WP5/11 SEARCH WORKING PAPER

Institutional Quality and Growth in EU Neighbourhood Countries

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January 2013

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Institutional Quality and Growth in EU Neighbourhood Countries

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Abstract

The research has investigated the relationship between institutional reform and economic growth the European neighbourhood policy (ENP) countries, and the extent to which formal and informal institutions have converged towards EU norms. Several key conclusions emerge from the analysis. First, the ENP countries show a weaker institutional convergence to the EU than candidate countries. Secondly, political stability, governmental accountability, freedom of media and control of corruption are important for the success of economic policies. However, 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 considerable progress over the last eight 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 is not yet 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 a more decisive role in the process. In sum, the process of institutional reform is incomplete due to an absence of a clear European perspective. Fifthly, in the ENP countries changes in the complementarity of institutional reform are positively related to growth, and 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 is 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 (slower) change in informal institutions. Reforms should therefore focus as much on informal institutions as on formal institutions. For example, the development of institutions based around 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 improving based on the considerable improvements in the quality of education in Ukraine, and in the capacity for innovation in Moldova.

Keywords

JEL Classification

P2, O40, C33

1.   INTRODUCTION

Although the role of institutions in social transformation has been extensively analysed in the sociological literature, their importance has only recently been recognised within economic thoery. In the period after WWII, economists argued that physical and financial capital, labour and technical progress could explain most differences in the rate of economic growth and development between countries (Solow, 1956). In the 1980s, the development of endogenous growth theory introduced the role of innovation (Romer, 1986) and education (Lucas, 1988) as important factors in explaining economic growth and development. However, since the beginning of the 1990s and the transition of the former socialist countries into market-based economies, interest in the quality of institutions as an important determinant of economic growth has increased considerably (Elster et al. 1998). The idea that institutions in both the public and the private sectors have distinctive role to play in supporting economic development is widely acknowledged (Acemoglu and Robinson, 2012; Rodrik, 2008). It has been argued that appropriate institutions can trigger economic growth and act as important growth accelerators (Housemann et al., 2004). The positive link between the quality of institutions and economic growth has been widely explored and empirically tested.[1]

Increasingly, investors take into account the quality of institutions as an important factor in assessing the risk of business operations. This is because the institutional framework creates both incentives and disincentives for economic transactions and business decisions. Firms are generally keen to invest in countries which protect property rights, have a developed legal framework and enforced rules of law, well developed public services without burdensome bureaucracy, redundant regulation or corruption. It is also important that government policies

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[1] The important empirical work on measuring institutional quality has been done by the World Bank; World Economic Forum, OECD; EBRD, Transparency International, Freedom House and others. For the theoretical background see the works of many neo-institutional economists started from North, 1990; Williamson (1994), Hodgson (1998), La Porta et al (1999), Rodrik (2004), Rodrik, (2008), Acemoglu, Johnson and Robinson (2004), Acemoglu and Johnson (2005), Boettke (2000) and many others. For the good overview of literature of literature see Campbell (2004).

are transparent, the judiciary does not hinder business and there is strong protection against crime and fraud. Institutional failures, on the other hand, significantly raise transaction costs for firms if public institutions fail adequately to enforce property rights, fail to protect business contracts or fail to ensure an adequate level of information to all market agents. Basic rules of conduct (both formal and informal) of citizens and enterprises and the instruments used to control corruption all reflect the capacity of society to efficiently enforce regulations and contracts (Budak, 2006; Budak and Sumpor, 2009). Such elements should be taken into account in measuring the quality of the institutional framework.

Political institutions affect the choice and shape of economic institutions both directly and indirectly, although the relation between institutions, governance and economic growth is complex (Acemoglu et al. 2004). The central hypothesis of 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 (Acemoglu and Robinson, 2012). Both institutions and governance structures are important for understanding the path of economic growth and why some countries have been more successful than others in building market-compatible institutions (Beck and Laeven, 2005). Transition countries that are better integrated into the EU such as the new member states (NMS) demonstrate better long-term economic performance and governance capacities then the countries in the European Neighbourhood or even EU candidate countries, and the quality of their institutional framework may provide some answers why this is so.

In our analysis we test the above hypothesis to see whether convergence towards transparent, stable institutions compatible with those in consolidated democracies and the developed market economies of the EU, has a positive impact on economic growth and development of the European Neighbourhood countries (ENC). Further conceptual frameworks for analysis of the quality of ENC institutions is set out in the analysis presented in the conceptual papers produced within the SEARCH project, especially Monastiriotis and Borrell (2012), Ascani et al. (2012) and Wesselink and Boschma (2012). This paper will map the quality of institutions measured by various governance indicators and assess the degree of "institutional complementarities" and harmonization with the EU in two European Neighbourhood countries, Ukraine and Moldova, which have stated their political aspirations to integrate with the EU and started to work towards institutional arrangements to achieve that goal. Both countries are part of the European Neighbourhood Policy (ENP) as well as the EU Eastern

Partnership (launched in 2009) which also includes Armenia, Azerbaijan, Belarus and Georgia. Although the EU is unlikely to enlarge on such a scale as it did in the 2000s, it nevertheless aims to facilitate political and economic development of its neighbours and bring them closer to its vision of Europe as a space of democracy and market economy based on respect for the rule of the law and human rights. These ENP countries will be compared with two accession and candidate countries (ACC), Croatia and Macedonia.

The next section sets out some theoretical background to the relationship between institutional reforms and economic growth in transition countries, exploring the concepts of social capital and institutional complementarity. Section 3 discusses the methodology of the research. In section 4, the comparative patterns of institutional evolution in the case study countries (Bulgaria, Croatia, Macedonia, Moldova, Romania and Ukraine) are analysed based on an exploration of a number of international databases on institutional quality. In section 5 an econometric analysis of the role of institutional complementarity in explaining differences in economic growth performance in transition economies is developed, comparing the ENP countries with other country groupings. Section 6 sets out the policy conclusions.

2.   THE QUALITY OF INSTITUTIONS AND SOCIAL CAPITAL

To understand economic transition and growth it is not enough to analyse physical and human capital; it is vital to also understand the broader context in which they perform. The discussion above has suggested that the level of institutional reform may affect the rate of economic growth in transition countries. However, in this paper we argue that it is not just the level of institutional reform that determines growth but also the path of change in the various institutions that make up the economic and social system that is important in explaining growth. Douglass North (1990) was among the first to highlight the role of both 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: 37). North's analysis initiated a growing literature addressing formal and informal institutions in relation to economic development. Institutions evolve over time. 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 meant that formal institutions that define

the economic, political and legal systems have changed in a short period of time. 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 the change in formal institutions may outpace the change in the informal institutions. If "institutional complementarity" is important to ensure the coherence of an economic and social system (Amable, 2003) then it is likely that the coherence of institutions diminishes during the initial stages of transition, and this may have adverse effects on economic growth. Institutions may become less complementary in these early stages of transition, and it may only be in a later stage of transition that the complementarity of institutions is restored, as informal institutions catch up with the rapid pace of change of formal institutions. We return to this paint later in section 4 below.

Informal institutions have also been analysed by sociologists. Pierre Bourdieu (1986) has identified social, cultural and symbolic capital as specific institutional configurations that also determine the pace of economic development and specifically the structure of social differentiation and inequality. Given the EU's new emphasis on "inclusive growth" in the Europe 2020 Strategy this would seem to be an important consideration for our analysis. Bourdieu argues that social capital depends on cultural capital, which is turn is formed by the acquisition of knowledge and skills that give a person a higher status in society. Furthermore, symbolic capital reflects additional resources based on prestige, status and honour. All these forms of capital are important elements in determining the extent of social inclusion. Bourdieu also emphasises the role of social networks as an important element of social capital (what North would call informal institutions) realising that they are underpinned by formal rules (the rule of the law and property rights). Individuals gain resources in the form of social, cultural and symbolic capital in part through their membership of social networks (Bourdieu, 1992). In this theoretical approach, any type of network could be used to gain advantage, including institutional as well as family networks.

The theory of social capital was also developed by Robert Putman who identified social capital with social networks. "Social capital refers to connections among individuals – social networks and the norms of reciprocity and trustworthiness that arise from them" (2000:19). In his analysis of social capital he stresses the importance of being involved in a community. The destruction of communities which can occurs with large structural changes such as those which occur during the process of economic transition represents a loss of social capital This

view, that social capital is essentially a question of membership in groups, has been adopted by international organisations such as the World Bank. However it has come under attack for neglecting the role of power relations and interests of the dominant elites which shape and provide a context to the institutional framework and which limit the extent of institutional reform (Harris, 2002; Spencer, 2011). Institutional reforms have become stuck at a sort of half-way stage in many transition economies, a phenomenon that can be explained by the resistance to continuing reform imposed by specific interest groups.

Institutional reforms in transition economies can be seen the outcome of a policy process which involves a political struggle between pro-reform and anti-reform elite groups and the emergence of political coalitions which have specific interests in the outcome. In the transition literature there has been a long debate about the relative influence of 'winners' and 'losers' on the transition process. According to one account, the potential losers from the transition process are likely to resist reform, and present the reform process with severe political constraints (Roland, 2000). The losers, including workers thrown out of their jobs as a consequence of the privatization and restructuring of state owned enterprises may be mobilized into opposition to reform by members of the old elites, including managers of state-owned enterprises and the top echelons of the security establishment who prefer the status quo to radical reform. In order to minimize this opposition to reform, pro-reform leaders should ensure that economic reforms are accompanied by appropriate social reforms, and that a social safety net is established to compensate vulnerable groups for their losses (Kramer, 1997). Another view holds that it is the winners from reform that are the most dangerous opponents of reform progress (Hellman, 1998). The winners are the new elites who gain from the early stages of reform. They include managers of large privatized enterprises, politically well-connected tycoons who gained privatized assets at bargain prices, media barons and directors of public institutions who owe their positions to political connections, and political leaders who represent these groups. According to this view, in a partially reformed economy, new elites establish monopoly positions that provide opportunities for rent-seeking, and they strive to prevent further reforms that would undermine their new privileges.

Social capital as an outcome of institutional reform can therefore be seen as a contested concept. While for Putnam, social capital is essentially a positive resource, for Bourdieu social capital can have both positive and negative consequences because social networks are

both inclusive and exclusive at the same time. An example is the Mafia, for which ties within a family are strong while at the same time members of the broader community are mistrusted. The Mafia has developed a strong presence in the EU Neighbourhood region (Glenny, 2008). Opinion polls have shown that the belief that organized crime and the mafia are the most influential group in Ukrainian society has increased over time (Panina, 2005).

A further influential analysis of social capital has been developed by Francis Fukuyama who emphasised the important role of inter-personal trust and economic and social networks in promoting economic growth (Fukuyama, 1995). In his view, social networks play an important role in market economies since they reduce the transaction cost of doing business on the basis of arms-length contracts with strangers by substituting for the need to monitor and enforce formal agreements. The networks that Fukuyama describes are those based on honesty, the keeping of commitments, reliable performance of duties and reciprocity - networks that have positive externalities for one's own group as well as for the broader society.

The transition countries provide an interesting example for the analysis of the role of institutions, social capital, trust and networks in explaining differences in the rate of economic growth and development among countries. In the 1990s, the institutional legacy of communism imposed a strong inertia on the evolution of institutions in both Ukraine and Moldova, as in other transition countries. Thus for example, many organizations and associations formed after the collapse of communism were connected with organizations from the communist period; trade unions, the industrialists' unions and agricultural organizations that were seldom independent from the state that either controlled them or co-opted them. Furthermore, the state discouraged the development of civil society on the basis of independent social networks, NGOs and pluralistic institutions. In cases where the state guaranteed a space for civil society its goal was often to fragment it and to prevent the emergence of independent associations (Kubichek, 2000).

3.   EMPIRICAL METHODOLOGY

The starting point of this research is the hypothesis that institutions affect the conditions in which economic agents, entrepreneurs and citizens interact, especially with regard to the

stability of political institutions and accountability of the government, voice in government policy-making, extensiveness of corruption and state capture, the quality of entrepreneurial infrastructure and business environment, and the quality of public services (education, quality of research and development system and the innovation system). Among their effects, we distinguish those that affect all citizens (such as stability of political institutions, accountability of government or level of corruption) from those that affect in particular entrepreneurs and investors (such as business environment and quality of public services). The analysis identifies the trends of convergence/divergence in the quality of governance indicators for the selected of countries, especially having in mind the geographical focus of the SEARCH Project. The analyses will also explore whether the pressure of Europeanization has provided an incentive to develop structures and institutions compatible with the other EU member states. For accession and candidate countries, the EU membership negotiations have also been an important external influence on national policies, institutions and governance structures, while the EU neighbourhood countries have been able to acquaint themselves with the conditionality and procedures for the accession.

