



## **PRESS RELEASE OF THE WORKING PAPER 5.11**

### **INSTITUTIONAL QUALITY AND GROWTH IN EU NEIGHBOURHOOD COUNTRIES**

**January 2013**

#### **OBJECTIVE**

This paper analyzes the relationship between institutional quality and economic growth in the European Neighbourhood Policy countries (ENP) and the extent to which formal and informal institutions have converged towards EU norms. The central argument is that the quality of both formal and informal institutions is an important factor in economic development. The research investigates this proposition by measuring the extent of convergence of institutions in the ENP countries to EU norms. However, the pace of institutional reform is not the only determinant of institutional quality. Formal and informal institutions can become misaligned during the process of economic transition, potentially reducing the rate of growth or even leading to economic decline. Hence the extent of institutional complementarity is important in shaping the way in which institutions affect growth. The research therefore further investigates the relationship between the institutional complementarity and the rate of economic growth in the transition economies of the region.

#### **MAIN RESULTS AND POLICY IMPLICATIONS**

Our analysis of institutional quality in the ENP countries is based on a set of indicators that measure political governance, public sector institutions and business environment institutions drawn from the World Governance Indicators dataset for 2004-2010. Data are also drawn from other sources such as the Freedom House database, the Global Innovation Index, the World Bank Ease of Doing Business survey and the World Economic Forum survey. The analysis measures the degree of convergence of institutional quality in the ENP countries to that in the EU. The econometric analysis of institutional complementarity is based on a set of transition indicators drawn from the European Bank for Reconstruction and Development transition indicators database. The dependent variable is the rate of economic growth and the independent variable is an index of reform complementarity and a set of contextual and policy variables. The unbalanced panel of data covers 28 countries over 22 years from 1989-2010.

Five key conclusions have emerged from the analysis. Firstly, the ENP countries show a weaker institutional convergence to the EU than do the neighbouring accession and candidate countries (ACC) in the Western Balkans. For the latter, the prospect of EU accession, accession conditionality and the Europeanisation of policies supported institutional convergence prior to accession. The lesser institutional convergence in ENP countries is due to the incomplete processes of democratic consolidation, and to an absence of a clear accession horizon for EU membership and inconsistencies in European Neighbourhood policies.

A second finding is that political stability, governmental accountability, freedom of media, and control of corruption are important for the functioning of economic institutions and consequently for the success of economic policies. Building institutions that support the implementation of these norms are important for ENP countries with aspirations to join the EU. However, mere nominal adoption or transposition of EU norms and rules does not guarantee successful institutional performance, as the continuing problems in Bulgaria and Romania demonstrate.

Thirdly, although Ukraine and Moldova have shown progress over recent years, they lag behind others in creating a stable rule of law, political and economic freedom, respect for minorities and free media and are still considered as only partly free societies with respect to political and civil liberties. The convergence target has not yet been reached and the final outcome is far from certain.

Fourthly, the EU has not yet played an important role as a “transformative power” shaping faster institutional convergence and there is a danger that the reform processes will either stagnate or “run out of steam” if the EU does not take on a more decisive role. Failing that, the process could even go in an opposite direction. In sum, the process of institutional reform is incomplete due to an absence of a clear European perspective. The provision of a more consistent set of policies towards ENP countries and a commitment to a stronger EU perspective might incentivise reforms, democratization and more effective market institutions.

Fifthly, in the ENP countries, changes in the complementarity of institutional reform are positively related to growth. Moreover, changes in reform level and reform complementarity have a greater effect on growth than in other regions. A corollary is that reforms that reduce institutional complementarity are likely to have a significant negative impact on economic growth. In Ukraine and Moldova the consequence has been an increase in corruption and in political instability. The change in formal institutions brought about by reforms should therefore not be allowed to outpace the inevitably slow pace of change in informal institutions. Consequently, reforms should focus as much on informal institutions as on formal institutions. For example, the development of institutions based on improvements in social capital that would counteract the deeply rooted tolerance for corruption would contribute greatly to the elimination of the “governance gap” between these countries and the EU.

Finally, the research suggests that capacities for change are progressing, in view of the considerable improvement in the quality of education in Ukraine and in the capacity for innovation in Moldova.