income trap, a phase of development characterized by recurring slowdowns in growth and by per capita incomes that are systematically below the high-income-country threshold. To overcome the string of growth slowdowns and the challenges of the wobbly global environment and to shift to a path to high-income status, these countries need to make the transition from strategies driven largely by investment to strategies that are supported by the importation and diffusion of global capital and the infusion of technology and knowledge and that take advantage of the dimension of innovation. Such a transition will require sustained foundational reform to fuel the engines of economic growth, while pivoting to new transformative reforms aimed at developing the more complex economic structures and institutions that can enable firms to accumulate human and physical capital, infuse fresh expertise and technology, and implement innovations that expand the frontier of products and processes. The emphasis on a strategy driven by innovation is also important for countries that have already attained high-income status to ensure that they do not become stuck at a low level of high-income status.

Investment, Infusion, and Innovation to Achieve and Sustain High-Income Status

This report follows the approach of *World Development Report 2024* on the middle-income trap to assess the prospects of the ECA countries and provide policy options on how they might achieve high-income status (World Bank 2024). This study concludes that the transition to high-income status among the ECA MICs is possible but will require reforms supplemented by measures to raise competition, unleash private enterprise, and cut inefficiencies. Reform will also be needed to reduce the waste and misallocation of talent and harness lower energy intensity to transition, ultimately, to net zero emissions to bolster productivity growth. Following *World Development Report 2024*, this report relies on the 3i strategy to articulate that the MICs in the region must navigate two key development transitions on the path to high income (refer to figure O.3), as follows.

- *From investment to investment and infusion.* The first transition is the shift from mostly investment-driven growth—the 1i strategy (often called accumulation in the economic literature)—to a strategy focused on both investment and infusion or integration in the global economy (the 2i strategy). The 2i strategy involves adopting new technologies, ideas, capital, and expertise from abroad and diffusing them domestically. Of the 20 MICs in the region, 17 are upper-middle-income countries in which the 2i strategy is being implemented. Governments and stakeholders in these countries should not ignore the need to boost investment in both human and physical capital.

FIGURE O.3 Reaching high-income status requires two transitions: from 1i to 2i and then to 3i



Source: World Bank 2024.

Note: The curves illustrate the relative contributions of capital and productivity to economic growth (y-axis) according to countries' proximity to the frontier (represented by leading economies). Countries farther out on the x-axis are closer to the frontier.

- *From investment and infusion to investment, infusion, and innovation.* The second transition involves the shift to the 3i strategy, whereby firms not only accumulate capital and infuse foreign expertise and technology but also advance innovation. This is challenging in most MICs in the region. Even enterprises in countries close to the high-income threshold are largely only production facilities that are linked through value chains to firms in the EU. They do not spend much on research and development (R&D), and they produce few innovations.

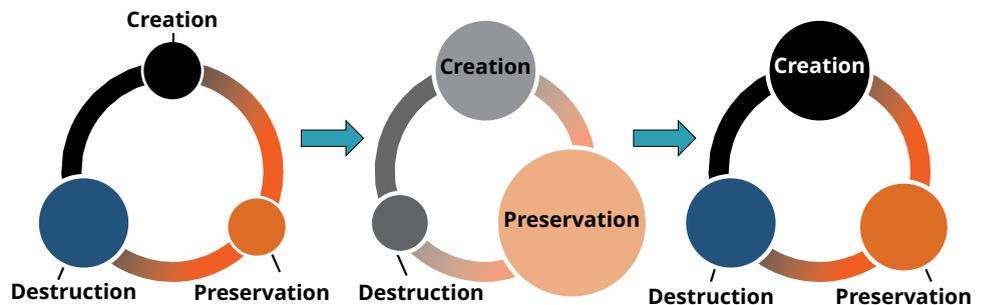
While these two transitions are essential if MICs in the region are to achieve high-income status, governments and stakeholders in the HICs in the region need to persevere in their efforts to realize the second transition to make economies more innovative and able to sustain growth within the challenging global context. The HICs in the region have benefitted tremendously from their participation in EU global value chains and the infusion of expertise and advanced technology. The HIC economies have prospered by being open to foreign trade and investment and, thanks to competitive wages and good skills, acting largely as production facilities for large European firms. Although these HICs are implementing the 3i strategy, their R&D spending and patenting performance are modest compared with European HICs, and their shift to an innovation-driven economy is still at an early stage. Accelerating this progress should help the ECA HICs strengthen productivity and growth despite the challenges faced by their main trading and investment partners.