In this paper, the institutional environment refers to the development of democratic institutions, which include both formal institutions such as parliaments and political parties as well as informal ones, such as civil society organisations. The rule of the law as well as respect for human rights is another important characteristic of the institutional environment. We focus on selected institutions as measured by the Worldwide Governance Indicators (WGI) from the World Bank Governance Matters database (Kaufmann et al., 2010). Kaufmann defines governance as "*traditions and institutions by which the authority in a country is exercised. This includes a) the process by which the governments are selected, monitored and replaced; b) the capacity of government to effectively formulate and implement sound policies and c) respect of citizens and the state for the institutions that govern economic and social interactions among them*" (Kaufmann et al., 2010: 4). Our analysis will build on that understanding of institutions by using data from other international sources such as Freedom House, Transparency International, UNESCO and the World Bank Doing Business database.

The institutions of public governance institutions, along with their misuse through corruption and state capture, continue to shape business environment in transition countries, especially in the European neighbourhood. Empirical analyses have suggested that the quality of

institution has an important impact on economic growth (Acemoglu et al 2004; Kaufman et al., 2010) as the choice of institutions reflects the initial distribution of political power and economic resources. Also different interest groups and especially ruling elites (Bartlett and Prica, 2012) may succeed in rent seeking and creating institutions that are favourable only to them and not for society as a whole. Several authors have argued that political and administrative corruption presents a significant obstacle for doing business in many transition economies (Griffits et al, 2009; Grodeland and Aasland, 2011;Dreher and Gassebner, 2007).

Our analysis of quality of institutions consists of various governance indicators combined at three levels, including but not limited to the following:

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.

Our focus will be on qualitative data analysis although in measuring the quality of public sector institutions, we will also construct a quantitative indicator (the Institutional Quality of Public Sector Index) as well as identify the trend of convergence or divergence of the selected countries measured by changes in the coefficient of variation over time. The period examined will be 2004-2011, to be compatible with the ICBSS analyses.

It should be notes that the WGI indicators are not without their critics. These argue that the World Bank defines governance as the way in which power is exercised in the management of a country's economic and social resources for development and stresses the role of the government. In short, for the World Bank the governance is what government does. However, social scientists have suggested that there is a need for the broader definition of governance, so that it includes both formal and informal institutions. "Governance refers to the formation and stewardship of the formal and informal rules that regulate the public realm, the arena in which states as well as economic and societal actors interact to make decisions" (Hyden et al. 2004:16). The WGI indicators are based on hundreds of specific and

disaggregated individual variables measuring various dimensions of governance taken from 35 data sources provided by 32 different organizations. The data reflect the subjective views of respondents from the public and private sectors and NGO experts, as well as thousands of survey respondents. The World Bank Governance Indicators are often criticised on technical and objective grounds. First, the data reflects points of view of experts. Yet, even if experts are not biased they are just one, usually small however vocal, group in a society. Second, how concepts are defined plays an important role in collecting data and interpreting them.

We start the examination of the quality of the public governance institutions in selected countries by looking at indicators of political stability, government accountability, success in the control of corruption, the protection of civil liberties and the effectiveness of governance institutions. We compare these indicators for selected accession, candidate and neighbourhood countries as well as the new EU member states directly bordering with the region. The point of departure of our analysis is the premise that effective public governance is underpinned by institutions that ensure political and democratic stability, political and civil freedoms and the rule of law. The focus of our analysis is to assess the institutional framework of Ukraine and Moldova, two members of the European Neighbourhood Policy (ENP) group, and extent of democratization and political stability of their governance institutions and the capacity to combat corruption. Two accession and candidate countries (ACC) Croatia and Macedonia are selected to illustrate the path ahead for Ukraine and Moldova on their way towards the EU. For comparisons, we added Bulgaria and Romania as two neighbouring new EU member states from the SEE region to see if they stand out when compared to selected ACC and ENP countries (see Table 2 in the Appendix). For this analysis we use the World Governance Indicators (WGI) dataset 2004-2010[2]. WGI provides percentile rank in the range of 1-100 for selected countries grouped into four categories: 0-25: 25-50; 50-75 and 75-100. The higher percentile rank the country holds, the better governance institutions function and perform.

4.   RESEARCH FINDINGS

[2] The data for 2011 are still not publically available.

According to the governance indicators (see Table 1. in the Appendix) despite the progress in compliance with democratic principles and rule of law, both Ukraine and Moldova are still fragile in terms of political stability, freedom of expression and media freedoms, as well as implementation of electoral processes. Both states are also 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, which made these two countries politically vulnerable, unstable and democratically less consolidated when compared to Croatia and Macedonia which had rather similar histories in the 1990s. The world financial and economic crisis has additionally aggravated the public governance problems of both Ukraine and Moldova (EBRD, 2011) and, according to the EBRD reform index, despite considerable progress on various reform fronts they continue to belong to the group of "slow reformers".

In 2004, the "Orange Revolution" in Ukraine increased expectations for the creation of a functioning democracy and market institutions. It brought about important changes that improved the constitution and brought the electoral system closer to international democratic standards. However, this also created new divisions among pro-reform forces and created political instability. Since 2006 the country has entered into a profoundly unstable period characterised by early elections and frequent changes of governments and struggles among political opponents including the arrest, conviction and imprisonment of former pro-reform Prime Minister Timoshenko. All these developments prevented the full consolidation of democratic institutions and a reduction of the trust placed in them and in the political elite. Political institutions have remained inadequately reformed and inefficient by international standards (FRIDE; 2010). Nevertheless, this non-linear and uneven progress in building the political institutions and other institutions of governance have not altered the underlying political consensus on the main directions of socio-economic development in Ukraine towards a market economy integrated with the EU. Most recently, in 2011 there has been some progress with both institutional and structural reforms (EBRD, 2011). For instance with regard fighting corruption, a new Anti-corruption Law become effective in July 2011 aimed at reducing red-tape and introducing measures to make the institutions of public administrative more effective.

In Moldova, the situation is rather similar with regard the changes in institutional and governance structures. However, political instability has been aggravated by the deadlocked conflict concerning secession of the eastern region Transnistria. As the situation has not been resolved for many years, most analysts consider this a determining reason why it was not possible to transform the country into the well-governed democratic state (Nieman and de Wekker, 2010). The secession of Transnistria was not internationally recognized but nevertheless still poses a serious political problem for Moldova as it threatens its sustainability as a state and blocks its faster transformation and integration efforts. The shared neighbourhood of Moldova between EU and Russia is another geopolitical aspect that prevents any easy and hasty solutions of that matter.

Not surprisingly, Croatia is the best ranked in the selected countries, given that it successfully complied with all the required political conditionality and transposed most of the common legal rules and adjusted its institutional system to the EU *acquis communautaire* as a precondition for joining the EU on 1 July 2013. Macedonia, another candidate country, has lower scores, especially in perceptions of political stability that have been aggravated by the dispute with Greece over the name of the state.

Figure 1: Political Stability Rank (2004-10)
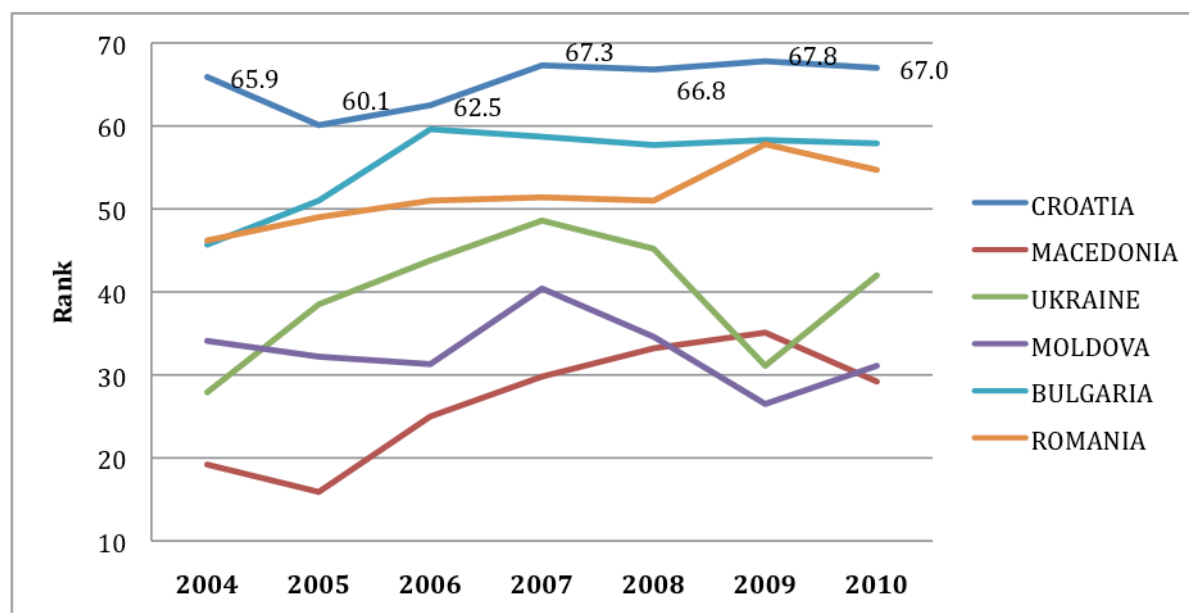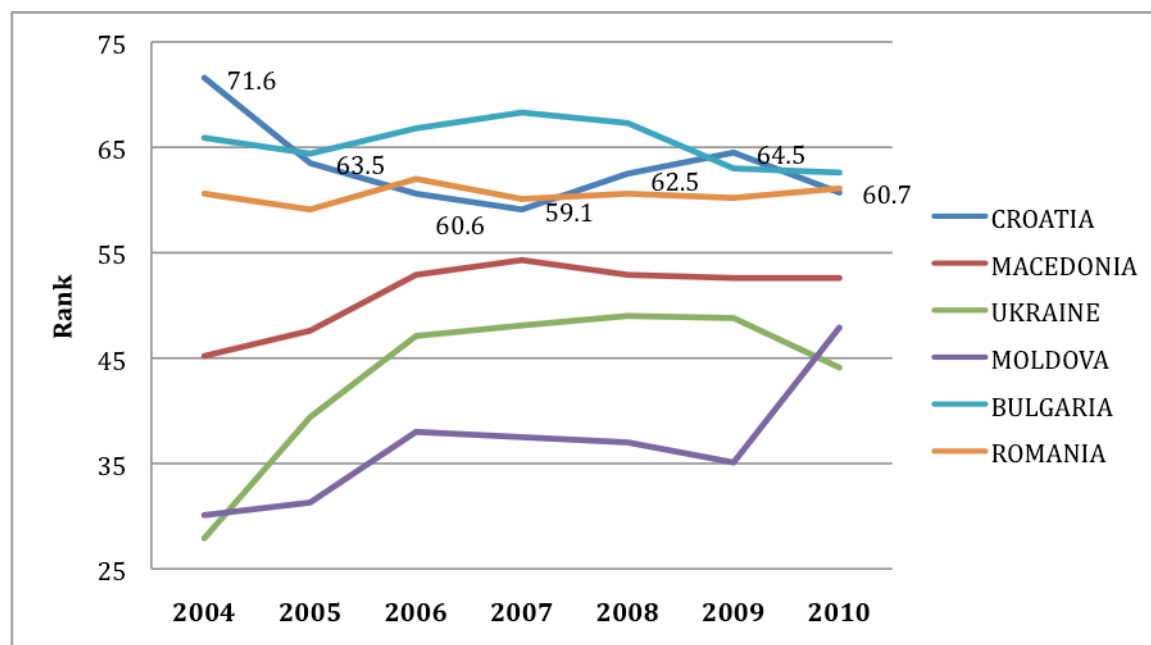

Source: WGI dataset 2011, The World Bank

Bulgarian and Romanian indicators are weaker than those for Croatia, indicating the persisting problems in the control of corruption, freedom of media and other civil liberties

and political stability. However, there is some progress, particularly in Romania since it joined the EU, especially with regard political stability while control of corruption has slightly improved right before and a year after joining the EU, but has worsened since 2008. In Bulgaria, the indicators of the perception of corruption control, voice and accountability of government have also worsened since 2007. It seems that intensified monitoring of combating corruption and increasing effectiveness of judiciary over the last five years has produced weak results. Given that fact, the toughening of the accession conditionality for Croatia and other candidate countries to create efficient institutions for dealing with corruption before joining the EU might be justified. Also the motivation for policy change is much higher in pre-accession period.

Figure 2: Voice and Accountability Rank, 2004-2010

Source: WGI dataset 2011, The World Bank.

As it seems the control of corruption remains weak across the South East Europe region, regardless of EU membership, as the level of corruption has stayed high in both Bulgaria and Romania. An explanation may be the role of the slow change in informal institutions, which are embedded in the culture, history and behaviour patterns in these countries.

