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COMPARATIVE ANALYSIS OF THE QUALITY OF EUROPEAN INSTITUTIONS 2003-2009: CONVERGENCE OR DIVERGENCE?

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Review article**
JEL: F15, F43, F55, E61, O43
UDC: 338

Abstract

This paper gives a comparative cross-country analysis of the quality of the institutional framework that underpins economic governance in European countries. The paper attempts to identify the trends of change in the quality of institutions and determine if there is a convergence in the quality of EU institutions. The countries included in the analysis are selected groups of EU countries and the Western Balkan Countries. The analysis is based on the results of the executive officers' opinion surveys conducted by the World Economic Forum for the Global Competitiveness Index 2003-2009. In order to identify the relative quality of public institutions and the trend towards convergence/divergence for different clusters of EU countries, a three-pillar composite indicator of institutional quality was constructed from available WEF indicators. The analysis was conducted at the aggregated level as well as for individual countries and pillars, measured in terms of difference to an average rank of survey response in the EU-14 + EU-8 members.

Key words: quality of institutions, economic performance, EU, Western Balkans, composite indicators

1 Introduction

The paper aims to provide a comparative cross-country analysis of the quality of the institutional framework that underpins the economic governance of European countries and affects their economic growth and international competitiveness rank. The paper

* The authors would like to thank two anonymous referees for their useful comments and suggestions.

** *Received*: September 28, 2009
Accepted: December 20, 2009

attempts to identify *the trends of change* in the quality of institutions and determine if there is a *convergence* or *divergence* in the quality of EU institutions in the 2003-2009 period. The analysis also examines at a more detailed level several factors behind institutional similarities/differences in selected clusters of EU countries.

In the second chapter we briefly deal with the question of why the quality of the institutional framework (legislative framework, regulative norms, formal and informal rules and codes, governing mechanisms) matters for economic growth and competitiveness at both country and business sector levels. We try to determine the components of the institutional quality that we intend to examine. We also define the theoretical and policy framework as well as the starting assumptions for the analyses that follow.

The third chapter offers some important remarks on the possible benefits and limitations of measuring institutional quality, which provides a broader perspective on the strength and validity of such a research exercise. We explain the reasons for the rising interest in the measurement of institutional quality and governance, point out the main problems encountered by the existing institutional quality indicators and examine the shortcomings and benefits of the assessment tools used.

In the fourth chapter we elaborate the methodological approach in the analysis of the World Economic Forum (WEF) and specify the indicators of the annual Global Competitiveness Index on the basis of which we attempt to measure institutional quality. For the purpose of this empirical exercise, we construct the indicative composite *"institutional quality index"* by defining three pillars (the quality of legal protection, quality and burden of regulation and level of corruption). We use 12 selected survey indicators of institutional quality as an explanatory tool for the levels of institutional convergence attained among different groups of EU and Western Balkan countries in the 2003-2009 period.

The analysis in the fifth chapter attempts to find an answer to the starting question of whether there is any convergence among European countries in the "institutional quality index"; which countries demonstrate positive/negative trends and if any significant deviations are found when the old and new EU-members as well as the selected EU "outsiders" are considered during the 2003-2009 period.

The sixth chapter is focused on the analyses of country groups, while in the seventh chapter we provide some more detailed findings of the main trends at the level of three sub-indexes (pillars) of the quality of institutions, in order to identify which institutional pillars and which countries account for the most identified trends towards change in the quality of institutions.

In the concluding eighth chapter we summarize the main findings of the paper and attempt to identify the underlying factors in institutional convergence for the clusters of countries that were determined on the basis of our analysis.

2 The quality of institutions in European countries and their impact on economic growth and competitiveness: why does it matter?

The link between quality of institutions and economic growth is theoretically well founded and has been repeatedly studied and empirically tested (North, 1990; North, 1997;

Olson et al., 2000; Rodrik, 2004; Campbell, 2004; Pedersen, 2008). In particularly since the beginning of the 1990s, economists have widely acknowledged the idea that good economic institutions in both the public and the private sectors are instrumental in economic growth.[1] The institutional framework conducive to a functioning market economy is very important primarily for the business community but ultimately for all citizens, for their living standards and general quality of life. Well designed institutions can trigger economic growth and act as important growth accelerators (Housemann, Prichett and Rodrik, 2004). At the business sector level, this link is most evident in investment decisions in which investors take into account the quality of institutions as a very important factor for the ease of doing business and when assessing the overall risk of future business operations in a country. The institutional framework could create incentives but also disincentives for economic transactions and business decisions. Firms are generally keen to invest in countries with a high respect for and protection of property rights; a developed legal framework and enforced rules of law; well developed public services with no burdensome bureaucracy, redundant regulation or corruption. It is important that government policies are transparent, the judiciary does not hinder business and that 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, business contracts or fail to ensure an adequate level of information on the market to all market agents. Apart from that some rules of conduct and institutional dimensions that fall within the area of "ethical behaviour" were also included in our analysis, with indicators of business ethics and public trust in the (financial) honesty of politicians, i.e. those created by the private sector subjects themselves are also very important and mirror the capacity of enforcement. These are the elements we have taken into account when measuring the overall quality of the current European institutional framework that affects the decisions of enterprises and market actors and consequently reflects on the countries' competitiveness rank.

In short, our analysis is based on the assumption that the quality of institutional framework *does matter* for the efficiency of economic transactions and economic growth. The institutional framework determines the path of economic growth of a country to large extent and increases our understanding of factors influencing economic growth patterns (North, 1990; Pederson, 2008; Rodrik, 2004; Olson et al., 2000). We similarly argue that growth and international competitiveness are better in countries which are better governed and *that differences in performance could also be attributed to the quality of economic governance and the institutional framework, i.e. rules, norms, and the formal and informal codes of behaviour of economic actors*.

Countries which rely on efficient and transparent institutions are better governed and have been able to extract therefrom an important *"development dividend"* for their economy (Kaufmann, 2005). Strong economic growth is usually linked to good governance and efficient underpinning from the institutional framework, while poor governance and weak institutions might explain the relative failures of reforms (Arndt and Oman, 2008).

[1] The theoretical background could be found in the number of works of many neo-institutional economists started from North (1990); Williamson (1994); Hodgson (1998); La Porta et al. (1999); Boettke (2000), Pejovich (1995) and many others. For the good overview of literature see Campbell (2004).

We also consider *institutional change and convergence* as an important public policy instrument and a useful explanatory tool concerning reform success for policy makers. In the empirical exercise done in this paper, by attempting to measure the quality of institutions, we also attempt to assess the preconditions and capacity for good governance, sustained economic growth and the upgrading of the international competitiveness ranking.

What factors affect the quality of institutions and institutional competitiveness in European countries? Is there a converging trend in the quality of institutions as a result of the deepening of the integration process within the EU and on the other hand the accession of new members? What impact do such processes have on candidate countries such as Croatia? These are the questions we are dealing with here. Our starting and rather self-evident assumption is that becoming part of the EU single market affects the quality of institutions and economic governance to a large extent. It is also to be expected that an important differentiation or even division lines will be formed among EU members (insiders) and non-EU members (outsiders). The other expectation is that within the EU itself, clear division lines in the quality of institutional framework will be formed among Euro Area (where deeper institutional integration exists) and non-Euro Area members.

In this paper we focus on how the quality of institutional framework and institutions, by which we refer to *rules, norms, the formal and informal codes of behaviour of economic actors,* affects the convergence trends. The convergence trends are measured by several sets of WEF indicators of institutional quality towards two groups of EU countries: (a) first to the EU-core countries (countries that joined the EU before 1995) and (b) towards the EU-core plus 8 new EU members (that joined in 2004). By institutional convergence we have in mind *increasing the similarity and complementarities and decreasing the differences of basic institutions that rule the formal and informal behaviour of organizations and individuals in the process of the integration into the EU institutional system*.