Understanding Growth Through the Lens of Schumpeterian Creative Destruction

A key feature of the analysis in *World Development Report 2024* is the Schumpeterian lens on development that helps clarify the path the MICs in the region need to take to achieve high-income status (Schumpeter 1942; World Bank 2024). In the early years of the transition from a planned economy to a market economy in the 1990s, the forces of destruction dominated in the economies of the MICs in the region. Among the countries that advanced the most rapidly, the forces of preservation were muted, and the forces of creation were emerging. Fast forward three decades: the forces of preservation now have the upper hand in the MICs. The forces of creation, destruction, and preservation must become more well balanced if these countries are to become HICs and achieve sustained economic progress (refer to figure O.4):

- *Creation.* Economic progress is driven by firms or entrepreneurs that take risks and incur costs to accumulate capital, infuse new technologies, and innovate. Incumbents and new entrants—whether firms or entrepreneurs—are both central to creative destruction. But incumbents tend to adopt technology and

FIGURE 0.4 Balance creation, preservation, and destruction to reach high-income status



Source: Adapted from World Bank 2024.

innovate more slowly. In the ECA region, there are too many small, low-productivity firms; few large companies other than large, legacy state-owned enterprises (SOEs); and even fewer global innovators. Creation is weak, and productivity growth is mostly driven by the reallocation of resources, not by innovation. A competitive environment that levels the playing field and allows the access of new entrants to the market is crucial.

- **Preservation.** Incumbents have often successfully driven the transition from a 1i strategy to a 2i strategy and are keen to preserve their positions by limiting the market access of new entrants. The key issue is the extent to which governments facilitate or blunt the natural force of creation represented by the entry and growth of new businesses. For example, the dominant SOEs in the region benefit from some of the world's highest subsidies on fossil fuels. Such subsidies hamper the scale-up of low-carbon technologies and incentivize the inefficient use of energy.
- **Destruction.** This allows scarce resources to be reallocated to the most efficient uses and often occurs during or after an economic crisis. Although it is a necessary process, governments often limit the extent to which destruction may take place, thus restricting the scope for creation. For instance, in MICs in the region, academic capture—whereby universities prioritize political or business interests over academic excellence—is a major reason for the poor quality of university education. Such inefficient structures and policies persist rather than being reformed or destroyed, resulting in the waste and misallocation of the talent needed to achieve high-income status. Another example is the dominant role of SOEs in several countries even in sectors with an abundance of competitive firms.

The Three Fundamental Drivers of Economic Growth

The process of creative destruction involves three fundamental drivers of economic growth: enterprises, talent and social mobility, and energy. The main difference between the MICs and the HICs in the ECA region is not the quantity of the inputs used by these drivers, but the efficiency—the productivity—of the use. Measured in purchasing power parity, the average amount of physical and human capital per worker used by enterprises in the ECA MICs is about 71 percent of the amount in the United States. This compares with about 80 percent in the ECA HICs. However, GDP per capita in the ECA MICs is only 38 percent of US GDP per capita. This difference is staggering and is the main reason many countries have become trapped in middle-income status. If they are to reach and sustain high-income status, the ECA countries must tackle the inefficiencies and make the best use of resources.