Figure 3. Control of Corruption Rank, 2004-2010
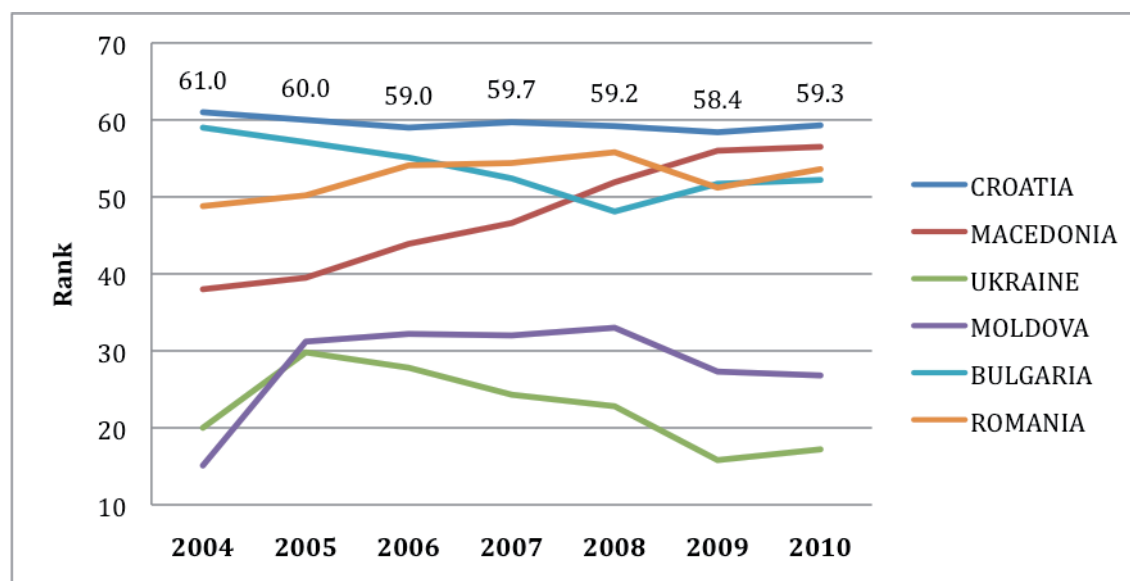
Source: WGI dataset 2011, The World Bank

In the European neighbourhood, Ukraine has the weakest institutions to fight corruption and needs to make a concerted effort to catch up with the accession and candidate countries. Combating corruption is among the priorities of Ukraine's recently signed Association Agreement with the EU (December 2011) and it is expected that more significant progress will be achieved in years to come. Moldova has done better, but nevertheless there is a clear gap between ENP and ACC countries in this respect.

According to the Worldwide Governance Indicators, Croatia is ranked better then Romania and Bulgaria in controlling corruption. However, the rank for that indicator has not changed much since 2004, which suggests a lack of convergence to EU norms especially when compared to the New Member States. Macedonia has made significant progress in controlling corruption since 2004, and by 2009-2010 outperformed both Bulgaria and Romania in this respect.

Although the WGI score ranks are actually composed from the indices of Freedom House and Transparency International (TI), it would be useful to look into their rankings separately as their focus slightly differ. The analysis of the control of corruption is therefore complemented by the *Transparency international Corruption Perception Index* dataset as provides more detail on the problem of corruption in public administration.
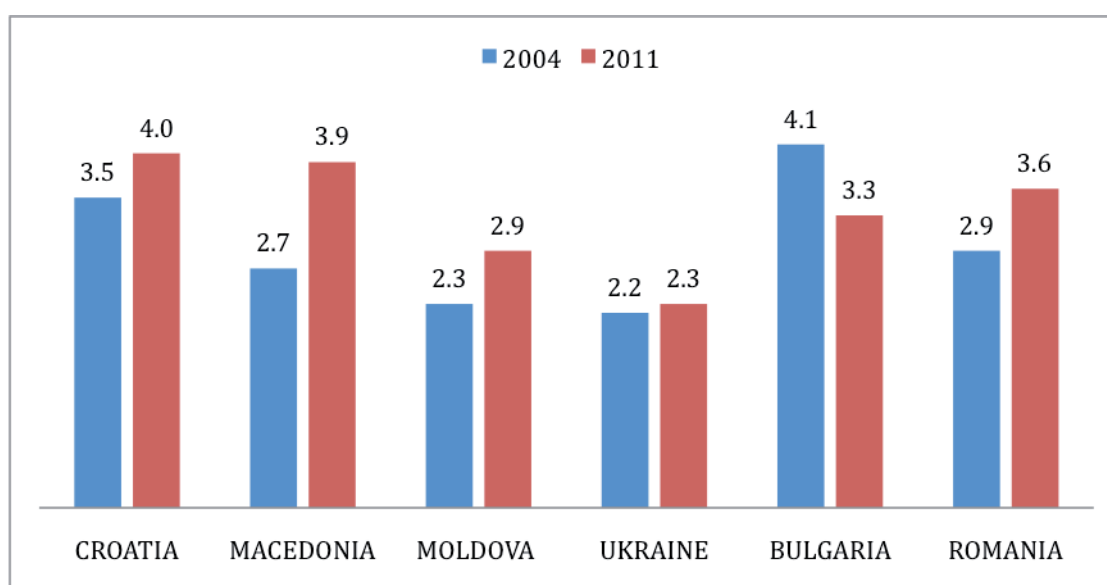
Table 3. Corruption Perception Index (CPI) in 2004 and 2011

Country	CPI Rank 2004 and Score		CPI Rank 2011 and Score	
MOLDOVA	114th	2.3	112th	2.9
UKRAINE	122th	2.2	152th	2.3
CROATIA	67th	3.5	66th	4.0
MACEDONIA	97th	2.7	69th	3.9
BULGARIA	54th	4.1	86th	3.3
ROMANIA	87th	2.9	75th	3.6

Source: Corruption Perception Index, Transparency International, 2004 and 2011, Explanatory Notes: CPI score relates to perceptions of the degree of corruption as seen by business people and country analysts and ranges between 10 (corruption free) and 0 (highly corrupt)

As with the WGI indicators, Croatia is best ranked according to the TI Corruption Perception Index 2011, remaining in 66th – 67th place during 2004-2011. The perception of corruption substantially worsened in Bulgaria, falling from 54th in 2004 to 86th place in 2011, diverging from other NMS. Ukraine plunged even further from 122th to 152th place, while Moldova improved its rank by only two places, from 114th to 112th. This vividly illustrates the weak capacities of the institutions in ENP to effectively deal with the problem of corruption.

Figure 4: Corruption Perception Index (CPI) Scores

Source: Corruption Perception Index, Transparency International, 2004 and 2011, Explanatory Notes: CPI score relates to perceptions of the degree of corruption as seen by business people and country analysts and ranges between 10 (corruption free) and 0 (highly corrupt)

In Croatia, according to the *Global Corruption Barometer 2011*, the highest corruption is perceived to be in the judiciary, followed by the parliament and political parties. In Macedonia, similarly, the judiciary leads, followed by the political parties and then parliament. In Bulgaria the judiciary is also perceived as highly corrupt and then political parties, public officials and civil servants. In Romania, the most corrupt according to citizens' perceptions are political parties, parliament and judiciary. In Ukraine it is again judiciary, police, public officials and parliament. In Moldova, the police are perceived the most corrupt, followed by the judiciary and political parties.

Table 4. The extent to which the following institutions are perceived by the public to be most affected by corruption in 2011

Country	Judiciary	Parliament	Political Parties	Public officials and civil servants	Police
CROATIA	4.1	4.0	4.0	3.8	3.7
MACEDONIA	3.9	3.5	3.7	3.6	3.3
BULGARIA	4.3	3.9	4.1	3.9	3.8
ROMANIA	4.0	4.5	4.5	3.8	3.9
MOLDOVA	3.9	3.7	3.8	3.8	4.1
UKRAINE	4.4	4.1	4.0	4.1	4.3

Source: Global Corruption Barometer 2011. Explanatory note: The perceptions are in the range from 1 (not at all corrupt) to 5 (extremely corrupt).

The Global Corruption Barometer also shows the perception of how many people pay bribes. In Croatia, According to *Global Corruption Barometer 2011*, only 5% of people were reported to pay a bribe[3], and only 8% in Bulgaria. The proportions are around one fifth to one quarter in Macedonia (21%) and Romania (28%), while the proportion is above one third in Ukraine (34%) and even Moldova (37%). These data suggest that the most important policy area in the ENP countries is strengthening institutions to combat corruption, state capture and bribery in order to reduce the transaction costs they impose on the economy. Having such a

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[3] For comparison, according to UNODC Report „*Corruption in Croatia: Bribery as Experienced by the Population*" (2011) based on field survey results of systemic and petty corruption which focuses more on people's experiences with bribe rather than perceptions, the rate of population paying bribes to public officials is higher and amounts around 11%.

high percentage of people who pay a bribe suggests that the public officials in the government administration pursue their own agendas rather than the interests of their societies, which increases general transaction costs and distorts the potential for economic growth.

An additional qualitative assessment of overall political stability, respect of political rights and freedoms, local democratic governance, free media and expression other civil liberties as well as control of corruption is provided by indicators from Freedom House. Basically the indicators attempt to describe whether the countries in question are consolidated democracies (scores 1-2.99); semi-consolidated democracies (3-3.99); transitional or hybrid regimes (4-4.99); semi-consolidated authoritarian regimes (5-5.99) or consolidated authoritarian regimes (6.99).

Table 5. Political Freedom Status, Civil Liberties and Political Rights in Ukraine and Moldova, Croatia, Macedonia, 2004-2011

Country	Year	Political Freedom Status	Civil Liberties (free media, academic freedom, etc) Rank	Political Rights
UKRAINE	2004	Partly Free 4.0	4	4
	2005	Partly Free 3.5	3	4
	2006	Free 2.5	2	3
	2007	Free 2.5	2	3
	2008	Free 2.5	2	3
	2009	Free 2.5	2	3
	2010	Free 2.5	2	3
	2011	Partly Free 3.0	3	3
MOLDOVA	2004	Partly Free 3.5	4	3
	2005	Partly Free 3.5	4	3
	2006	Partly Free 3.5	4	3
	2007	Partly Free 3.5	4	3
	2008	Partly Free 3.5	4	3
	2009	Partly Free 4.0	4	4
	2010	Partly Free 3.5	4	3
	2011	Partly Free 3.0	3	3
CROATIA	2004	Free 2.0	2	2
	2005	Free 2.0	2	2
	2006	Free 2.0	2	2
	2007	Free 2.0	2	2
	2008	Free 2.0	2	2
	2009	Free 1.5	2	1

	2010	Free 1.5	2	1
	2011	Free 1.5	2	1
MACEDONIA	2004	Partly Free 3.0	3	3
	2005	Partly Free 3.0	3	3
	2006	Partly Free 3.0	3	3
	2007	Partly Free 3.0	3	3
	2008	Partly Free 3.0	3	3
	2009	Partly Free 3.0	3	3
	2010	Partly Free 3.0	3	3
	2011	Partly Free 3.0	3	3

Source: Freedom House, Country Reports, 2004-2011

Moldova and Ukraine have shown considerable progress in the last eight years but have had difficulties in complying with democratic standards and are still considered to be only partly free societies with selective respect to political and civil liberties.

The Freedom House (FH) data especially point out towards the deterioration of democratic conditions in the last two years in Ukraine whose status altered from Free to Partly Free (limited respect for political rights and civil liberties) due to number of negative political developments that were accented by the conviction and imprisonment of Yulia Timoshenko on doubtful charges (Freedom House, 2012). The deterioration was especially visible in the indicator measuring civil liberties and freedom of expression. In Moldova, there were no significant shifts in the assessment of the level of the democratic governance, as the country remained Partly Free throughout the examined period, although there were some signs of progress in 2011 especially with regard media environment and loosening of the political influence over the media. On the other hand, there were setbacks in the protection of minorities' rights, including gay rights, with the government withdrawing an EU-backed Anti-Discrimination Law. The FH ratings provide a separate assessment of the breakaway Transnistria region, considering it to have authoritarian regime lacking respect for basic democratic rights.

Table 6. Political Freedom Status, Civil Liberties and Political Rights in Bulgaria and Romania, 2004-2011

Country	Year	Political Freedom Status	Civil Liberties (free media, academic freedom etc) Rank	Political Rights

BULGARIA	2004	Free	1.5	2	1
	2005	Free	1.5	2	1
	2006	Free	1.5	2	1
	2007	Free	1.5	2	1
	2008	Free	1.5	2	1
	2009	Free	2.0	2	2
	2010	Free	2.0	2	2
	2011	Free	2.0	2	2
ROMANIA	2004	Free	2.0	2	2
	2005	Free	2.5	2	3
	2006	Free	2.0	2	2
	2007	Free	2.0	2	2
	2008	Free	2.0	2	2
	2009	Free	2.0	2	2
	2010	Free	2.0	2	2
	2011	Free	2.0	2	2

Source: Freedom House, Country Reports, 2004-2011

The Freedom House data also confirm that Croatia, Bulgaria and Romania belong to the group of consolidated democracies and could be considered as free societies with democratic respect of political and civil liberties, free media, academic and other freedoms. Also their ability to control corruption is also higher, despite the fact that problems remain.