3 Measuring institutional quality: introductory remarks on potential benefits and limitations

Why is it useful to measure institutional quality and explore its correlation with economic growth of different countries or their international competitiveness ranking based on the benchmark indicators? What might be the limitations and benefits of pursuing such a research exercise as the analysis of a large number of different governance and institutional quality indicators? And finally – is an empirical search for an appropriate assessment and measurement tool a “mission impossible” when it comes to satisfying rigorous academic analytical standards and therefore doomed to failure? These are questions that unavoidably confront every researcher who attempts to approach the problem of the empirical comparison of the quality of institutions in different countries.

The rising interest in the quality of institutions and economic governance has resulted in a growing number of studies that have attempted to measure it by cross-country indicators in the last 15 years, especially by international organizations that are the main funders of reforms and therefore keen to evaluate their progress even in areas that are hard to measure such as for instance effectiveness in combating corruption or the grey economy, the rule of law, protection of norms and judicial independence, etc. (World Bank, OECD, IMF, EBRD, EC, etc.).

Measuring institutional quality, which is an important element in economic governance indicators, is a methodologically demanding exercise especially when it comes to the generation of quantitative indicators. Early experiences with the quantification of the quality of broader institutions such as political institutions, economic freedom indicators, rule of law, corruption, government effectiveness, regulatory burden, etc. were confronted with many problems (see evolution of POLITY database, International Country Risk Guide, Business Environment Risk Intelligence, Index of Economic Freedom, Freedom House Reports, Transparency International, World Bank Governance Indicators, etc.).[2] For that reason, measurements started to rely to a large extent on qualitative assessments and surveys of country-specific opinions, attitudes and perceptions. Nevertheless, both hard data collection and the analyses of gathered survey data have continued to be confronted with many methodological obstacles that tested out their strength and research validity (Williams and Siddique, 2008; Arndt and Oman, 2006; Knack, 2006). Critics refer in particular to several key shortcomings of composite cross-country indicators, such as: (a) difficulty of comparing different data sources for different countries; (b) difficulty of comparisons over longer periods of time; (c) changes introduced over time in the content of the indicators themselves; (d) indicators based predominantly on viewpoints are subjective and biased towards the views of the expert and business elite; (e) the data sources are overly influenced by recent economic performance and or level of development of a country (rich countries do get better results); and (f) flaws in the evidence of the causal (two way) relationship between institutions, governance and growth.

Aware of potential pitfalls and in-built deficiencies, researchers have tackled institutional quality measurement in a more and more systematic and cautious manner, especially since the mid 1990s. These attempts resulted in valuable insights of the possible limitations of the methodology and the ultimate usefulness of research results for analysts and policy makers.

The evolution of indicators such as those of World Bank Governance Indicators, Transparency International, World Economic Forum or OECD Governance Indicators provides at least some answers to the above questions. They are summarised well in one of the works of Kaufmann and Mastruzzi (2007), written in an attempt to defend the usefulness of institutional and governance indicators in explaining the failures of given reforms or policies in a country.

The experience of the World Bank for instance indicates the problem of the construction of *composite indicators* and their *sub-component*s as well as their relevance for policy making as most of the qualitative indices were actually built upon highly correlated indexes and rely on the subjective opinions and assessments of the "country experts". The general problem with producing qualitative indicators is that they could give biased or even distorted views, depending on what experts were interviewed and the size of the expert survey sample (Williams and Siddique, 2008; Knack, 2006). The fact is that most qualitative institutional indicators used to measure the quality of institutions in a certain country are perception-based although interviews are done with informed experts who

[2] For a thorough overview of evolution of cross-country indicators on quality of institutions and governance see Willams and Siddique (2008).

know the field well. Including more countries into the analysis does not help but aggravate this problem even more.

The time horizon in measurement is also often considered another problem, and having consistent data for periods of 5-10 years still does not solve the methodological problem as the analysts could not say anything about the situation in the preceding years. Prior to the measurement of the change in the indicators. For that reason it is quite hard to access how profound the institutional change was for the economy and what the lessons for policy-making are.

Another problem observed[3] is that the questionnaires used for opinion surveys each year are not always entirely identical (although a core list of questions are), so the comparisons of such indicators are rather difficult and not always precise. Nevertheless, many of these different data sets have been aggregated into composite ratings and indicators (Williams and Siddique, 2008; Arndt and Oman, 2008). For that reason, the cross-country and cross-sectional datasets were especially problematic and often misused or misunderstood.

The inventory list of other problems related to the use of institutional and governance indicators is rather long, and cannot be tackled in depth here. Nevertheless, it is important to bear them in mind especially when identifying the policy relevance of such analyses. The critics tend to agree that while being useful as a first source of information for investors, institutional quality and governance indicators do not tell much about the underlying factors that explain the specific position of a country or a sector (Budak and Sumpor, 2009).

Having said all this, and being fully aware of the possible limitations and benefits of the rough cross-country measurement exercise presented in this paper, we were not however discouraged. In defence of the use of qualitative institutional and governance indicators Kaufmann and Kray (2007:2), in one of their articles quote Albert Einstein's saying: "Not everything that could be counted counts and not everything that counts could be counted". In short – the capacity and quality of institutions does count, no matter how imperfect the assessment tool might be. This paper is an attempt to contribute to a meaningful analysis of some selected evidence of institutional quality in Europe that we found in the available dataset of the World Economic Forum International Competitiveness Index, in the period of 2003-2009. The magnifying lens was especially directed towards the analysis of three sets of institutional sub-indicators important for investors when assessing the overall risk of future business conduct in one country.

4 Measuring European institutional quality and convergence: the methodological approach

The empirical analysis that follows is based on the data from the Executive Opinion Survey, published by the World Economic Forum (WEF) in the Global Competitiveness Reports for the period between 2003 and 2009. The WEF survey indicators measure the

[3] For instance in the World Bank, Transparency International, OECD Governance Indicators and also World Economic Forum Global Competitiveness Indicators that we use in our analysis.

business community perception of many competitiveness factors that can not be measured by hard statistical data. The survey is conducted every year in a large number of countries, with a generally identical set of questions and a clearly defined sample, providing a sound base for analysis.

Table 1: Methodological approach: indicative institutional index

Subindexes	Indicators	Original WEF survey questions
Enforcement of rule of law	Judicial independence	Is the judiciary in your country independent of influences of members of government, citizens or firms? (1 = No – heavily influenced; 7 = yes – entirely independent)
	Property rights protection	Property rights in your country, including over financial assets, are: (1 = Poorly defined and not protected by law; 7 = Clearly defined and well protected by law)
	Intellectual property protection	Intellectual property protection and anti-counterfeiting measures in your country are: (1 = Weak and not enforced; 7 = Strong and enforced)
	Reliability of police protection	Police services in your country: (1 = Cannot be relied upon to enforce law and order; 7 = Can be relied upon to enforce law and order)
Regulative institutions	Effectiveness of antitrust policy	Anti-monopoly policy in your country is: (1 = Lax and not effective in promoting competition; 7 = Effective and promotes competition)
	Regulation of security exchanges	Regulation of securities exchanges in your country is: (1 = Not transparent, ineffective and subject to undue influence from industry and government; 7 = Transparent, effective and independent of undue influence from industry and government)
	Strength of auditing and accounting standards	Financial auditing and reporting standards regarding company financial performance in your country are: (1 = Extremely weak; 7 = Extremely strong – the best in the world)
	Burden of government regulation	Complying with administrative requirements for businesses (permits, regulations, reporting) issued by the government in your country is: (1 = Burdensome; 7 = Not burdensome)
Anti-corruption institutions	Business costs of corruption	Do illegal payments to influence government policies, laws or regulations impose costs on or otherwise negatively affect your company? (1 = Yes, they have a significant negative impact; 7 = No, they have no impact)
	Favouritism (clientelism) in decisions of government officials	When deciding upon policies and contracts, government officials in your country: (1 = Usually favour well-connected firms and individuals; 7 = Are neutral)
	Public trust of politicians	Public trust in the financial honesty of politicians in your country is: (1 = Very low; 7 = Very high)
	Business costs of organized crime	Organized crime (mafia-oriented racketeering, extortion) in your country: (1 = Imposes significant costs on businesses; 7 = Does not impose significant costs on businesses)

There is a general problem in the analysis of WEF survey data, which are subject to changes in overall business sentiment, i.e. perception proved to be rather volatile. However, the executive survey complements the formal methods of measuring institutional development, by trying to depict the impact of the quality of institutions, as witnessed by the expert end-users, i.e. well-informed members of the business community.