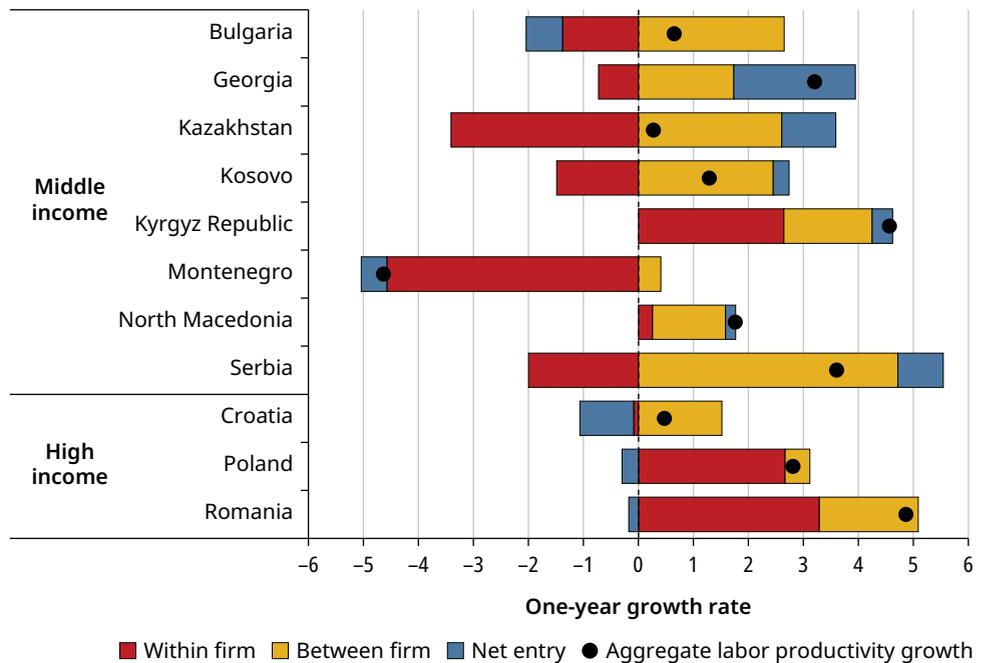
Enterprises

Business dynamism based on more productive and efficient resource use is critical to achieving stronger economic growth and creating jobs. Most governments and stakeholders in the ECA MICs rely on the 2i strategy, that is, a combination of investment and the infusion of technology and expertise from abroad. Measured at the firm level, productivity growth in the MICs is almost wholly driven by the reallocation of resources to more productive uses and improvements in the functioning of factor and product markets. Investment in R&D is low (around 0.2 percent of GDP in the Caucasus and Central Asia, for example), and innovation is mostly absent.

Frontier innovation, the key component of the 3i strategy, is challenging and requires good skills, substantial management capacity, and strong incentives. These inputs are in short supply in the MICs relative to the HICs in the region and take time to develop. Because of more sluggish structural transformation in some countries, the MICs innovate even less than what might be expected based on income levels. In the ECA HICs, by contrast, firm upgrading and more effective management play a greater role. Within-firm productivity rather than reallocation thus drives expansion in these countries (refer to figure O.5). However, even these countries are behind the European HICs in R&D spending, innovation, and patenting performance.

The enduring presence of SOEs in the region dulls the impact of market competition on creative destruction. If SOEs are more prominent, the broader economy-wide impacts include reduced entrepreneurial activity, lower business entry and exit, and reduced investment. In sectors in which SOEs are present, especially in competitive sectors, there is substantial labor hoarding and more modest job creation and destruction.

FIGURE 0.5 Drivers of productivity growth: between-firm reallocation and within-firm upgrading



Sources: World Bank elaboration based on data of national statistical institutes; Melitz and Polanec 2015; Orbis (portal), Moody's, New York, <https://www.moody.com/web/en/us/capabilities/company-reference-data/orbis.html>.

Note: The data reported are one-year arithmetic averages. A dynamic Olley-Pakes decomposition was performed at the three-industry level of NACE Rev. 2 and used a two-year rolling window (changes between t and $t - 2$) (EC 2008). Firms and sectors were weighted according to the employment weight in each activity and economy during the reference period. NACE = Statistical Classification of Economic Activities in the European Community.