Institutional Quality of the Public Sector

In trying to measure the most important elements of the quality of services generally provided or organized by the public sector we focused on four elements i.e. pillars that may be crucial for economic growth and in particular for capacities of human capital development and for business development. These pillars are education, research and development (R&D), innovation and the use of information and communication technologies (ICT). In this preliminary analysis we relied on the secondary database of the INSEADs Global Innovation Index 2012[4], which uses a variety of primary information sources. For the indicators we have chosen, these sources are UNESCO, International Telecommunication Union, UN Public Administration Network, World Intellectual Property Organization, World Bank Development Indicators and Wikimedia Foundation. The indicators are compared with the average of EU-8 (Central and Eastern Europe members) and EU-14 (old EU-members) and time series will be analysed to indicate convergence or divergence trends for the selected countries over

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[4] http://www.globalinnovationindex.org

time. For each of the four pillars, we have selected three indicators. The selected indicators and their original values are presented in the following table.

Table 7. Indicators of the Institutional Quality of Public Sector Index

	Bulgaria	Romania	Croatia	Macedonia	Moldova	Ukraine
Education						
Years of schooling	13.77	14.72	13.85	13.32	11.85	14.76
Pupil-teacher ratio (secondary)	11.99	12.39	8.33	12.36	10.5	n.a.
Tertiary enrolment	53.02	63.77	49.17	40.42	38.15	79.47
Research and Development						
Gross expenditure on R&D (% GDP)	0.53	0.48	0.83	0.23	0.53	0.86
GERD financed by business (% of total)	30.62	34.75	39.79	7.79	0	25.9
Researchers, (per million population)	1767	1430	2697	1002	988	1666
Innovation						
National patent application (per billion GDP in USD PPP)	2.6	5.48	3.49	1.73	11.8	8.34
Royalty and licence fees receipts (per 000 GDP)	0.71	2.88	0.52	0.75	0.84	0.96
Creative goods exports (% total exports)	1.38	2.35	2.82	0.88	4.58	1.18
Use of ICT infrastructure						
Government online service index	0.49	0.52	0.64	0.45	0.52	0.42
ICT use index	3.17	3.2	4.33	3.11	2.26	1.35
Wikipedia monthly edits (per population 15-69)	5227	1887	5651	3907	1482	3076

Source: Global Innovation Index 2012, INSEAD

In order to put these data in broader perspective and make them comparable, we have used the original rank values for each indicator, as presented in the Global Innovation Index 2012 report. Combining these rank values for each pillar as a simple average, we calculated average score for each pillar. Finally, we have calculated average values of the respective four pillars to create a single Institutional Quality of Public Sector Index.

## Table 8. Pillars of the Institutional Quality of Public Sector Index (rank values)

	Bulgaria	Romania	Croatia	Macedonia	Moldova	Ukraine
Institutional Quality of Public Sector Index	**48.0**	**42.3**	**36.4**	**60.0**	**52.0**	**44.8**
Education	**47.0**	**37.0**	**37.3**	**57.0**	**62.0**	**22.0**
School life expectancy	53	38	52	65	90	36
Pupil-teacher ratio (secondary)	46	51	13	49	34	n.a.
Tertiary enrolment	42	22	47	57	62	8
Research and Development	**48.7**	**51.0**	**38.0**	**70.7**	**66.7**	**46.0**
Gross expenditure on R&D (% GDP)	52	57	40	80	53	37
GERD financed by business (% of total)	51	47	41	76	90	57
Researchers, (per million population)	43	49	33	56	57	44
Innovation	**47.7**	**28.7**	**36.7**	**56.7**	**21.7**	**40.7**
National patent application (per billion GDP in USD PPP)	47	32	41	57	15	25
Royalty and licence fees receipts (per 000 GDP)	37	19	42	36	35	32
Creative goods exports (% total exports)	59	35	27	77	15	65
Use of ICT infrastructure	**48.7**	**52.3**	**33.7**	**55.7**	**57.7**	**70.3**
Government online service index	71	61	40	84	61	88
ICT use index	46	45	33	48	57	81
Wikipedia monthly edits (per population 15-69)	29	51	28	35	55	42

Source: Global Innovation Index 2012, INSEAD. Note: The scores of the indexes (pillars) are calculated as simple averages of the ranks of the underlying indicators, which means the lower value is favourable

This simplified analysis provides a first glance into the present "state of art" in selected countries. Rather unexpectedly, the overall score for Ukraine and Moldova is not as low as expected having in mind rather low level of GDP per capita. The score for the two new EU members (Bulgaria and Romania) is lower than for Croatia and not much better than for Moldova and Ukraine. Macedonia stands out as a country with significantly lower values of the Index and pillars.

Finally, Figure 5 compares values of the four pillars within each country.

Figure 5. Pillars of the Institutional Quality of Public Sector Index (in brackets)
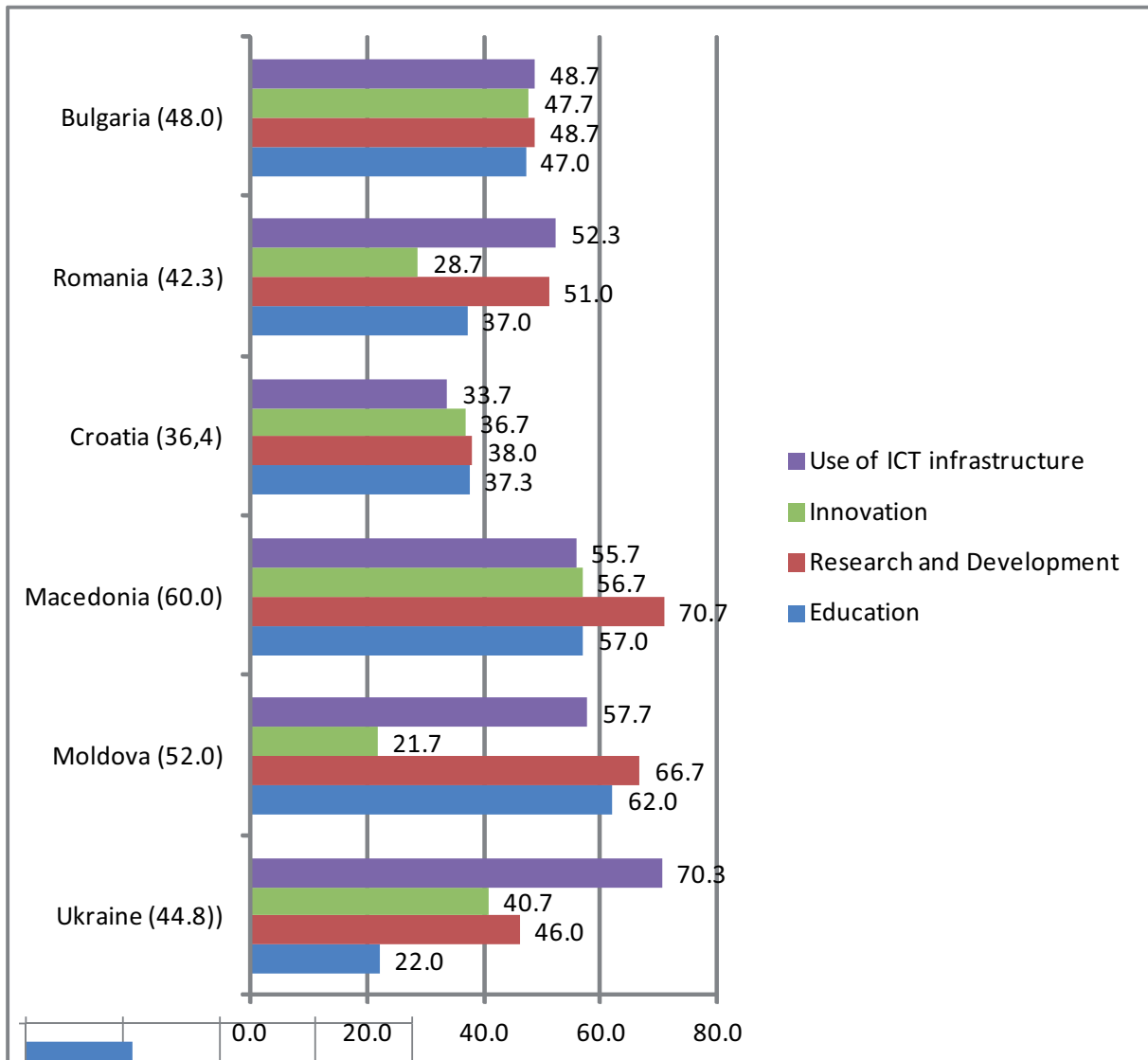
Source: Global Innovation Index 2012, INSEAD

Croatia has very similar values of the four pillars, indicating no significant strength and weakness among them. Romania is relatively more advanced in innovation and education, while lagging behind in the use of ICT. Ukraine shows a similar pattern while performing rather well in education. Bulgaria has well-balanced scores, apart from a significantly lower average score for ICT use. Moldova is rather specific case, with very good performance in innovation while education and R&D lagging behind. Finally, Macedonia performance scores the weakest, with comparatively much lower scores in R&D and ICT use.
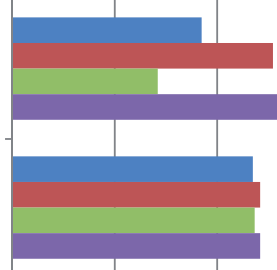
Ukraine is a specific case with Innovation and R&D pillars surprisingly better than in Bulgaria, while being ranked low in the use of ICT infrastructure. The very good scores for the Education pillar will be further reviewed because the overall score was very much influenced by high tertiary enrolment figures.

In order to test the previous findings we tried to create a similar, complementary index, composed of the same four pillars, with each of three indicators, using the WEF survey data for 2006-2011. The values of indicators, shown in Table 9 below, were calculated using moving averages – i.e. biannual averages for each indicator to mitigate yearly discrepancies in the public opinion to better investigate long-term trends. Moldova was not included in the 2008/09 competitiveness report, which limits the analysis for this country. The selection of the survey indicators is made to assess the impact on the private sector and how it is perceived within the framework of business competitiveness. For a detailed explanation of the methodology see Table 3 in the Appendix. The value of each pillar was calculated using simple averages of the underlying indicators, and the final index value was calculated as simple average of the four pillars. In order to show the relative performance, all values were expressed as compared to the average of the "old" EU members (EU15=100). For comparison, the values were also calculated for the "new" EU members (EU10). In order to calculate how much the six countries lag behind the EU15 countries we have calculated simple averages of the relative values of the four pillars and the final index. Also, to assess if the six countries converge or diverge to each other, we have calculated the variation coefficient for these countries.

Table 9: The pillars, survey indicators and questions used to create the survey based Institutional Quality of Public Sector Index

EU15=100			INDEX	Education	R&D	Innovation	ICT
2010	EU15		100.0	100.0	100.0	100.0	100.0
2010	EU10		84.4	89.2	80.5	75.1	92.5
2010	SEE	Bulgaria	70.8	73.9	65.9	62.3	80.9
2010	SEE	Croatia	76.2	84.1	72.6	69.4	79.0
2010	SEE	Macedonia	70.5	78.1	62.0	57.9	83.9
2010	SEE	Romania	69.2	80.0	61.5	63.1	72.8

Year	Group	Country					
2010	SEE	Ukraine	73.2	82.1	67.9	66.8	76.7
2010	SEE	Moldova	65.1	72.4	55.8	57.5	74.8
		SEE Average	*70.8*	*78.4*	*64.3*	*62.8*	*78.0*
		SEE C.V.	*5.3*	*5.8*	*9.0*	*7.5*	*5.3*
2008	EU15		100.0	100.0	100.0	100.0	100.0
2008	EU10		86.2	93.2	82.5	77.3	92.0
2008	SEE	Bulgaria	72.4	77.9	67.8	61.4	82.5
2008	SEE	Croatia	76.8	82.7	73.8	70.9	80.1
2008	SEE	Macedonia	69.9	81.9	62.3	56.8	79.1
2008	SEE	Romania	72.8	83.0	69.4	65.8	73.8
2008	SEE	Ukraine	74.7	83.9	71.4	66.9	77.3
2008		*SEE Average*	*73.3*	*81.9*	*69.0*	*64.3*	*78.6*
2008		*SEE C.V.*	*3.6*	*2.9*	*6.3*	*8.4*	*4.1*
2006	EU15		100.0	100.0	100.0	100.0	100.0
2006	EU10		84.0	92.2	79.8	75.6	88.9
2006	SEE	Bulgaria	69.2	78.1	65.8	58.4	75.3
2006	SEE	Croatia	79.1	85.7	77.5	75.1	78.4
2006	SEE	Macedonia	64.9	79.5	61.4	55.2	64.3
2006	SEE	Romania	73.0	86.5	71.6	61.8	73.2
2006	SEE	Ukraine	72.7	82.4	70.9	67.3	70.8
2006	SEE	Moldova	62.9	73.4	59.7	56.1	63.2
2006		*SEE Average*	*70.3*	*80.9*	*67.8*	*62.3*	*70.9*
2006		*SEE C.V.*	*8.4*	*6.1*	*10.0*	*12.3*	*8.6*

Source: Authors calculations based on WEF, GCI, survey data

If we compare the values of the variation coefficient, the six countries diverged among themselves in the institutional quality of the public sector in 2010/11 as compared to 2006/07. The difference is largest for innovation and rather small for education.