Although the Global Competitiveness Report already used the "institutions" index as a pillar for the measurement of the competitiveness rank, it was not entirely suitable for the purpose of our analysis. We aimed to have a somewhat different *scope and angle* of analysis and therefore create targeted sub-indexes, to capture specific issues of the quality of institutions. We have selected 12 survey indicators to construct three "pillars", which denote different aspects of the quality of institutions. The pillars and corresponding indicators are listed in the Table 1.

The scores of the WEF survey questions are in the range from 1 (worst) to 7 (best), averaged at the level of each country and published as such in the Global Competitiveness Reports. The original WEF scores for 12 indicators were aggregated (as simple averages) to the level of three sub-indexes and to calculate the final "institutions" index.

Enforcement of rule of law was measured here by using survey indicators of judicial independence, protection of property rights and intellectual property, as well as the indicator of reliability of police protection. The main aim was to assess the general legal framework and the quality of operative judicial (and police) protection of rights, as felt by the business sector.

In order to measure *the quality of regulative institutions*, we employed survey indicators of effectiveness of antitrust policies, regulation of security exchanges, quality of audit and accounting, to cover the most important policies by which public institutions control the abuse of the rules of free market conduct in the private sector. Apart from that, we included the indicator of the burden of government regulation because regulation should be effective, however without imposing an excessive burden on free entrepreneurship.

The quality of institutions that combat corruption was measured by taking into account survey indicators of business costs of corruption and organized crime, government officials' favouritism and public trust in politicians. Although trust in the honesty of politicians is presumably influenced by a number of other variables of the institutional quality, we consider it an important indicator of the (perception of) corruption at the highest level.

We have targeted these three pillars to focus on a narrow definition of institutions, leaving out the issues of economic policy effectiveness and overall quality of public services.

The analysis is benchmarking the values of these indexes for three groups of countries, defined for the purpose of this analysis as follows:

- *EU-14* are the old EU members that had joined the EU by 1995 *(Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden* and *United Kingdom);*

- *EU-8* are the states that joined the EU in 2004 *(Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia* and *Slovenia);*
- *SEECs* are the countries that joined the EU in 2007 *(Romania and Bulgaria)*, together with 3 SEE accession countries *(Croatia, Macedonia and Serbia)*.

Luxemburg, Malta and Cyprus were not included in the analyses due to lack of WEF data, and the small sizes of their economies, which means that their absence will not significantly influence the results of the analysis. Other countries of South East Europe are not included due to lack of WEF data. The EU-8 group was selected because their reform experience is instructive for the candidate countries from the South East Europe. The reason for forming the third group of countries is that, although they are in rather different phases of the process of accession to the EU, they are all significantly lagging behind the first two groups of countries in terms of economic development and competitiveness.

The analysis has two main purposes. The first purpose is to identify if there is a trend of convergence in the quality of institutions (within the scope of the method used) in all three groups of countries. The second purpose is to provide some more detailed findings of the main trends at the level of the three pillars of institutional quality, in order to identify which institutional pillars and which countries underline the identified trends of change in the quality of institutions. In our analyses we consider upgrading and convergence of the quality of institutions an important indicator and illustration of a positive link between good governance and economic performance.

What might be the value added of our methodological approach when compared to the already existing WEF Global Competitiveness Index or for that matter the World Governance Indicators of the World Bank? We definitely do not have the ambition to introduce a new composite Institutional Index. Our intention was merely to select the indicators of institutional quality that present more vividly the cracks in the institutional framework thus capturing more clearly some important policy issues and lessons from a rather different angle. The other aim was to have a simple link to a limited number of indicators that would enable us easily to track the probable explanations of the changes at the level of (perceived) overall quality of institutions, as well on the level of pillars. To check the robustness of our results, different data sources apart from WEF were used to confirm or challenge the main identified trends.

5 Main trends: is there improvement and convergence in the quality of European institutions?

Good governance and institutions have undoubtedly contributed to the economic development and growth of EU countries over the last 50 years.[4] The improvement of institutions became even more important with the formation of the single market and within the process of accession of new members. However, our analysis is focused on a rather limited time horizon – the very recent period from 2003 to 2009, by attempting to identify if there is a convergence trend in institutional quality both within the EU insiders and between the EU old and the new and future members.

[4] Easterly and Levine, 1997; Johnson, Kaufman and Schleifer, 1997; Lippert and Umbach, 2005.

The current EU economic governance regime and practice as well as underpinning institutional framework reflects to a great extent the prevailing "soft" coordination methods as apart from the monetary policy, most economic policies and institutions remained in the competence of national policy-making. For that reason, the current economic governance mechanisms have leaned more towards the regime of soft intergovernmental coordination than implementing an efficient and harmonized EU-wide mix of institutions that govern the behaviour of economic agents and individuals. The current economic governance and institutional framework also reflects divisions among functions of state and markets in member countries (Begg, 2008; Marcussen, 2006; Dyson, 2002; Umbach and Wessles, 2008; Dahausse, 2008). The divisions are also substantial between Euro zone and non-Euro zone members (Dyson, 2008).

Although several issues covered by the indicators of institutional quality we selected fall under the jurisdiction of the European Commission and commonly agreed regulatory and legislative framework within the *acquis communautaire* determined by the treaty on EMU, most of the indicators are still mainly under the competence of national legislation and policy-making.[5] Out of our three pillars, only some regulatory and market competition protection institutions are under the auspices of EU institutions. Development of institutions is still to a large extent subject to national legislations and policies, although they accepted the EU and international standards (enforcing property rights, intellectual property protection, accounting standards, etc.). Apart from that, certain elements of institutional quality, such as judiciary efficiency and the fight against corruption must be improved in all member states, especially in the countries that have historically faced the most significant problems such as Romania, Bulgaria, Italy and Greece. Therefore, a trend of convergence in the quality of regulatory and other institutions (broadly defined) will illustrate the extent of the successful integration of the EU institutions.

With an attempt to measure the level and direction of convergence, we have calculated a simple *Coefficient of variation*[6] for the selected groups of countries. The results are shown in Figure 1.