To strengthen the forces of creation, governments and stakeholders in the MICs need to focus more attention on young businesses with high-growth potential. The business demography of these countries is characterized by an excess of incumbent small and medium enterprises (SMEs) and a scarcity of large firms. This phenomenon might be dubbed the “missing large” challenge. Start-ups in ECA countries enter the market at half the size of their peers in the United States, suggesting that barriers to entry are low in the region, but also that business opening may be driven more by necessity than by market opportunities. ECA firms grow less than US firms over the life cycle. In the United States, the average size of firms five years or older is six times that of new firms, while, in the ECA region, the size of the former is less than four times the size of the latter. Firms in the ECA region are small at entry and tend to grow less.

Traditional policies centered on supporting SMEs in general are often misguided because they lead to an excess of SMEs and do little to promote growth in jobs and output. Start-ups and young firms, rather than SMEs in general, drive job dynamism

in the ECA region and around the world. In MICs and HICs in the ECA region, start-ups and young companies generate 25 percent of gross jobs each, even though, together, they account for less than 20 percent of total employment. Large companies account for a substantial share of overall employment, but they create a small share of the overall jobs.

Large incumbent companies, including SOEs, are often the main forces preserving the status quo. Ensuring that new entrants in the market for renewable energy obtain the permits necessary to build, operate, and connect to the grid, for example, will require government efforts to overcome these forces of preservation.

Governments in the MICs can help enterprises become more dynamic by focusing on foundational or horizontal policies to improve the business environment and on policies targeting firms. Chapter 2 specifies such policies in detail across the categories of ECA countries. The horizontal policies include the following:

- Ensure market contestability by strengthening and empowering competition agencies, reducing the presence of SOEs in competitive sectors, limiting red tape, and enforcing intellectual property rights.
- Make it easier for unproductive firms to close.
- Direct support toward young, dynamic enterprises, which account for the bulk of job creation.
- Deepen capital markets to expand access to long-term finance. Facilitate venture capital and other forms of risk capital to support innovative entrepreneurs.
- Develop a skilled workforce, together with quality management staff.

These horizontal policies need to be supplemented by policies directly targeting firms, as follows:

- Enhance technology adoption; incentivize private R&D investments, especially among younger firms; and foster collaboration between businesses and academia.
- Support firms in accessing global markets by reducing trade barriers and improving logistics and border procedures.
- Enhance management quality. Create incentives for businesses to invest in upskilling the workforce and in technical training programs anchored in market and business demand.

Talent and Social Mobility

The shortage and misallocation of talent are becoming an increasingly binding growth constraint in ECA countries. This limits the ability of firms to invest; to infuse technologies, capital, and expertise from abroad; and to innovate.