The countries show some improvement in building an institutional framework for improvement of competitiveness of private sector. The survey data also reveal the good position of Ukraine, which was ahead of Romania in Bulgaria and slightly improving. Moldova has also improved, although its overall level is very low.
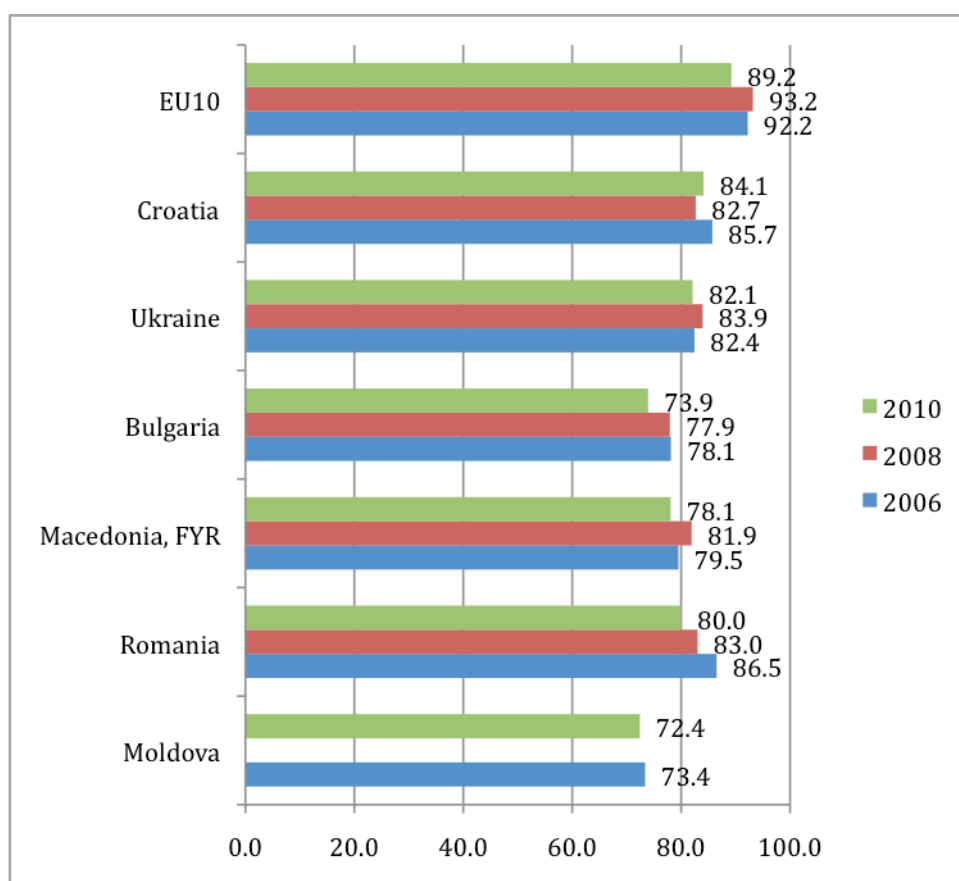
Figure 6: Values of the Survey Based Institutional Quality of Public Sector Index, EU15=100
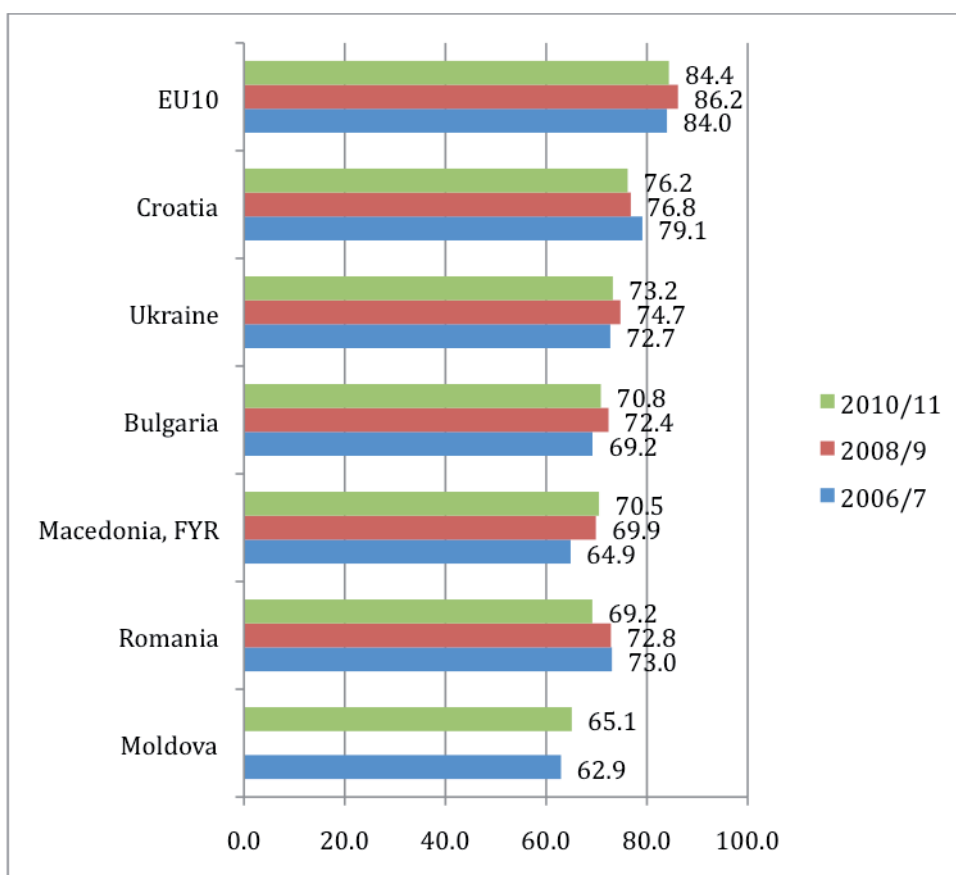
Source: Authors calculations based on WEF, GCI, survey data

For education, there is no clear improvement in any country, and Romania has even deteriorated.

Figure 7: Values of the <u>Education</u> Pillar of the Survey Based Institutional Quality of Public Sector Index, EU15=100

Source: Authors calculations based on WEF, GCI, survey data

For R&D there are also no signs of improvement, while the levels of the pillars are strikingly low.

Figure 8: Values of the <u>R&D</u> Pillar of the Survey Based Institutional Quality of Public Sector Index, EU15=100

Source: Authors calculations based on WEF, GCI, survey data

For innovation Moldova showed some improvement, however still at a rather low level. Ukraine did not change significantly in that area, while Bulgaria and Romania have improved, being able to use the potentials of the lager EU market and funding incentives directed towards innovation activities development.
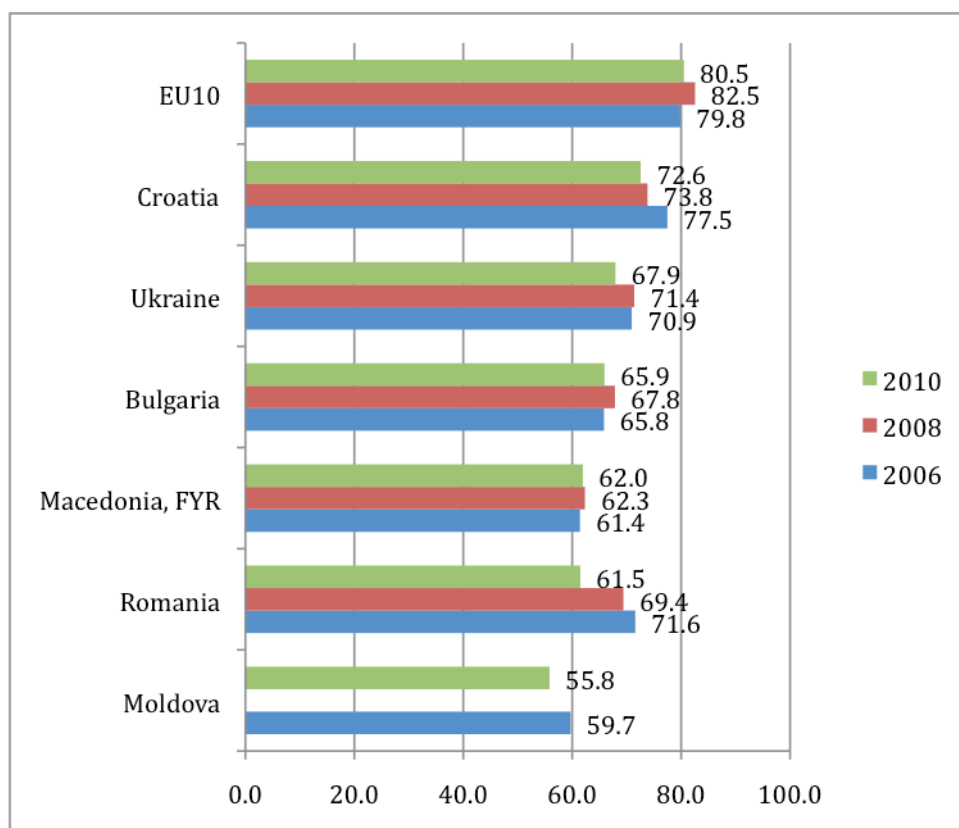
Figure 9: Values of the <u>Innovation</u> Pillar of the Survey Based Institutional Quality of Public Sector Index, EU15=100

Source: Authors calculations based on WEF, GCI, survey data

Values for R&D activites were very low and deteriorating in most of the countries. In Ukraine and Moldova, decrease is rather significant.
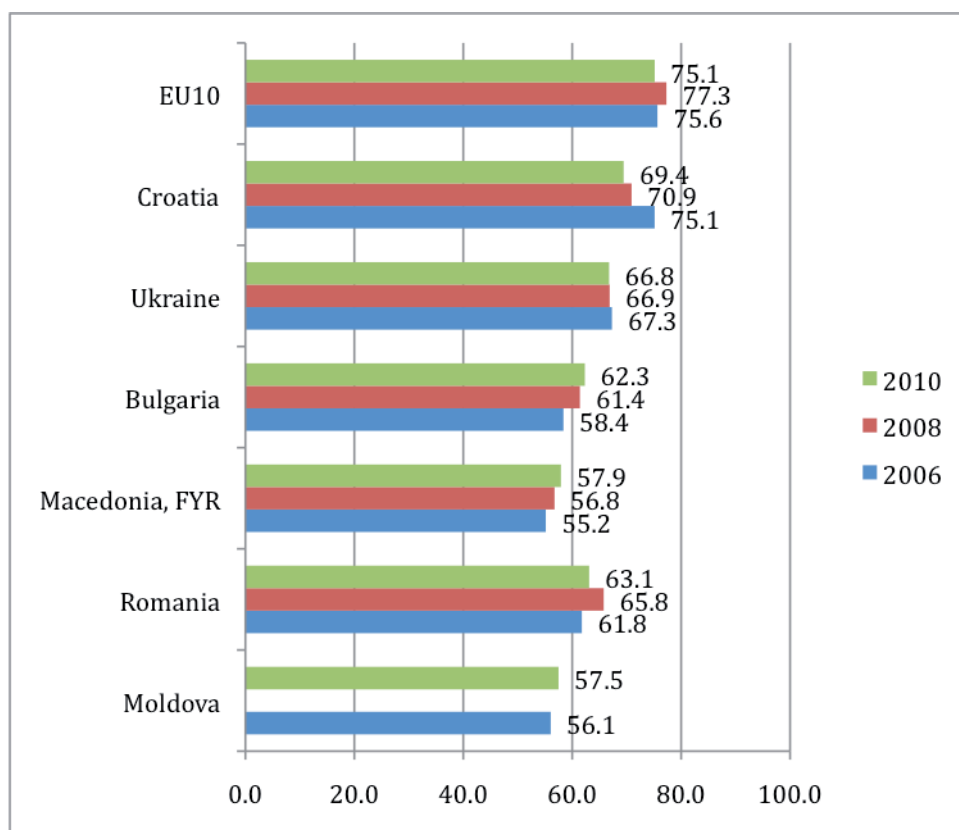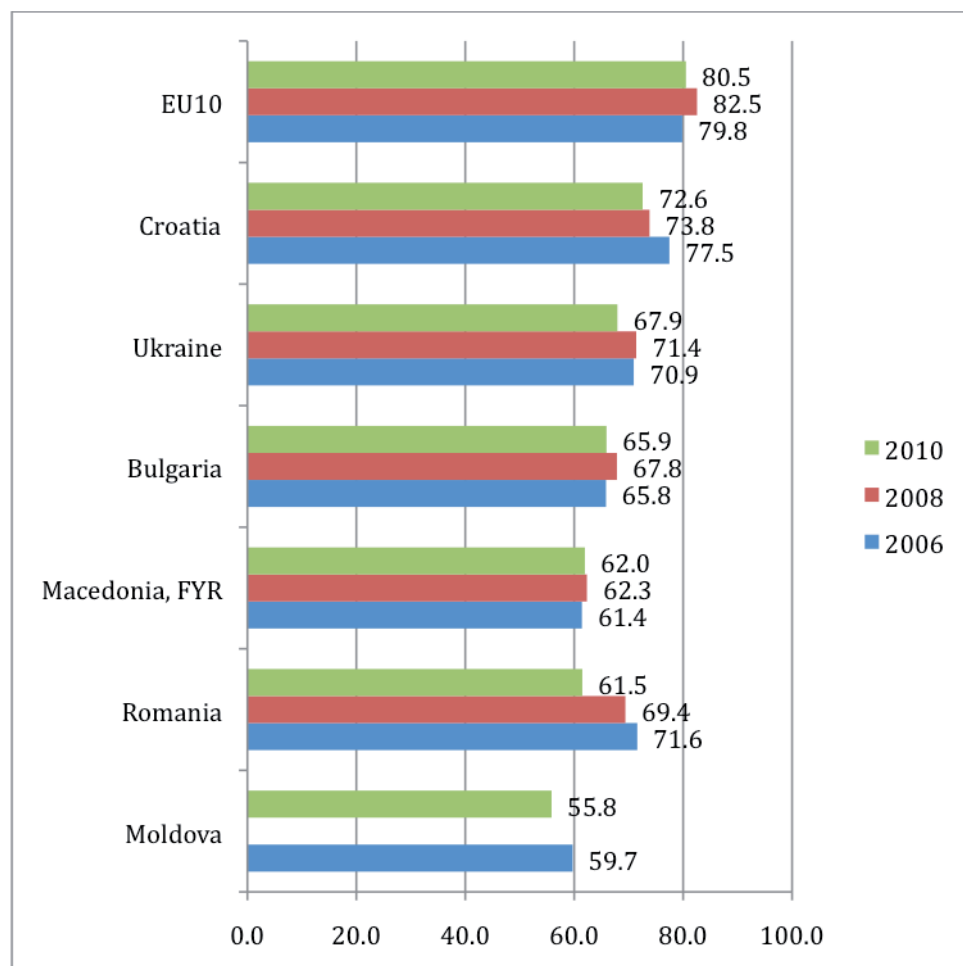
Figure 10: Values of the <u>R&D</u> Pillar of the Survey Based Institutional Quality of Public Sector Index, EU15=100