If convergence is present, a downward slope of the coefficient of variation curve is present. We found rather unexpected developments, summarized as follows:

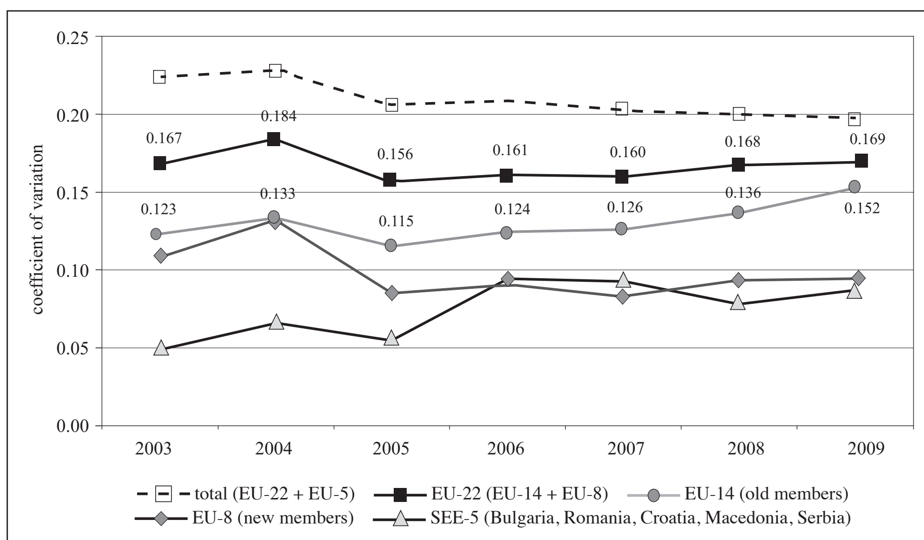
- for the most important level, i.e. for assessing intra-EU convergence (EU-22 = EU-14 + EU-8), there was a significant convergence episode in 2005, followed by a slow but clear and persistent divergence thereafter;
- in the case of EU-14 (old members), a similar one-off convergence episode occurred in 2005, however a strong trend of divergence is evident for the whole period under review;
- in 2005, a strong convergence between EU-8 (new members) occurred, with stagnation since;

[5] Renewed Lisbon's governance instruments within the Open Mechanism of Coordination (OMC) rely heavily on voluntary arrangements, leaving the individual member states to support the EU economic reform by own policies, taking more responsibility for it, and at the same time learning from other experiences (benchmarking), while viewing the Commission role more as a facilitator rather than the manager or controller of what is being done (EC, 2008).

[6] Coefficient of variation (CV) is a normalized measure of dispersion of a probability distribution. It is defined as the ratio of the standard deviation to the mean (average value).

- the difference between SEE countries increased in 2006 (i.e. they diverged) and the variation coefficient remained stable since;
- if we take into account the whole sample of the countries, i.e. 27 countries, there is a general convergence trend, especially strong in 2005.

Figure 1: Coefficient of variation of the indicative institutions quality index



Source: Authors' calculations based on WEF data 2003-2009.

It is not easy to explain the convergence episode in 2005 at the aggregate level, which may be a result of the "enlargement euphoria", that moved perception of the quality of institutions (as well as the perception of overall competitiveness) upwards in a number of countries.

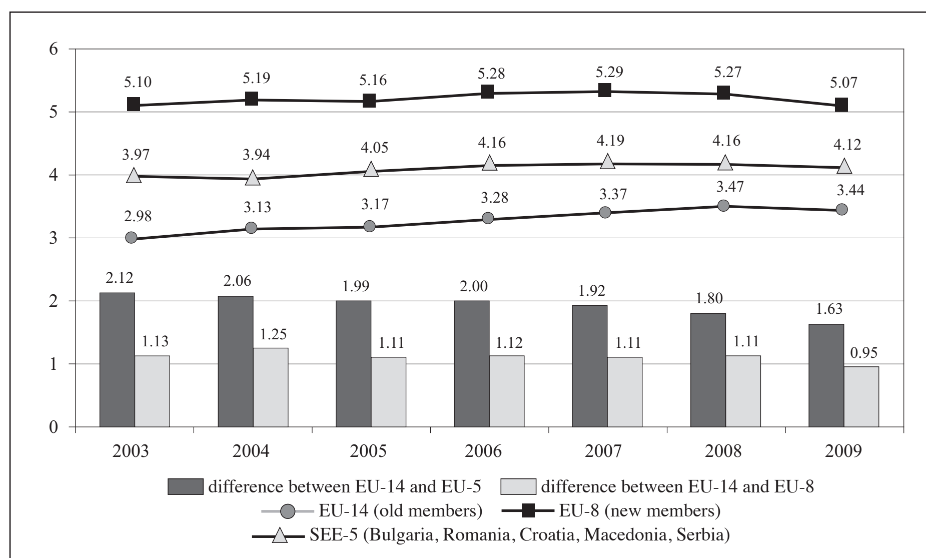
However, the overall divergence trend in recent years at the level for assessing intra-EU convergence (EU-22 = EU-14 + EU-8) seems more founded on the data. The main reason behind the trend is strong divergence of the (perceived) quality of institutions between the old EU member states, clearly indicated with an upward curve for these countries. By contrast, variation among the new members has significantly decreased in 2005 and remained rather stable. In short – the gap between the two clusters of countries remained rather substantial.

The convergence for the whole sample of countries (including non-members) is almost solely attributable to a general improvement of the quality of institutions in the SEE countries, however inadequate. In order to illustrate that, we shall consider the absolute values of the "institutions" index (Figure 2).

At the level of overall *indicative institutions quality index* for old EU members (EU-14) there was a very slow upward trend until 2006 and a significant fall thereafter. Although

the fall was not immense, it indicates that there was no improvement in the quality of institutions in the EU in recent years, as perceived by "users", i.e. business sector. The outcome of the new EU members (EU-8) was also weak, showing that these countries may have not improved the quality of their institutions as they would have had to in order to catch up with the level of the old members. The difference between the two groups of countries remained largely unchanged throughout the period under review, only to be reduced in 2009, but not due to improvement in the new members, but due to the fall of the value of index for the old EU members. One rather simplified explanation might be that the economic governance mechanisms within the OMC do not exert such pressures to converge as prior to membership when the drive of Europeanization of their institutions was almost a must.

Figure 2: Indicative institutions quality index



Note: Difference between the groups of countries is calculated by simple subtraction of the values of the pairs of indexes for each year.

Source: Authors' calculations based on WEF data 2003-2009.

This may be connected to the "reform fatigue" that was predicted by some analysts even before the accession in 2005. In the 2004 speech, the Vice President of the European Central Bank[7] predicted that "EU membership is not sufficient to ensure continued economic success and real economic convergence of the new EU countries with the older member states. There is a risk that reform fatigue will set in after EU accession, because the incentive for reform may no longer be as strong as before".

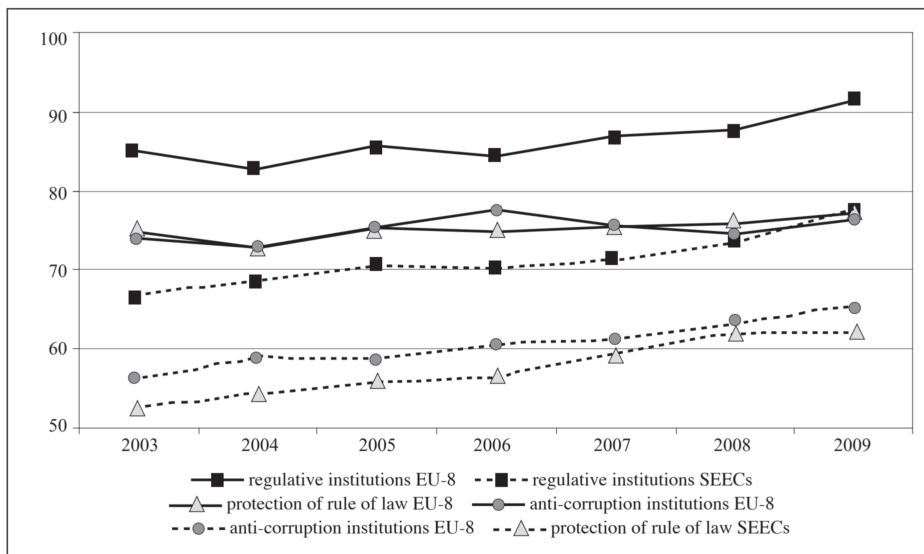
[7] Opening address at the Third ECB Central Banking Conference "The new EU Member States: convergence and stability" speech by Lucas Papademos, Vice President of the ECB Frankfurt am Main, 21 October 2004, available at: [http://www.ecb.int/press/key/date/2004/html/sp041021.en.html2004].