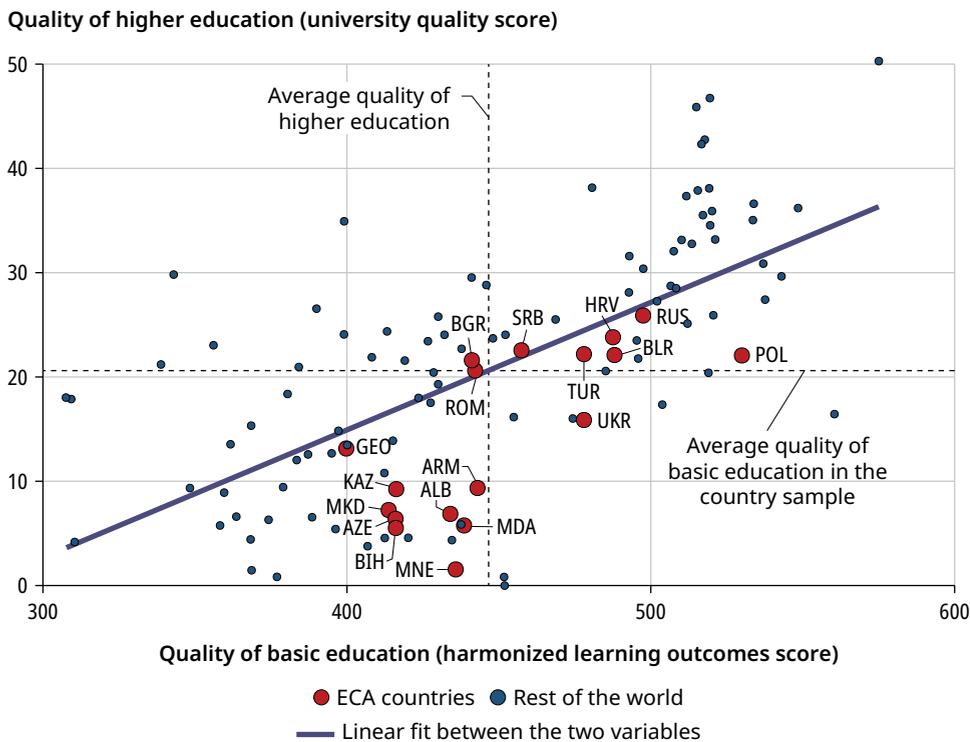
Social mobility—proxied in this report by educational mobility—is the most important measure of intergenerational improvement in welfare status, that is, whether children are doing better than the previous generation or whether their talents are being wasted. Social mobility has been declining among the younger generations in the ECA region. The probability that children are more well educated than their parents has been decreasing. The correlation between a child’s education and the education of the child’s parents has also increased, and household circumstances are playing a larger role in determining educational attainment among children. The only bright spot is the increasing probability that children will be able to attain higher education even if their parents were not able to do so.

The gains from equal access to education are limited if the quality of education is low or if job opportunities are few. Talent will flourish only if good education systems have been established. Basic primary and secondary education must provide foundational skills, and higher education institutions must produce innovators, thereby strengthening the forces of creation. However, the quality of primary and secondary education as measured by the scores of the Program for International Student Assessment (PISA) (15-year-olds) and the Progress in International Reading Literacy Study (9-year-olds) has been declining, a trend that preceded and was then aggravated by the COVID-19 pandemic. Over the past decade, PISA math scores across the region have plummeted by the equivalent of a full year of schooling.

One of the most pressing issues in the region is the effectiveness of vocational education and training (VET). Almost 45 percent of upper-secondary students in the region and as many as 80 percent in some countries are channeled early in their school careers into VET. While VET programs are frequently touted as a viable pathway to enhance employability, they often fail to equip students with the skills to thrive in a rapidly evolving job market. This disconnect raises concerns about the negative impact of such programs on the effort to nurture talent, foster upward mobility, and reduce inequality.

The situation is gloomier at universities. The quality of higher education is below the level that might be expected given the quality of basic education in the region (refer to figure O.6). Obtaining diplomas trumps receiving knowledge or skills. Because individuals with higher educational attainment are more likely to become innovators, the poor quality of university education poses an existential risk to the region’s long-term growth prospects. In the Times Higher Education world university rankings, only one university in the region is ranked among the top 100, and only nine universities are ranked among the top 500.³ Academic capture (whereby universities prioritize political or business interests over academic excellence), inadequate funding, outdated curricula, a lack of modern infrastructure, and the proliferation of tertiary institutions are among the leading causes of the poor quality of tertiary education.

FIGURE O.6 In Europe and Central Asia, higher education quality is low relative to basic education



Sources: Demirgüç-Kunt and Torre 2022; HLO (Harmonized Learning Outcomes) Database, World Bank, Washington, DC, <https://datacatalog.worldbank.org/search/dataset/0038001>; Human Capital (Data Portal), World Bank, Washington, DC, <https://humancapital.worldbank.org/en/home>.

Note: The quality of basic education is proxied by the harmonized learning outcomes score by country (refer to the sources). The quality of higher education is proxied by the aggregate university quality score as calculated by Demirgüç-Kunt and Torre (2022). For country abbreviations, refer to International Organization for Standardization (ISO), <https://www.iso.org/obp/ui/#search>.