Source: Authors calculations based on WEF, GCI, survey data

In conclusion, the final Figure 11 presents the "big picture" on how much countries lag behind the EU average in the four pillars. In general, like the EU10 countries, the six countries have rather well developed education and ICT, while they lag significantly behind in innovation and R&D.

The survey responses for innovation and R&D, as compared to the EU15 average, are 66% for Ukraine and 55% for Moldova, which is very low in terms of the survey methodology used. However, the comparison with the EU10 countries shows that these countries still have

to improve their performance also within the issues of ICT and education, which is at the level of 90% of the EU15 average for the NMS, while being at 80% for Ukraine and below 75% for Moldova.

Figure 11: Values of 4 Pillars of Survey-Based Institutional Quality of Public Sector Index 2010/11 EU15=100
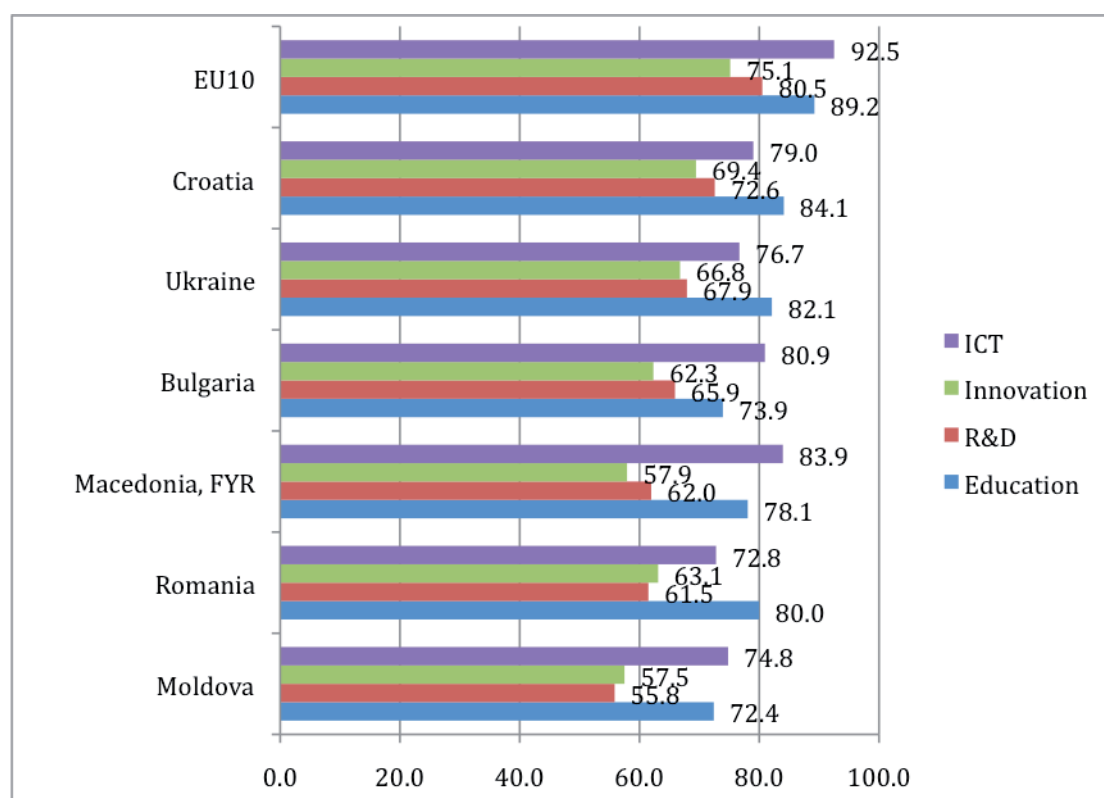
Source: Authors calculations based on WEF, GCI, survey data

Business environment quality in a narrower sense

Investor decisions are often guided by the quality of the business environment, especially when it comes to enforcing contracts and protecting investors, registering the property and transfer of property titles, issuance of building permits, issuance of business licences, paying taxes and the availability of credits. The comparative analyses for the selected countries are based on the *World Bank Doing Business Reports* dataset, 2004-2011.

We observe a general trend of improvement of the business environment indicators in the new EU members in the SEE (Bulgaria and Romania), but also especially in the countries in

the accession (Croatia) and candidate countries (Macedonia), while the slower progress could be observed in Moldova and Ukraine where the pressure of Europeanization of business environment was not so strong.

In the ENP countries Ukraine and Moldova, the situation needs further improvements especially when it comes to time to enforce contracts, ease of starting business and issuing building permits and licences, especially in Ukraine. The pressure of Europeanization of business institutions was weak and in phases of acute political instability even doubtful. That was reinforced by an absence of the clear accession prospects in the form of an association agreement with the EU which would push such processes forward and create stronger incentives for their realization. Such circumstances made the institutional convergence of ENP countries both more ineffective and impractical (Monastiriotis and Borrell, 2012). The impact of the participation in the EU neighbourhood programs (and its action plans and association agendas[5]) on the evolution of institutions in ENC countries was in this respect much weaker (Wesselink and Boschma, 2012).

Nevertheless, one could also notice progress in several aspects of creating an institutional framework for doing business in Moldova where the time to register a property was only 5 days in 2011 as compared to 48 days in 2008. Also, the time to start a new business has fllen to just 10 days, as compared to 42 days in 2004. Regrettably, there was no visible progress in reducing time spent for issuing building permits, a highly sensitive area for foreign direct investment (see Table 12).

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[5] Such as for instance 2009 EU-Ukraine Association Agenda, or 2009 Eastern Partnership Project initiated by the EU with Moldova, Ukraine, Georgia, Armenia, Azerbejdan and Belarus. Although introducing positive conditionality is a step forward it is still rather weak driving force of change in these countries. Recent signing of the Association Agreement between the EU and Ukraine in December 2011 might bring additional impetus for a faster institutional change.

Table 12. Selected World Bank Doing Business indicators for business environment quality in the EU neighbouring countries (ENC), 2004-2011

		Time to enforce contracts (days)	Registering the property (days)	Issuance of building permits (days)	Time to start business (days)	Time to finish bankruptcy procedure (years)
UKRAINE	2004	354	93 (2008)	429 (2008)	27	2.9
	2011	345	117	374	27	2.9
MOLDOVA	2004	210	48 (2008)	292 (2008)	42	2.8
	2011	365	5	292	10	2.8

Source: Data base of World Bank Doing Business 2004-2011

Furthermore, in both Ukraine and Moldova, an encouraging sign of improvement in the quality of institutions for doing business is the reduction in the time to complete bankruptcy procedures which is even shorter than in the EU members Bulgaria and Romania, and in the soon-to-be EU member Croatia. Short bankruptcy procedures facilitate the market exit of firms failing firms, making more room for the new start-ups. As for general ease of doing business in 2011, Moldova is ranked at 90th place, which is only six places after Croatia (84th), while Ukraine is at 145th place out of 174 countries.

The conclusion of the negotiations for the Deep and Comprehensive Free Trade Area (DCFTA) as well as Association Agreement between the EU and Ukraine at the end of 2011 might stimulate faster convergence of the quality of the business environment of Ukraine in the years to come. Moldova is also following the same path as it has launched negotiations for DCFTA with the EU at the end of 2011 as a step towards signing future Association Agreement. As in Ukraine, it is expected that this will provide better framework for increasing institutional complementarity with the EU.

Another benchmark indicator of the extent and intensity of cross-border exchange with neighbouring regions is the ease of trading across borders, measured by the time, costs and

documents needed for export and import. According to Doing Business 2011 Report, both Moldova and Ukraine are still ranked rather low at 141st and 139th place respectively. This indicates another institutional area that needs substantial improvements.

Table 13. Selected World Bank Doing Business indicators for business environment quality in accession, candidate and EU members from SEE, 2004-2011

		Time to enforce contracts (days)	Registering the property (days)	Issuance of building permits (days)	Time to start business (days)	Time to finish bankruptcy procedure (years)
CROATIA	2004	330	174 (2008)	255 (2008)*	29	3.1
	2011	47	104	315	7	3.1
BULGARIA	2004	410	19	131 (2008)*	32	3.8
	2011	564	15	139	18	3.3
ROMANIA	2004	225	150 (2008)	243 (2008)*	29	3.2
	2011	512	48	228	14	3.3
MACEDONIA	2004	509	98 (2008)	192 (2008)*	48	3.6
	2011	370	58	146	3	2.9

*Source: Database of World Bank Doing Business 2004-2011; * the indicator on issuance of building permits is comparable across the countries in DB dataset since 2008.*

The selected indicators show the quality of the key institutions that shape the business environment in ACC and NMS countries. According to the Doing Business Reports, Croatia has demonstrated continuous progress in improving the level of institutional quality since 2004 and now mostly outperforms Bulgaria and Romania, the SEE countries that already are full members of the EU. This refers in particular to having shorter time for enforcing contracts, the time needed to start a new business and the time needed for exit of the firm from the market by completing the bankruptcy procedure. The weakest points of the business environment in Croatia are the poor cadastral registers and the slow issue of building permits and other business licences, which still takes much longer than in Bulgaria and Romania. Macedonia has also made substantial progress in these areas in recent years. It should also be

noted that according to Transparency International Reports on the perception of corruption and UNODC 2011 Report, these parts of public administration services remain highly exposed to bribery and corruption in Croatia.

A detailed analysis of the Doing Business dataset 2004-2011 for the selected indicators shows that nominal convergence towards formal institutional rules would not necessarily mean that enforcement and respect of these rules on the ground would be smooth and imbedded or guaranteed. The Croatian, Bulgarian and Romanian cases demonstrate where the gap between the adopted and enforced rules and norms is high and how this still hinders business development and why investors still feel inefficiently protected. For instance, according to 2012 Doing Business Report, Croatia is at 133rd place with regard to the protection of investors and at 143rd place with regard the ease of obtaining building permits. This suggests that there is a persisting inefficiency in business administration and in the judiciary – an example of the slow pace of adaptation of informal institutions.

On the broader regional level, the SEE countries have on average advanced considerably in the last eight years. Already in 2009, the time to enforce contracts in these countries converged to the EU-15 level and even better than the average time in the new EU members from CEE (EU-8 countries). However, the cost of enforcing contracts is still substantially higher. In spite of advances, the legal system in the SEE is still not efficient when it comes to bankruptcy procedures, with the recovery rate still below 30%. It is evident that "old" EU members are far ahead of both EU-8 and SEE countries according to the bankruptcy loss and time to finish procedure (Cuckovic and Jurlin, 2009).