In the field of institutions, exactly this might have happened. The WEF (2009, p. 26) pointed out that: "While this relative flexibility and stability will provide advantages on the way to recovery, the Global Competitiveness Index points to other areas that will need to be addressed on a priority basis in the region. Most of all, the countries' institutional environments will need to be strengthened. Much progress has been achieved since the early days of transition, but even the regional best performer in this area, Estonia, ranked 31st, does not reach the average level of the EU-15 with respect to the quality of public institutions; other relatively advanced countries from the region, such as the Czech Republic (66th) or Slovenia (43rd), lag behind by an even wider margin. (…) Stronger private and public institutions would ultimately reduce vulnerability related to greater integration with the global economy."

The SEE countries showed a slow but rather persistent improvement from a low level below 3 (1-7 scale) in 2003 towards the (still low) level of 3.5 in the last two years.

According to the EBRD (2009, Chapter 1, p. 3) "One region where progress remains evident and several upgrades have occurred is the Western Balkans. All countries in this region are either candidate or potential candidate countries for membership of the European Union and, as the experience of previous candidates (and now members) has shown, this provides an important motivation to reform." The EBRD recorded 7 upgrades in the SEECs (including Croatia), while for the transition countries that joined EU in 2005, there were only two upgrades and one downgrade.

Figure 3: Catching up: WEF based pillars; EU-14=100

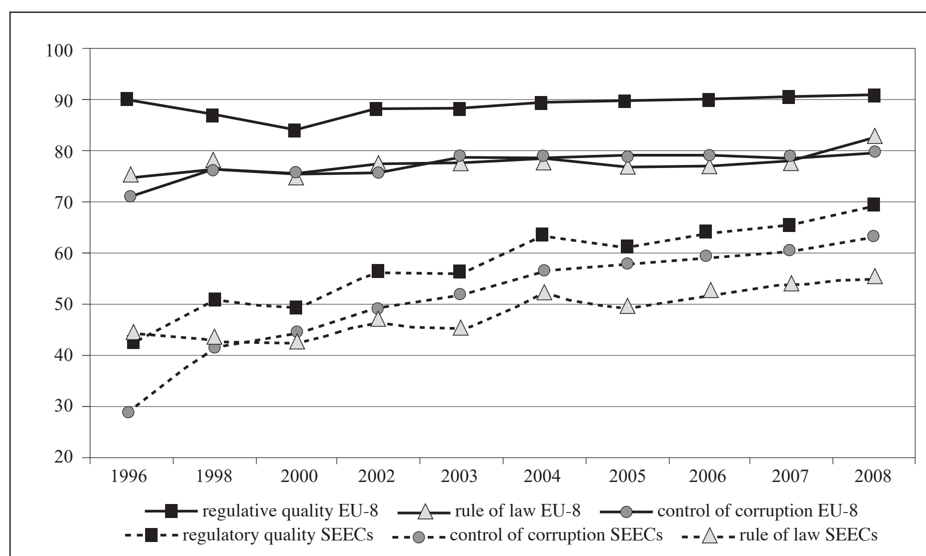


Source: Authors' calculations based on WEF data 2003-2009.

To get into more detail, we will present the values of our three selected pillars, i.e. *enforcement of rule of law, regulative institutions* and *anti-corruption institutions* (Figure

3). In parallel we will present the relative values of 3 out of 6 sub-indexes (dimensions) of the World Bank Governance Indicators, i.e. *rule of law, regulatory quality,* and *control of corruption* (Figure 4). These 3 pairs of sub-indexes are very differently defined and calculated, however their meaning and capture to a large extent correspond to each other. The presented WB indicators cover the 1996-2008 period, while the WEF data are for the 2003-2009 period.

Figure 4: Catching up: World Bank Governance Indicators; EU-14=100



Source: World Bank Governance Indicators database [*http://info.worldbank.org/governance/wgi/index.asp*]

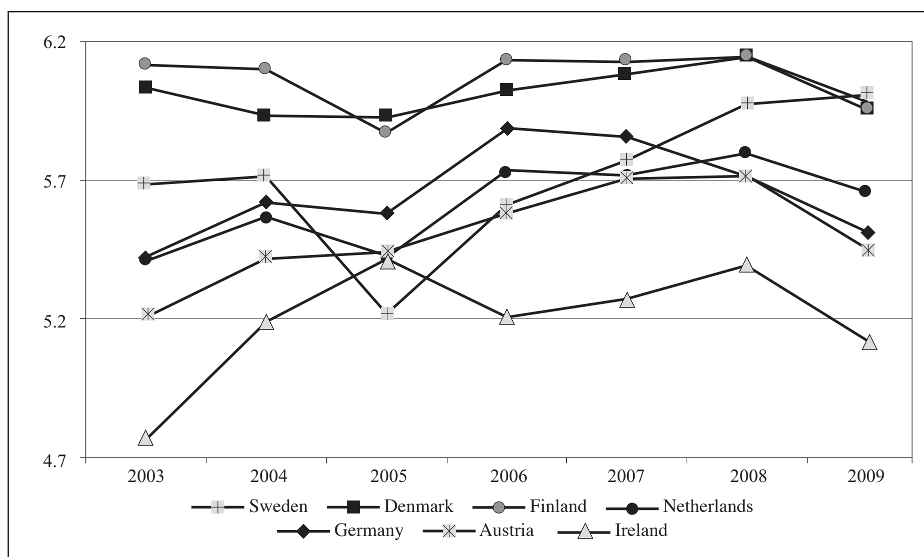
The range and values of indicators are rather different due to the nature of sub-indexes and indicators embedded. However, there are several similarities.

- For regulative institutions (WEF) and regulatory quality (WB) the catching up was by far the most successful. EU-8 countries reached a (stylized) level of 90% of the EU-14 average, and the CEECs reached a satisfactory level. What is equally important, the improvements, as compared to the EU-8 average, have continued throughout the period under review.
- The fight against corruption in the new EU members has been at a stalemate according to both sub-indexes. SEECs have advanced considerably; however, the level is still low.
- Protection of rule of law proved to be the most difficult field of catching-up with the EU-14. For the EU-8, the advance is going at a snail's pace and the SEECs are a long way from getting to a satisfactory level. The advance in the last years under review is not due to improvement in the two groups of countries, but due to deterioration in the old EU members.

6 Analysis at the different country-groups level

In further analysis we will examine the trends of the "institutions" index on the level of countries under review. The old EU members may be divided in two groups when considering level and dynamics of the quality of institutions. The first group consists of countries with scores above 5.0, in spite of a significant fall in the last year (Figure 5).

Figure 5: Institutions quality index 2003-2008: "old and successful members"



Source: Authors' calculations based on WEF data 2003-2009.