Talent is nurtured not only in the educational system. Societies in which talented individuals are not employed miss the opportunity to foster a productive population, especially among women, who are typically better educated than men in the ECA region, and among disadvantaged groups. Female labor force participation in the region is heterogeneous. A low participation rate may not be explained by differences in skills but by social norms. Without urgent action to boost social mobility; reverse the decline in educational quality, especially in higher education; and improve the allocation of workforce talent, the MICs in the region will not be able to reach high-income status in the next one or two generations.

The authorities are invited to consider the following policy options to address these challenges (discussed in chapter 3):

- Strengthen foundational skills to reverse the decline in the quality of secondary education.
- Thoroughly revamp VET systems, first, by raising the age of VET track selection and reinforcing the links with industry to ensure the delivery of relevant skills.
- Preserve equal access to higher education, but implement merit-based policies to promote successful graduation.
- Merge research centers with universities and strengthen university–industry links to foster innovation.
- Consolidate universities to make more effective use of resources, and improve the management of universities.
- Facilitate the broader participation of women in the labor market.

Energy

Reaching and sustaining high-income status in the ECA countries depend crucially on tackling energy inefficiencies and ensuring the transition to better energy security, lower energy intensity, and lower emissions. MICs in the region are on the verge of decoupling growth in emissions from growth in output, a feat accomplished mostly only by high-income economies. The ECA region is the most energy-intensive developing world region and maintains some of the world's highest energy subsidies. An average 1.5 times more energy is required to produce one unit of GDP in ECA countries than in East Asia and the Pacific and 2.5 times more than in the EU. Policy, market, and regulatory barriers and resistance from incumbent SOEs often hinder energy-efficiency-enhancing reforms and the rapid transition to cleaner energy sources.

The impact of lower-emission technology innovation on GDP growth and jobs is already visible in China, Europe, and the United States. It is also clear in the ECA countries in which the transition to a market economy has advanced the most, the pressure exerted by incumbents is better contained, and young and dynamic firms enjoy a level playing field. Among the ECA solar and wind frontrunners (Croatia, Poland, Romania, and Türkiye), the share of renewables in power generation has increased to 15 percent, in line with the global average, though it is below the 30 percent share of the global frontrunners, including Germany and the United Kingdom.

But lower emissions technology adoption and innovation may not occur without a push because of the general scarcity of frontier innovation activities across most of the region. Policy makers observing China, the EU, and the United States may be thinking that industrial policy offers an answer to the slow pace of technology

adoption and innovation. However, expenditures of scarce public resources on such policy interventions should be carefully weighed against alternative resource policies and uses, including the critical need to raise dramatically the quality of education and improve the competitive environment.

Part of the reason the forces of creation have been inadequate in the region's energy sector is the dominance of powerful SOEs. In the ECA region, SOEs control 100 percent of transmission, more than 80 percent of fossil fuel power generators (double the global average), and more than 65 percent of electricity distributors. Besides the huge disincentives of fossil fuel subsidies on the transition to lower emissions and lower energy intensity, a crucial obstacle is the low profitability across energy SOEs in the region. Around 30 percent of these SOEs are unprofitable, double the share in other MICs.

ECA market participants believe that most electricity transmission companies do not have the capacity to facilitate any additional connections by independent renewable power producers. More than four in five private companies in the ECA region deem grid access a high or remarkably elevated risk. They expect most ECA countries to encounter issues in integrating the planned solar and wind volumes without substantial investment in transmission and distribution networks. Without adequate battery storage, a lot of the energy produced by the new entrants would be wasted, while average electricity prices remain high.

To facilitate creation, governments need to help cushion the impact of the forces of destruction. The transition to lower carbon emissions generates losses among consumers, workers, and businesses and thus encounters resistance. If energy is costlier, vulnerable households may ration energy consumption, energy-intensive firms may lose competitiveness, and pressures for government subsidies may grow. Affected groups will push back against well-intentioned reform.