5.   INSTITUTIONAL COMPLEMENTARITY

This section focuses on the evolution of institutions and reforms in three groups of transition countries: the EU New Member States (NMS), the EU Candidate and Potential Candidate countries (ACC) states in the Western Balkans and the EU Eastern Neighbourhood Policy (ENP) transition countries. The section presents an econometric analysis of the relationship between growth and reform in the three country groupings. The analysis is based on panel data methods use the indicators of reform complementarity. This section investigates the relative importance of three sets of factors - initial conditions, macroeconomic stabilization and structural reforms - as determinants of growth in transition economies. We test a specification in which both levels and variations of the average and complementary reform indicators are included among repressors, as in the following model:

$$\Delta\text{GDP} = g \text{ (initial conditions, macrostabilisation, RL, RC, }\Delta\text{RL, }\Delta\text{RC)} \qquad (1)$$

The measure of initial conditions is an index, based on a principal component used in a study by Falcetti et al. (2002). As our measure for stabilization, we use the rate of inflation expressed as the growth of the consumer price index. Structural measures are an average of nine EBRD sectoral transition indicators (RL) and an index of reform complementarity (RC). Following De Macedo and Martins (2008) we introduce the concept of reform complementarity as:

$$\text{RC} = \frac{1}{\sum_i \left(\dfrac{R_i}{\text{RL} \cdot N} \right)^2} \qquad (2)$$

where RL is the simple average reform level, and N is the number of reform dimensions. In this case the range of variation of RC is [0.66, 9].

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). We estimated a

sample of 28 transition economies listed in the EBRD database organised into the following regional groupings of interest.

Table 14: The regional groupings

Regional grouping	Number of countries
TC - Transition countries	28
SEE (South East Europe including the Western Balkans, Bulgaria, Romania and Moldova)	9
NMS –New EU Member States (before 2007)	8
ENC - EU Neighbourhood Countries (NIS)	11

The results of the econometric analysis are presented in the following tables.

Table 15: Growth, reform level and complementarity: An empirical test on all 28 countries

Dependent variable: growth rate of real GDP	All Transition countries					
	One-way fixed-effects	One-way fixed-effects	Random effects	Random effects	Two-way fixed effects	GMM
	all TC (N=28)	all TC (N=28)	all TC (N=28)	all TC (N=28)	all TC (N=28)	all TC (N=28)
	(1)	(2)	(3)	(4)	(5)	(6)
Initial conditions	/	/	0.4612308	0.520712	/	/
			0.2311734**	0.2102787**		
CPI growth	-0.002225	-0.002145	-0.0025217	-0.0025446	-0.0016445	-0.0050772
	0.000441***	0.000422***	0.0004425***	0.0004309***	0.0004238***	0.0005347***
Reform level (RL)	5.577858	6.587967	4.15991	4.624001	-0.8387236	2.403909
	0.63825***	0.626712***	0.589706***	0.5776242***	1.4374770	0.4780946***
Reform complementarity (RC)	-2.770031	-2.264253	-3.0879780	-2.858275	-2.161978	-5.037184
	0.824713***	0.791989***	0.7807039***	0.7546775***	0.8600808**	0.7815221***
Change of reform level (ΔRL)	-12.60397	-13.361590	-15.09700	-16.64153	-5.602389	-26.551430
	2.283126***	2.186291***	2.224437***	2.169453***	2.278607**	2.373653***
Change of reform complementarity (ΔRC)	4.487859	3.795028	5.102146	4.72629	3.359892	5.36948
	0.990323***	0.952179***	0.9952318***	0.9724157***	0.9906842***	0.8138272***
$V_{2009, 2010}$	/	-7.779528	/	-6.73432	/	/
		1.092216***		1.125257***		
No. Observations	567	567	567	567	567	567
R^2 (within)	0.3214	0.3803	0.3142	0.3671	0.4832	
F-test	50.58	54.53			19.23	
(Prob)	(0.0000)	(0.0000)			(0.0000)	
Wald test	4.25	5.00			8.05	
(Prob)	(0.0000)	(0.0000)			(0.0000)	510.51
Sargan test of overid. restrictions:						(0.0000)
(Prob)						

Notes: Country fixed-effects are not reported. GMM indicates the Arellano-Bond dynamic panel-data estimation, one-step difference GMM results, using the complementarity indicator and its difference as an instrument. For this we used the xtabond2 command in STATA developed by Roodman (2005). ***, ** and * indicate significance at the 1,5 and 10 percent level, respectively. $V_{2009, 2010}$ is a dummy variable that takes value 1 in years 2009 and 2010 and value 0 for previous years.

The first two columns in Table 15 shows the results of the fixed effect estimator with country dummies, which excluded the time invariant variable related to initial conditions. We estimated two different specification of these models with and without a dummy variable related to the financial crisis (column (1) and (2)). The results of a Wald test confirmed that the country fixed dummies are needed. Then we estimated two-fixed effects models by including time fixed effects (column model (5)). We find that we also need the time fixed dummies. Initial conditions were added in the context of a GLS random-effects and we estimated two models that include initial conditions (column (3) and (4)). Finally, in order to consider the critique of the endogeneity of policy indicators in the growth model we estimated a dynamic GMM model (column (6)).

Table 16: South East Europe

Dependent variable: growth rate of real GDP	South East Europe					
	One-way fixed-effects	One-way fixed-effects	Random effects	Random effects	Two-way fixed effects	GMM
	SEE (N=9)	SEE (N=9)	SEE (N=9)	SEE (N=9)	SEE (N=9)	SEE (N=9)
	(1)	(2)	(3)	(4)	(5)	(6)
Initial conditions	/	/	**-0.41264**	**-0.464821**	/	/
			1.617364	0.9483236		
CPI growth	**-0.010092**	**-0.009099**	**-0.0109552**	**-0.012044**	**-0.006143**	**-0.0157793**
	0.003806***	0.0037009**	0.0037424***	0.0037016***	0.0036214*	0.002838***
Reform level (RL)	**4.241475**	**5.537161**	**3.72584**	**3.702448**	**-5.412297**	**1.739075**
	1.660667**	1.656109***	1.622736**	1.616469**	3.388143	1.1371070
Reform complementarity (RC)	**-3.521883**	**-3.005629**	**-3.39077**	**-2.720395**	**-3.188246**	**-3.003614**
	1.873199*	1.821809*	1.847338*	1.837835	1.963911*	1.331097**
Change of reform level (ΔRL)	**1.433214**	**-0.603094**	**1.44148**	**-0.390315**	**5.290399**	**2.92501**
	5.816142	5.664750	5.75647	5.806766	5.413319	4.316.612
Change of reform complementarity (ΔRC)	**0.135608**	**-0.804837**	**0.21664**	**-0.371319**	**-6.415345**	**0.5133527**
	2.114653	2.069572	2.09808	2.122743	2.254024***	1.565702
V$_{2009, 2010}$	/	**-7.749925**	/	**-6.635987**	/	/
		2.329993***		2.385235***		
No. Observations	170	170	170	170	170	170
R^2 (within)	0.0921	0.1526	0.0913	0.1427	0.4288	
F-test	3.17	4.65			4.08	
(Prob)	(0.0094)	(0.0002)			(0.0000)	
Wald test	2.79	7.56			4.01	
(Prob)	(0.006)	(0.0000)			(0.0000)	
Sargan test of overid. restrictions:						315.8
(Prob)						(0.0000)

Notes: Country fixed-effects are not reported. GMM indicates the Arellano-Bond dynamic panel-data estimation, one-step difference GMM results, using the complementarity indicator and its difference as an instrument. For this we used the xtabond2 command in STATA developed by Roodman (2005). ***, ** and * indicate significance at the 1,5 and 10 percent level, respectively. V$_{2009, 2010}$ is a dummy variable that takes value 1 in years 2009 and 2010 and value 0 for previous years. The countries included are Albania, Bulgaria, Romania, Croatia, Serbia, Bosnia and Herzegovina, FYR Macedonia, Montenegro and Moldova

The results confirm that countries with a higher reform level (RL) tend to have higher growth, but that a change in the reform level (ΔRL) displays a negative sign. The level of

complementarity (RC) displays a negative sign while its variations (ΔRC) has the expected positive sign. To sum up, the level of reforms and the changes in their complementarity have a positive effect on growth. We also find that initial conditions and macrostabilisation are related to growth in the sample of transition economies.

Table 16 presents the results of the analysis for the countries of South East Europe. Again we find that both time and country fixed effects are needed (Wald test). The results for SEE countries are somewhat different and not that robust. First, our findings do not confirm that changes in reform level and complementarity are related to growth. The same stands for initial conditions. However, growth in this group of transition countries is related to the level and complementarity of reforms.

Table 17: New EU Members

	new-EU members (without Bulgaria and Romania)					
Dependent variable: growth rate of real GDP	One-way fixed-effects	One-way fixed-effects	Random effects	Random effects	Two-way fixed effects	GMM
	NEUM(N=8)	NEUM(N=8)	NEUM(N=8)	NEUM(N=8)	NEUM(N=8)	NEUM(N=8)
	(1)	(2)	(3)	(4)	(5)	(6)
Initial conditions	/	/	**0.2003882**	**0.2206395**	/	/
			0.3505334	0.3499065		
CPI growth	**-0.018797**	**-0.0169230**	**-0.018811**	**-0.016969**	**-0.016856**	**-0.0178245**
	0.003154***	0.002595***	0.0031064***	0.0025612***	0.0027203***	0.0029503***
Reform level (RL)	**1.462614**	**2.3775080**	**1.402959**	**2.316927**	**4.131637**	**1.120286**
	0.880804*	0.729552***	0.8649674*	0.7186501***	2.183171*	0.6975934*
Reform complementarity (RC)	**2.137695**	**2.9570060**	**2.019104**	**2.800524**	**2.312164**	**2.353581**
	1.594595	1.310499**	1.542718	1.27768**	1.400409*	1.213091**
Change of reform level (ΔRL)	**-6.808474**	**-7.6503850**	**-7.101587**	**-7.974053**	**-6.695022**	**-7.253929**
	2.635622**	2.162665***	2.547755***	2.108775***	2.458167***	2.53823***
Change of reform complementarity (ΔRC)	**2.435112**	**1.2666830**	**2.519285**	**1.359219**	**1.058001**	**2.515158**
	1.392231*	1.149043	1.366215**	1.131282	1.318154	1.05424**
$V_{2009, 2010}$	/	**-9.831611**	/	**-9.786576**	**-10.409460**	/
		1.122872***		1.109252***	5.741022*	
No. Observations	168	168	168	168	168	168
R^2 (within)	0.5316	0.6873	0.5316	0.6872	0.7963	
F-test	35.19	56.41			21.11	
(Prob)	(0.0000)	(0.0000)			(0.0000)	
Wald test	1.28	1.98			3.80	
(Prob)	(0.2646)	(0.0613)			(0.0000)	
Sargan test of overid. restrictions:						242.32
(Prob)						(0.0000)

Notes: Country fixed-effects are not reported. GMM indicates the Arellano-Bond dynamic panel-data estimation, one-step difference GMM results, using the complementarity indicator and its difference as an instrument. For this we used the xtabond2 command in STATA developed by Roodman (2005). ***, ** and * indicate significance at the 1,5 and 10 percent level, respectively. $V_{2009, 2010}$ is a dummy variable that takes value 1 in years 2009 and 2010 and value 0 for previous years. The countries included are those that joined the EU in 2004: Czech Republic, Poland, Slovakia, Slovenia, Hungary, Estonia, Latvia and Lithuania.

Table 17 presents the results for the New Member States that joined the EU in 2004. The Wald test indicates that we do not need country dummies, but independently we find that we do need time fixed effects. In this sub-sample of transition countries the results show that initial conditions are an insignificant variable in the growth equation. However, the results confirm that countries with a higher reform level (RL) and a change in reform complementarity (ΔRC) tend to have higher GDP growth. The levels of complementarity (RC) and variations in reform level (ΔRL) have the expected negative sign.