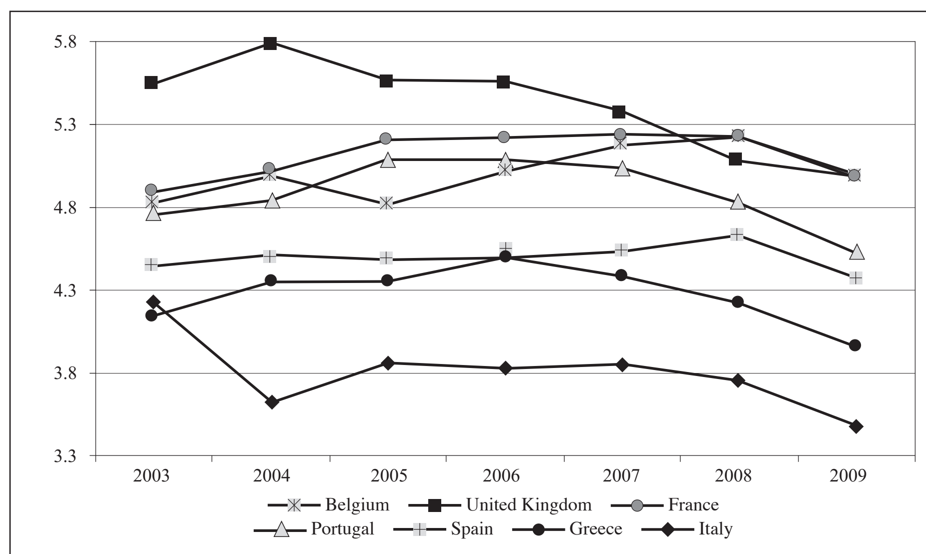
At the top of the list there are the Nordic countries: Finland and Denmark, joined by Sweden in 2009, following a rather significant improvement of the perceived quality of institutions. Netherlands, Germany and Austria experienced very similar upward trend until 2007, witnessing a downturn in the last two years. The main reason for a significant fall in the last year lies in worsened survey responses for favouritism in decisions of government officials and a fall of public trust in politicians. It seems that the business community consider their politicians and officials responsible for not preventing the financial crisis by more adequate policies. Apart from that, in Austria and Ireland, there was a strong drop in the perception of quality of regulation of security exchanges, which is no surprise having in mind the unprecedented drop in the stock markets.

The second group of old EU members consists of countries with scores below 5.0, and without sound improvement throughout the period under review (Figure 6).

The deterioration in 2009 common to this cluster of countries was expected, bearing in mind how hard they were hit by the global financial and economic crisis. For some countries worsening in the institutions index was noticeable even in the earlier years.

According to Transparency International (2009), Greece gives particular reasons for concern, with its "insufficient levels of anti-corruption enforcement, lengthy delays in the judicial process and a string of corporate corruption scandals which point to systemic weaknesses. Greece's poor score shows that joining the EU does not automatically translate into a reduction in corruption". According to Heritage Foundation (2009, p. 225), for Italy, "Property rights and freedom from corruption are relatively weak".

Figure 6: Institutions quality index 2003-2008: old EU members facing problems



Source: Authors' calculations based on WEF data 2003-2009.

Following the analytical approach that we have used, and in the period under review, the divergence among the old EU members is to be largely attributed to the significant worsening of the position of certain countries.

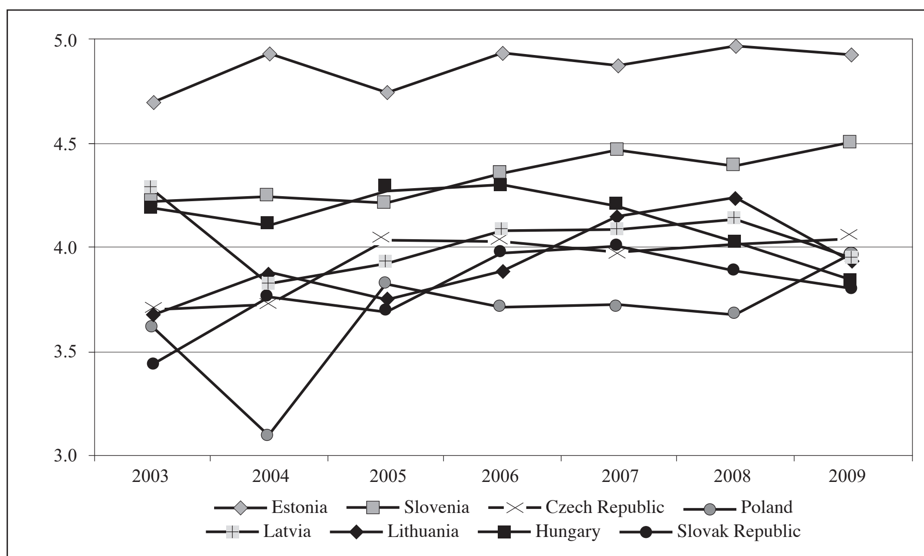
As shown previously, on average the new EU member states face a certain stalemate in the quality of institutions, without clear convergence towards the EU average (Figure 7).

Only Estonia and Slovenia keep in line with the successful old EU members, while other countries face some sort of "institutional quality worsening", most evident in the case of Hungary, and also in Slovakia and Latvia in recent years. According to Transparency International (2009) "Latvia has suffered from the government's bailout of a locally-owned bank at the end of 2008, which eventually contributed to the collapse of the Latvian economy".

Hungary is somewhat different from the other countries, with a worsening of position starting from 2006 and for Hungary, the Heritage Foundation (2009, p. 209) stated that "The rule of law is strong, and corruption is perceived as moderate. Challenges include

the need for fiscal consolidation and better management of public finance." However, the WEF indicators record worsened perception of corruption, problems connected with property rights and the burden of regulation.

Figure 7: Institutions quality index 2003-2009: new members



Source: Authors' calculations based on WEF data 2003-2009.

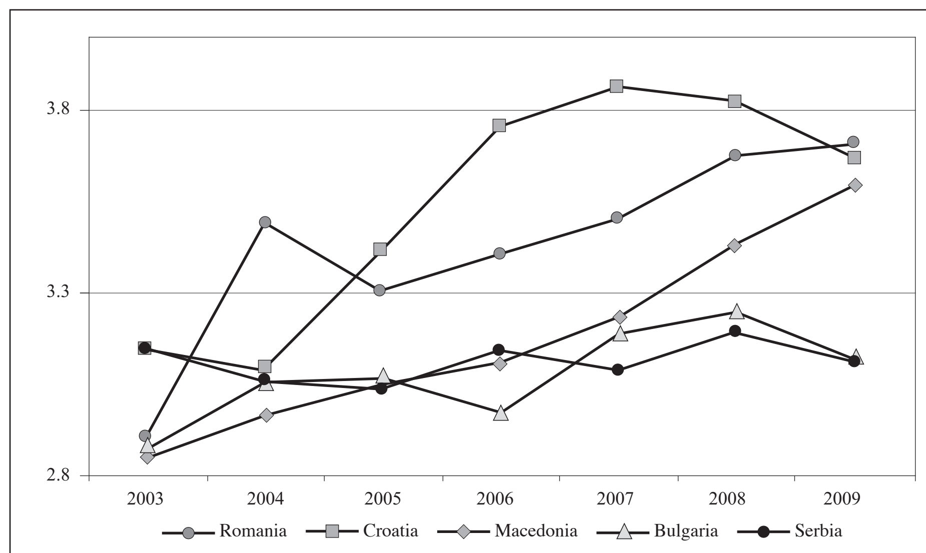
Turbulent developments are evident in Lithuania and Poland, while Poland surprisingly improved its position in the 2009, as compared to 2004. According to WEF (2009, p. 25), Poland "…has seen measurable improvements in the quality of its public institutions, with greater confidence in the efficiency and honesty of the country's public servants. EU membership and buoyant growth over past years have provided an incentive and the means for conducting reforms. This, along with prudent regulation of financial markets and the large size of the domestic market, has helped Poland to weather the effects of the current global downturn and become one of the most economically stable countries in the region".

