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INSTITUTIONAL QUALITY AND GROWTH IN EU NEIGHBOURHOOD COUNTRIES

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OBJECTIVE

The main objective of this paper is to analyze the relationship between the nature of the institutional environment and the pace of economic development in the European Neighbourhood Policy (ENP) countries. In this paper we argue that it is not just the level of institutional reform that determines growth but that the degree of complementarity among the various institutions is also an important factor.

Douglass North (1990) was among the first to highlight the role of formal and informal institutions for economic performance. Formal institutions are formed by sets of rules such as laws and property rights, while informal rules are "a part of the heritage that we call culture" (North, 1990). Informal institutions evolve over time, often more slowly than formal institutions. This point is rather important, especially in the context of the transition countries in Eastern Europe, the Western Balkans, and the European Neighbourhood region. Political and economic changes in the early 1990's brought about rapid changes in the formal institutions that define the economic, political and legal systems. However, informal institutions have needed time to absorb these changes as they have evolved at a slower pace. This suggests that, during the process of transition, change in formal institutions may outpace change in informal institutions. The research investigates the differences in such changes between different groups of countries defined by their level of EU integration.

The degree of institutional complementarity is also an important factor in explaining economic growth. Amable (2003) has argued that institutional complementarity is important to ensure the coherence of economic and social systems. If this complementarity of institutions diminishes in the early stages of transition then this may have adverse effects on economic growth. The research therefore aims to investigate the relation between institutional complementarity and economic growth and identify differences in this relationship between the ENP countries, accession countries and new member states in transition.

SCIENTIFIC/ RESEARCH METHODS

The central hypothesis of existing empirical research into the impact of the quality of institutions on economic development is that institutions that guarantee political and civil freedoms and rule of law are necessary for economic development (North, 1990; Acemoglu and Robinson, 2012). The research therefore maps the quality of institutions measured by various governance indicators and assesses the degree of "institutional complementarity" and in two ENP countries, Ukraine and Moldova, in comparison with two accession countries (Croatia and Macedonia) and two EU new member states (Bulgaria and Romania).

Our analysis of quality of institutions is based on the quantitative measurement of various governance indicators combined at three levels:

1. Overall political governance (such as political stability, government accountability, control of corruption, and civil liberties)
2. Institutions shaped by the public sector (education, R&D, innovations and the quality of infrastructure).
3. Business environment institutions in a narrower sense, such as enforcing contracts and protecting investors, the availability of credit, property rights and the ease of obtaining licences and permits.

We use selected institutions as measured by the Worldwide Governance Indicators from the World Bank "Governance Matters" database and the World Bank "Ease of Doing Business" database. We apply a comparative analytical method comparing our three country groups. This is effectively a **quasi-experimental study** making use of the natural experiment provided by the different degrees of integration into the EU of these three groups of countries. We identify the trend of convergence or divergence of the selected country groups measured by changes in the coefficient of variation over time. We furthermore construct a new synthetic quantitative indicator (which we call the Institutional Quality of Public Sector Index) in order to facilitate the comparative analysis. The period examined will be 2004-2011.

In the second stage of the analysis we are interested to test the hypothesis that the degree of complementarily of institutions influences the pace of economic growth, and that this relationship differs between our three groups of countries due to differences between them in the degree of EU integration. In order to test the hypothesis we draw on the database of transition indicators developed by the EBRD and construct a measure of institutional complementarity drawing on the work of de Macedo and Martins (2008). On this basis, we develop a **panel data regression model** to test the relationship between economic growth and institutional complementarity. The unbalanced panel data covers 28 countries over 22 years (1989-2010). In order to test the robustness of the results we used different estimators: one and two-way fixed effects, GLS random-effects and a dynamic GMM estimator. The dynamic Arellano-Bover methodology was used to estimate the model in order to correct for possible endogeneity bias between growth, inflation and level of reforms (see Arellano and Bover, 1998).

POLICY VALUE - ADDED

According to the comparative analysis of governance indicators, both Ukraine and Moldova are fragile in terms of political stability, freedom of expression and media freedoms, as well as implementation of electoral processes despite some progress in compliance with democratic principles and the rule of law. Both states are characterised by lower levels of government's accountability and confusing responsibility chains. But most of all, dealing with corruption remains the greatest problem these countries face. This is not surprising, given the political struggles and accompanying social and economic instability in the last decade that made these two countries politically vulnerable, unstable and democratically less consolidated especially when compared to the control groups of candidate countries (Croatia and Macedonia) and EU new member states (Bulgaria and Romania).

The comparative empirical analysis of quality of institutions has identified some key conclusions. Firstly, the prospect of accession to the EU is a powerful driver of institutional convergence. The analyses showed that ENP countries have a much weaker institutional convergence path than accession countries, and a lower level of governance capacity than in the new member states. This may be due to an absence of a clear accession horizon for EU membership, and the associated weak and inconsistent European Neighbourhood policies which place ENP countries in the "realm between accession, integration and external relations policies" (Monastiriotis and Borrell, 2012). However, nominal adoption or transposition of current EU norms and rules does not guarantee successful institutional performance, as the continuing problems in Bulgaria and Romania demonstrate.

Secondly, although Ukraine and Moldova have shown considerable progress over recent years, difficulties in compliance with core democratic standards (rule of law, political and economic freedoms, respect for minorities, free media) persist. Nevertheless, the findings concerning our new "Institutional Quality of Public Services Index" show that capacities for change have improved based on the considerable improvements in the quality of education in Ukraine, and in the capacity for innovation in Moldova. However, convergence is not complete and the final outcome is far from certain. Given that good governance and democratisation are among the top priorities of the ENP Instruments for Ukraine and Moldova, the EU has so far failed to promote transformative processes and to encourage the complementary evolution of institutions. The EU has not yet fulfilled its potential role as a "transformative power", shaping faster institutional convergence and improved internal institutional complementarity. Under such circumstances, there is a danger that if they are indefinitely delayed the reform processes will either stagnate or "run out of steam".

Thirdly, in the ENP countries changes in the complementarity of institutional reform are strongly and positively related to economic growth, and changes in reform level and reform complementarity have a greater effect on growth than in other regions. This suggests that serious attention should be given to the complementarity of the institutional reforms that take place under the process of transition. A corollary of the findings is that reforms that lead to a lower level of institutional complementarity are likely to have a significant negative impact on economic growth. The change in formal institutions brought about by reforms should therefore not be allowed to

outpace the (slower) change in informal institutions. In Ukraine and Moldova the likely consequence of continuing discontinuities in the pace of institutional change could be an increase in corruption and political instability. Reform programmes should therefore focus as much on informal institutions as on formal institutions in the design of policy in order to create stable democratic change and functioning market economies. For example, the development of endogenous institutions and incentives to eliminate the deeply rooted tolerance for corruption would contribute greatly to the elimination of the "governance gap" between these countries and the EU.

In sum, the process of democratic consolidation is incomplete due to absence of a clear European perspective, the convergence towards the EU institutional framework is uncertain, the core democratic standards are not yet reached and association policies should be more consistent. Relying solely on domestic pro-reform forces might be a slow, fragmented and piecemeal process.

References

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