Table 18: EU Eastern Neighbourhood

Dependent variable: growth rate of real GDP	NHC (NIS without Moldova)					
	One-way fixed-effects	One-way fixed-effects	Random effects	Random effects	Two-way fixed effects	GMM
	NHC(N=11)	NHC(N=11)	NHC(N=11)	NHC(N=11)		NHC(N=11)
Initial conditions	/	/	**2.12176**	**2.4661990**	/	/
			0.9305255**	1.038948**		
CPI growth	**-0.001071**	**-0.000973**	**-0.00151**	**-0.001367**	**0.000555**	**-0.0027616**
	0.000466**	0.000451**	0.0004703***	0.0004573***	0.0004274	0.0004259***
Reform level (RL)	**8.832169**	**9.894883**	**6.45122**	**7.732958**	**4.9280810**	**3.364993**
	1.020061***	1.022932***	0.9247986***	0.9508133***	1.964982***	0.6205642***
Reform complementarity (RC)	**-0.823166**	**-0.293759**	**-1.647583**	**-1.1249500**	**-3.8371810**	**-4.043218**
	1.239134	1.206278	1.210045	1.1914030	1.583379**	0.8643998***
Change of reform level (ΔRL)	**-17.2073**	**-18.073330**	**-20.719110**	**-21.0009000**	**-0.922836**	**-31.617840**
	3.573421***	3.464051***	3.622583***	3.529924***	3.92527	3.040509***
Change of reform complementarity (ΔRC)	**7.007993**	**6.475384**	**8.090889**	**7.4796610**	**8.09419**	**9.427564**
	1.390679***	1.352159***	1.42427***	1.384198***	1.719129***	1.087927***
V$_{2009, 2010}$	/	**-6.531186**	/	**-5.7158710**	**-7.67604**	/
		1.654891***		1.711093***	2.465137***	
No. Observations	229	229	229	229	229	229
R^2 (within)	0.5493	0.5802	0.5386	0.5723	0.7406	
F-test	51.93	48.83			22.05	
(Prob)	(0.0000)	(0.0000)			(0.0000)	
Wald test	5.80	6.11			6.28	
(Prob)	(0.0000)	(0.0000)			(0.0000)	
Sargan test of overid. restrictions:						210.6
(Prob)						(0.0000)

Notes: Country fixed-effects are not reported. GMM indicates the Arellano-Bond dynamic panel-data estimation, one-step difference GMM results, using the complementarity indicator and its difference as an instrument. For this we used the xtabond2 command in STATA developed by Roodman (2005). ***, ** and * indicate significance at the 1,5 and 10 percent level, respectively. V$_{2009, 2010}$ is a dummy variable that takes value 1 in years 2009 and 2010 and value 0 for previous years. The countries included are the New Independent States (NIS) of the former USSR without Moldova and Russia

Table 18 presents the results for the group of countries in the EU Eastern Neighbourhood region. Again we find that we need both, time and country fixed effects. In this sub-sample of transition countries we find that initial conditions are a significant variable in growth relation. The results confirm that countries with a higher reform level (RL) and a change in reform complementarity (ΔRC) tend to have higher GDP growth. The levels of complementarity

(RC) and the variations in reform level (ΔRL) have the expected negative sign. For the Eastern neighbourhood countries, variations in reform level (ΔRL) and reform complementarity (ΔRC) have a greater effect on growth than in other regions (comparing absolute values of the estimated coefficients for different groups of countries).

In summary we find different relationships between growth, level of reform and reform complementarities among our different groups of countries. The results are summarised in the following table.

Table 19: Summary results

	RL	RC	ΔRL	ΔRC
ALL	+ ***	- ***	- ***	+ ***
SEE	0	- *	0	0
NMS	+ ***	+ **	- ***	+**
ENC	+ ***	-***	- ***	+ ***
De Campos and Martins	+	-	-	+

6.   CONCLUSIONS

The empirical analysis of quality of institutions in two ENP countries, Ukraine and Moldova, has identified some key conclusions. First, the prospect of accession to the EU, the positive accession conditionality and the accompanying process of Europeanisation of economic policies and governance structures acts as a powerful drive of institutional convergence, especially in the accession and candidate countries (ACC), i.e. prior to accession. The analyses showed that ENP countries have a much weaker institutional convergence path than ACC countries, and a lower level of governance capacity than the average in the EU. This is mainly a result of their incomplete process of democratic consolidation, but it may also be due to an absence of a clear accession horizon for EU membership, and the associated weak and inconsistent European Neighbourhood programs and policies which place ENP countries

in the "realm between accession, integration and external relations policies" (Monastiriotis and Borrell, 2012).

Secondly, political stability, governmental accountability and responsibility chains, freedom of media and control of corruption are important for the configuration and operation of key economic institutions and consequently for the success of economic policies. Building institutions that support the implementation of these norms are of crucial importance for the ACC countries, as well as for those ENP countries with aspirations to join the EU. The compatibility of institutions is a standard request of EU accession conditionality, and is also a precondition of good relations with neighbouring countries. 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.

Thirdly, comparative studies of the quality of institutions over a long period (World Bank, Transparency International, Freedom House) have shown that general social welfare and higher economic growth stem mostly from better regulatory infrastructure, greater civil liberties, more efficient government administration and a professional civil service. Basically, consolidated democracies and free societies tend to have more efficient public governance institutions and enable higher social wellbeing and economic development. Although Ukraine and Moldova have shown considerable progress over the last eight years, they still have difficulties in complying with core democratic standards (rule of law, political and economic freedoms, respect for minorities, free media) and are still considered as only partly free societies with respect to political and civil liberties (FRIDE, 2010). The convergance target is not yet reached and the final outcome is far from certain.

Fourthly, providing more consistent association policies towards ENP countries and a commitment to an EU perspective might incentivise reforms for further democratization and more effective market institutions (Nieman and de Wekker, 2010). This would give both Ukraine and Moldova better perspective managing their accession aspirations. The case of Croatia is a good example, as the pace of institutional and economic reforms accelerated following the signature of the SAA in 2001, and even more so after membership negotiation started in 2005. There is a need for "joint ownership" of reforms because domestic pro-reform forces often provide a rather slow, fragmented and piecemeal reform process. A more active role of the EU is therefore also needed, especially given its proclaimed role as a

normative power (Manners, 2002). Given that good governance and democratisation are among the top priorities of the European Neighbourhood Partnership Instruments for Ukraine and Moldova, the EU role has so far failed to promote transformative processes and to encourage the evolution of institutions. The EU has therefore not yet played an important role as a "transformative power", shaping faster institutional convergence[6]. Under such circumstances, there is a danger that if they are indefinitely delayed the reform processes will either stagnate or "run out of steam". If the EU does not take a more decisive role in the process, it could even go in the opposite direction (Altmann et al., 2010). In sum, the process of democratic consolidation is incomplete due to absence of clear European perspective, the convergence towards the EU institutional framework is uncertain, and so association policies should be more consistent since relying solely on domestic pro-reform forces might be a slow, fragmented and piecemeal process.

As shown in section 4 above, in the ENP countries changes in the complementarity of institutional reform are strongly and positively related to 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. As we have seen in the analysis in section 3, in Ukraine and Moldova the likely consequence is an increase in corruption and in political instability. Reform programmes should therefore focus as much on informal institutions as on formal institutions in the design of policy 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.

Finally, and on a more positive note, the findings of the research concerning the Institutional Quality of Public Services Index suggests that improved capacities for change are apparent

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[6] Many analysts note that in the last decade the EU has more prioritised self-interests in the policies towards ENC countries (for instance energy security supply) then true democratic transformation of these countries (c.f. Altmann et al, 2010, Niemann and de Wekker, 2010).

based on the considerable improvements in the quality of education in Ukraine in the last two years, as well as in the capacity for innovation in Moldova.

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8.   APPENDIX

Figure A1: GDP per capita (PPP) for analyzed countries (EU27=100)
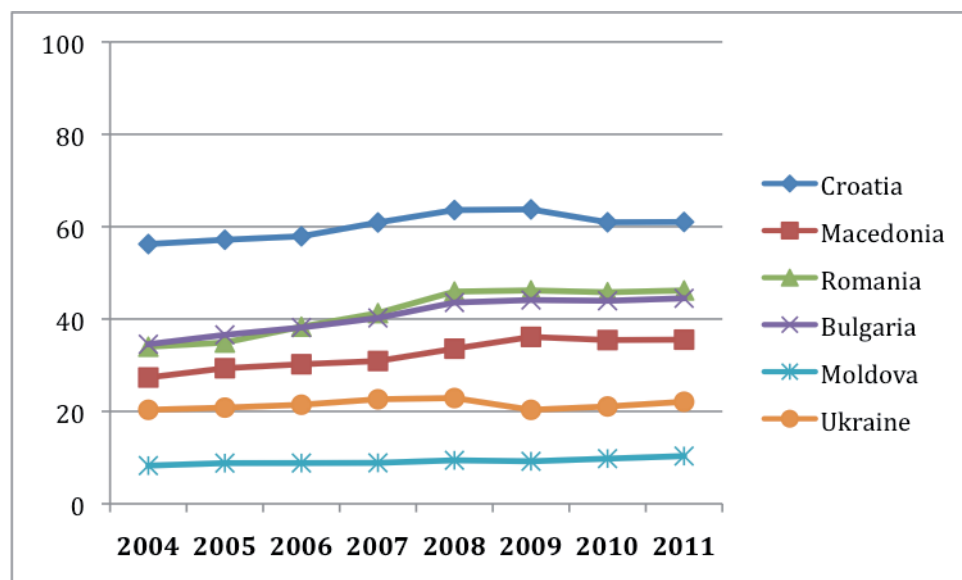
Source: World Bank, World Development Indicators, 2004-2011

Table A1. Political stability; accountability and control of corruption, 2004-2010

Country	Year	Political Stability Rank	Voice and Accountability Rank	Control of Corruption Rank
CROATIA	2004	65.9	71.6	61.0
	2005	60.1	63.5	60.0
	2006	62.5	60.6	59.0
	2007	67.3	59.1	59.7
	2008	66.8	62.5	59.2
	2009	67.8	64.5	58.4
	2010	67.0	60.7	59.3
MACEDONIA	2004	19.2	45.2	38.0
	2005	15.9	47.6	39.5
	2006	25.0	52.9	43.9
	2007	29.8	54.3	46.6
	2008	33.2	52.9	51.9
	2009	35.1	52.6	56.0
	2010	29.2	52.6	56.5
UKRAINE	2004	27.9	27.9	20.0
	2005	38.5	39.4	29.8
	2006	43.8	47.1	27.8
	2007	48.6	48.1	24.3

	2008	45.2	49.0	22.8
	2009	31.8	48.8	15.8
	2010	42.0	44.1	17.2
MOLDOVA	2004	34.1	30.3	15.1
	2005	32.2	31.3	31.2
	2006	31.3	38.0	32.2
	2007	40.4	37.5	32.0
	2008	34.6	37.0	33.0
	2009	26.5	35.1	27.3
	2010	31.1	47.9	26.8

Source: WGI dataset 2011, The World Bank.

Table A2. Political stability, accountability and control of corruption in Bulgaria and Romania, 2004-2010

Country	Year	Political Stability Rank	Voice and Accountability Rank	Control of Corruption Rank
BULGARIA	2004	45.7	65.9	59.0
	2005	51.0	64.4	57.1
	2006	59.6	66.8	55.1
	2007	58.7	68.3	52.4
	2008	57.7	67.3	48.1
	2009	58.3	63.0	51.7
	2010	57.9	62.6	52.2
ROMANIA	2004	46.2	60.6	48.8
	2005	49.0	59.1	50.2
	2006	51.0	62.0	54.1
	2007	51.4	60.1	54.4
	2008	51.0	60.6	55.8
	2009	57.8	60.2	51.2
	2010	54.7	61.1	53.6

Source: WGI dataset 2011, The World Bank

Table A3: The pillars, survey indicators and questions used to create the survey based Institutional Quality of Public Sector Index

Edu cati on	Quality of the educational system	How well does the educational system in your country meet the needs of a competitive economy? (1 = Not well at all; 7 = Very well)
	Quality of math and science education	How would you assess the quality of math and science education in your country's schools? (1 = Poor; 7 = Excellent – among the best in the world)
	Quality of management schools	How would you assess the quality of management or business schools in your country? (1 = Poor; 7 = Excellent – among the best in the world)
R& D	Quality of scientific research institutions	How would you assess the quality of scientific research institutions in your country? (1 = Very poor; 7 = The best in their field internationally)
	Local availability of specialized research and	In your country, to what extent are high-quality, specialized training services available? (1 = Not at all available; 7 = Widely available)

	training services	
	Production process sophistication	In your country, how sophisticated are production processes? (1 = Not at all – labour-intensive methods or previous generations of process technology prevail; 7 = Highly – the world's best and most efficient process technology prevails)
Inno vati on	Capacity for innovation	In your country, how do companies obtain technology? (1 = Exclusively from licensing or imitating foreign companies; 7 = By conducting formal research and pioneering their own new products and processes)
	Competitive advantage	What is the competitive advantage of your country's companies in international markets based upon? (1 = Low-cost or natural resources; 7 = Unique products and processes)
	Extent of marketing	In your country, to what extent do companies use sophisticated marketing tools and techniques? (1 = Very little; 7 = Extensively)
ICT	Government prioritization of ICT	How much priority does the government in your country place on information and communication technologies? (1 = Weak priority; 7 = High priority)
	Online government services	To what extent are online government services (e.g. personal tax, car registrations, passport applications, business permits, customs procedures and e-procurement) available in your country? (1 = Not available at all; 7 = Extensively available)
	Extent of business Internet use	To what extent do companies within your country use the Internet in their business activities (e.g. buying and selling goods, interacting with customers and suppliers)? (1 = Not at all; 7 = Extensively)