The South East European countries show an upwards trend as they are, in different phases of institutional reforms, under strong pressure of Europeanization (Figure 8).

While Croatia lost momentum in the last 2 years, which might be partly explained by the Slovenian blockade of negotiations in the last year, the upwards trend is evident in the case of Romania and Macedonia. For Macedonia, the improvement may be linked to the reforms within the framework of the EU accession. As stated in the Progress Report for Macedonia (Commission of the European Communities, p. 28), "The legal system for a functioning market economy is largely in place. The financial independence and administrative capacity of regulatory bodies were strengthened. Clarification of property rights

has further advanced. (…) Corruption has been addressed by policy measures, but remains prevalent in many areas."

Figure 8: Institutions quality index 2003-2009: SEECs



Source: Authors' calculations based on WEF data 2003-2009.

Surprisingly, Bulgaria, which recently became a EU member, according to selected indicators, performs at a same low level as Serbia, which is only in the very early phase of institutional adjustment to cope with the *acquis*. In Bulgaria "Reforms were introduced in the customs and border police with the aim of freeing an additional 600 million euro in blocked EU funds. However, reforms to curb political corruption and address organised crime have yet to be introduced" (Transparency International, 2009).

7 Analysis at the level of indicators

In further analysis we attempt to identify in more detail what led to the convergence/divergence trend in the quality of institutions within the period under review, using the methodology we employed. In order to do that, we have presented average values for each of 12 survey indicators creating three pillars, averaged for the 3 country groups under review (EU-14, EU-8 and SEECs).

In that way we are able to analyse dynamics of change at the level of indicators and determine what contributed the most to the above presented trends of institutional quality in the recent years.

7.1 Enforcement of rule of law

Enforcement of the rule of law was measured with survey indicators of judicial independence, protection of property and intellectual property, as well as the indicator of the reliability of police protection (Table 2). The main aim was to assess the general legal framework and quality of operative judicial (and police) protection of rights, as felt by the business sector.

Table 2: Protection of rule of law

		Judicial independence	Property rights protection	Intellectual property protection	Reliability of police services
EU-14	2003	5.4	5.8	5.4	5.5
	2004	5.6	5.9	5.5	5.5
	2005	5.3	5.9	5.4	5.5
	2006	5.5	6.1	5.6	5.7
	2007	5.6	6.1	5.6	5.7
	2008	5.6	6.0	5.5	5.8
	2009	5.5	5.8	5.3	5.7
EU-8	2003	4.2	4.6	4.0	3.8
	2004	4.0	4.7	3.8	3.9
	2005	3.8	4.8	3.8	4.1
	2006	4.0	4.9	4.0	4.3
	2007	4.1	5.0	4.0	4.3
	2008	4.1	5.0	4.0	4.3
	2009	4.1	4.7	4.0	4.3
SEE	2003	2.6	3.0	2.6	3.5
	2004	2.6	3.4	2.8	3.4
	2005	2.6	3.6	2.7	3.5
	2006	2.7	3.8	2.9	3.5
	2007	2.9	3.9	3.0	3.9
	2008	3.0	4.0	3.1	4.1
	2009	3.0	3.8	3.1	3.9

Source: Authors' calculations based on WEF data 2003-2009.

In the old EU members, a strong deterioration of property rights' protection was evident even before crisis, i.e. from 2007, while the other 2 indicators fell in 2009. In contrast to the EU-14, the selected new EU members show upward developments but are still far behind the average EU-14 institutional quality line. However, as a result of the financial and economic crisis, the perception of property rights protection has deteriorated in the EU-8 too. In the SEE countries, significant improvement is evident, but judicial independence is still very much lagging behind the EU members average. In 2009 there was a notable worsening of quality of police services and protection of property rights.

The presented findings may be also backed up by selected hard data from the World Bank *Doing Business* database that may serve to illustrate the quality of property protection and efficiency of legal framework (Table 3).

Table 3: Selected World Bank Indicators for protection of rule of law

		Time to enforce contracts (days)	Cost to enforce contracts (% of claim)	Bankruptcy recovery rate (cents on the dollar)	Time to finish bankruptcy procedure (years)
SEECs	2003	647.4	24.8	21.3	3.5
	2009	528.4	25.7	27.5	3.1
EU-8	2003	626.3	20.4	33.5	3.6
	2009	587.5	21.7	37.1	3.1
EU-14	2003	538.2	19.8	70.9	1.4
	2009	529.2	20.0	71.5	1.3

Source: Data base of Doing Business 2003-2009, available at: [*www.doingbusiness.org*].

The SEECs have advanced considerably in the last 6 years. The time to enforce contracts in these countries converged to the EU-14 level, which is even better than for the 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.

7.2 Regulatory framework institutions

Regulatory quality indicators have become an important practice in the EU when measuring the success of the Lisbon Strategy in achieving its goals in member states. In 2004 the European Commission adopted an integrated regulatory impact assessment to measure various costs and benefits associated with the legislative and regulatory changes as well as a cumulative impact of quality of regulatory environment on the economic performance and competitiveness of member states (European Council, 2004). Traditionally, for many years these were the assessment tools of OECD and World Bank[8] which measured it by composite indicators in yearly surveys for Worldwide Governance Indicators with an attempt to link regulatory reforms and modes of public governance with performance indicators of the examined countries. Reducing the regulatory burden as a constraining factor of country competitiveness is also one of the avenues to go down (regulatory guillotine) in line with the goal of decreasing the administrative burden for business set by the revised Lisbon Strategy.

The regulatory framework pillar shows that old members generally have witnessed stagnation until 2007, with a strong fall in the last 2 years (Table 4).

This could reflect the strong impact of the financial crisis on the perception of selected indicators of regulatory quality by the surveyed managers, while the indicators with the strongest decline were Regulation of Security exchanges.

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[8] See Worldwide Governance Indicators, World Bank [http://info.worldbank.org/governance/wgi/sc_country.asp].

Table 4: Regulatory framework institutions

		Effectiveness of antitrust policy	Regulation of security exchanges	Strength of auditing and accounting standards	Burden of government regulation
EU-14	2003	5.3	5.8	5.9	3.0
	2004	5.3	5.8	5.7	3.2
	2005	5.4	5.7	5.8	3.2
	2006	5.5	5.8	5.9	3.2
	2007	5.4	5.6	5.9	3.2
	2008	5.3	5.6	5.8	3.1
	2009	5.1	5.1	5.5	3.1
EU-8	2003	4.2	4.9	5.0	3.0
	2004	4.1	4.7	4.8	2.9
	2005	4.4	4.8	5.1	3.0
	2006	4.4	4.7	5.0	3.1
	2007	4.4	5.0	5.0	3.1
	2008	4.3	4.9	5.1	3.0
	2009	4.3	4.6	5.2	3.1
SEE	2003	3.1	3.9	4.1	2.3
	2004	3.0	3.9	4.1	2.6
	2005	3.1	4.3	4.3	2.6
	2006	3.2	4.1	4.2	2.7
	2007	3.3	4.0	4.3	2.8
	2008	3.3	4.0	4.3	2.8
	2009	3.4	3.9	4.4	2.8

Source: Authors' calculations based on WEF data 2003-2009.

On the other hand, new EU members again show an upwards trend, driven by the improved perception of the *Strength of auditing and accounting standards,* with only deterioration in *Regulation of security exchanges*, brought about by the enormous losses in stock exchange in these countries in the last 2 years.

Developments in the SEE were very similar, with continuous improvement in the effectiveness of antitrust policy. It is interesting to note that there is virtually no difference in the perceived burden of government regulation in all 3 country groups, while the other 3 indicators are very different, with less developed countries lagging behind and rather slowly catching up.