Addressing these political economy concerns requires careful policy sequencing so that reforms impose no unbearable burdens on any group. Yet, focusing only on low-hanging fruit that is unlikely to create a backlash may not lead to the emergence of new firms and the destruction of inefficient practices and enterprises. Reductions in fossil fuel subsidies among vulnerable groups may be balanced by income support, while saving money because most fossil fuel subsidies apply to all population groups, including the most affluent. Because destruction also involves job losses, such as in coal mining, cushioning policies must reach beyond income transfers and support new opportunities for affected workers.

While the transition to lower energy intensity and lower emissions may promote the transition to high-income status, the link is not automatic and will require the following deliberate, well-sequenced steps (discussed in chapter 4):

- Enable prices to reflect the true economic and social cost, phase out fossil fuel subsidies, and introduce a carbon tax or an emission trading system. Fossil fuel subsidies represent the greatest market disincentives for reducing energy

intensity and decarbonization. Explicit carbon pricing that reflects the negative externalities of emissions and pollution encourages efforts to reduce carbon emissions.

- Facilitate the tighter integration of enterprises into global markets by supporting structural transformation among enterprises that can accelerate the adoption of energy-efficient, lower-emission, and more highly productive technologies and strengthen the ability of firms to overcome the limits to potential growth associated with the small size of many economies in the region.
- Discipline incumbent energy SOEs to ensure that new competitors can enter the market and connect to the grid without hindrance.
- Introduce more stringent standards and regulatory policies for the decarbonization of housing, transport, and other economic sectors in which emissions are difficult to abate.
- Design and implement policies to bolster domestic and foreign investment in renewable energy generation, while ensuring economic merit-order dispatch (that is, the sources of electricity with the lowest marginal cost are dispatched first).
- Sustain macroeconomic stability, and ensure investor certainty.

Notes

1. The 10 countries that have attained high-income status since 1990 are Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia. The World Bank reclassified Bulgaria and the Russian Federation as having reached the high-income threshold in July 2024, but the 2024 data behind most of the statistics used in this report are not consistently available. As a result, in this report, these two countries are still considered middle-income countries.
2. In the ECA region, the footprint of the state is still large. Clearly, this is associated with the long history of central planning in many of the countries in the region (refer to World Bank 2023).
3. See THE (Times Higher Education) World University Rankings (dashboard), Times Higher Education, London, <https://www.timeshighereducation.com/world-university-rankings>.

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Twenty-seven countries have reached high-income status since 1990. Ten of these are in the Europe and Central Asia region and have joined the European Union. Another 20 in the region have become more prosperous since the 1990s. However, their transition to high-income status has been delayed. These middle-income countries have found that the prospects for growth to high-income status have become even more difficult since the 2007–09 global financial crisis. This reflects partly a slowdown in structural reforms at home and partly the challenges associated with a deterioration in the global environment.

The concern has emerged that many countries in the region may be caught in the middle-income trap, a phase in development characterized by a recurring deceleration in growth and by per capita incomes that are systematically below the high-income threshold.

To ensure that these countries overcome the obstacles to growth and achieve progress toward high-income status, policy makers need to make the transition from a strategy driven largely by investment to a strategy that is supported by the importation and diffusion of global capital, knowledge, and technology and then to a strategy that complements these with innovation.

The report *Greater Heights: Growing to High Income in Europe and Central Asia* relies on the *3i* strategy described in *World Development Report 2024*—investment, infusion, and innovation—to propose policy options to assist middle-income countries in Europe and Central Asia in the effort to reach high-income status. Drawing on comprehensive empirical analysis, the report offers actionable recommendations that will enable policy makers to advance stronger economic growth across the region. Such a transition will require continued and sustained foundational reform to maximize the drivers of economic growth while pivoting to new transformative reforms to promote the development of more complex economic structures and institutions. These involve the need to discipline incumbents, boost the role of the private sector, strengthen the competitive environment, and reward merit. The emphasis on a strategy driven by innovation is also critically important for those countries that have already attained high-income status.



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