The presented findings may be tested by the selected hard data, from the World Bank *Doing Business* database, chosen to illustrate the burden of regulation (Table 5).

The time to start a business is now similar in all 3 groups of countries. The SEECs have significantly advanced in registering property from 253 days in 2005 to 67 in 2009, which is a better figure than that for the new EU members. However, getting construction permits in the SEECs has become more difficult. The old EU members are still far ahead of the other 2 groups of countries, especially in time for registering property and time for paying taxes.

Table 5: Selected World Bank Indicators for regulatory framework

		Starting a business (days)	Dealing with construction permits (days)	Registering property (days)	Time for paying taxes (hours per year)
SEECs	2005	29	233	253	283
	2009	13	245	67	274
EU-8	2005	34	218	114	355
	2009	15	202	96	298
EU-14	2005	23	174	49	198
	2009	15	163	32	186

Source: World Bank, Doing Business, 2005-2009.

7.3 Anti-corruption institutions

It is interesting to note from that there is no clear trend of improvement in the (perceived) quality of anti-corruption institutional scores for either old or new EU members (Table 6).

Table 6: Anti-corruption institutions

		Business costs of corruption	Favouritism in decisions of government officials	Public trust of politicians	Business costs of organized crime
EU-14	2003	5.3	4.3	3.8	5.8
	2004	5.9	4.3	3.9	5.8
	2005	5.8	4.2	3.9	5.8
	2006	6.0	4.2	3.9	5.8
	2007	5.9	4.4	4.1	6.0
	2008	5.8	4.6	4.2	6.0
	2009	5.6	4.3	4.0	5.9
EU-8	2003	3.9	3.2	2.5	4.5
	2004	4.6	3.1	2.2	4.6
	2005	4.6	3.0	2.3	4.9
	2006	5.0	3.1	2.4	5.0
	2007	4.6	2.9	2.5	5.3
	2008	4.5	2.8	2.4	5.7
	2009	4.2	2.8	2.3	5.8
SEE	2003	2.7	2.6	2.0	3.4
	2004	3.7	2.6	1.9	3.6
	2005	3.5	2.5	1.9	3.6
	2006	3.9	2.5	1.9	3.8
	2007	3.7	2.6	2.0	4.1
	2008	3.7	2.6	2.1	4.5
	2009	3.5	2.6	2.2	4.7

Source: Authors' calculations based on WEF data 2003-2009.

On the other hand, SEE countries improved significantly; however, they retained a rather low comparative score level. For the old EU members, the fall started in 2007 is evident for the business costs of corruption, while corruption of politicians and government officials lost momentum in 2009, falling notably. However, there is no emergence of mafia (organized crime) activities, and this indicator stood rather well throughout the years under review.

New members have also improved in combating organized crime, however corruption is "alive and kicking", from 2007 onwards. Public trust in the financial honesty of politicians and public servants is very low and further falling, which is rather a surprise for the countries that have been full EU members for 5 years.

Table 7: Corruption perception index

Country	2004	2009	Difference
EU-14	7.64	7.28	-0.36
Denmark	9.5	9.3	-0.20
Sweden	9.2	9.2	0.00
Finland	9.7	8.9	-0.80
Netherlands	8.7	8.9	0.20
Germany	8.2	8.0	-0.20
Ireland	7.5	8.0	0.50
Austria	8.4	7.9	-0.50
United Kingdom	8.6	7.7	-0.90
Belgium	7.5	7.1	-0.40
France	7.1	6.9	-0.20
Spain	7.1	6.1	-1.00
Portugal	6.3	5.8	-0.50
Italy	4.8	4.3	-0.50
Greece	4.3	3.8	-0.50
EU-8	4.64	5.26	0.62
Estonia	6.0	6.6	0.60
Slovenia	6.0	6.6	0.60
Hungary	4.8	5.1	0.30
Poland	3.5	5.0	1.50
Czech Republic	4.2	4.9	0.70
Lithuania	4.6	4.9	0.30
Latvia	4.0	4.5	0.50
Slovakia	4.0	4.5	0.50
SEECs	3.18	3.80	0.62
Croatia	3.5	4.1	0.60
Bulgaria	4.1	3.8	-0.30
FYR Macedonia	2.7	3.8	1.10
Romania	2.9	3.8	0.90
Serbia	2.7	3.5	0.80

Source: Transparency International, CPI Annual Reports, 2004 and 2009.

In the SEE countries, trends in the business costs of the mafia and corruption were almost identical to those in the new EU members. However, the level of these indicators is still significantly lower. Contrary to the EU members, financial honesty of politicians is (surprisingly) improving, although still at a low level. Nevertheless, the most notable change is a very strong deterioration in the business costs of corruption.

To test the presented findings by the selected other source, we relied on the most common data of the Transparency International (Table 7).

The table best supports and summarizes the general findings of this paper. On average, the old EU members still stand well ahead of new members, with SEECs further lagging behind. However, the EU-14 on average declined in terms of the value of Corruption Perception Index, with a fall in a number of countries. In 2009 two old EU countries (Italy and Greece) had an index value lower than the average of the new members. On the other hand, new members all improved their stance regarding corruption perception, with the most notable improvement in Poland. However, Estonia and Slovenia stand alone and rather high, close to the EU-14 average. Similarly to our findings based on WEF indicators, Bulgaria worsened its position, in spite of becoming a EU member, while other SEECs improved significantly. However, all the Western Balkans (SEECs) countries are still worse than Slovakia, which is the country with the highest perceived corruption among the EU-8. It comes as surprise that Greece, although a EU member for a number of years, has the value of indicator identical as for the SEECs average, while scores for Italy are also not much better.

8 Concluding remarks and areas for further research

The paper was motivated by the growing interest in the empirical efforts put into measuring quality of institutions and governance in the last 15 years. The analyses attempted to demonstrate the significant differences among the selected EU and non-EU countries in the institutional quality we assessed by indicative "institutional quality index" based on 12 various indicators from WEF Executive Survey for Global Competitiveness Index Report, 2003-2009.

While aware of the limitations and benefits of the employed methodological exercise, which has some in-built deficiencies[9], the presented cross-country comparison may more vividly portray the components of the mosaic and will be helpful in explaining the reasons for the convergence and divergence trends in the quality of the institutions that affect the economic performance of these countries and perception by investors.

The general trends identified in our analyses were similar to those identified by World Bank Governance Indicators and Transparency International. Interesting differences in terms of change of institutional quality were determined among the clusters of countries examined.

It is important to note that the difference between the new and old EU members remained rather high and in the last 4 years the new EU members have not improved the (perceived) quality of institutions. Additionally, no real convergence trend in the new EU members could be detected from the presented data.

[9] See Kaufman et al. (2007), Arndt and Oman (2006), Williams and Siddique (2008), Knack (2006), etc.

For the third group of countries (Bulgaria, Romania, Croatia, Macedonia and Serbia) the analyses indicated rather strong progress in the quality of institutions, which goes in line with complying with the formal convergence criteria as reported by the European Commission, and also as measured by the other cited literature. However, looking into more detailed indicators we have shown that they still have much to reform, especially in several examined fields of institutional quality. Directed efforts are needed especially when it comes to improving the independence of the judiciary; enforcement of business contracts as well as in fight against corruption and organized crime especially in Western Balkan countries.

More detailed examination of specific indicators of institutional quality shows that nominal convergence and transposition of EU norms des not necessarily guarantee their enforcement. The gap between the adopted and enforced norms is still rather high while effectiveness of government in delivering good governance and institutional quality is still low. As many other similar reports and studies have demonstrated[10], converging institutional environment in terms of quality requirements especially in the new EU members and candidate countries is still very much "work in progress". This is true even of some old EU members.

As an avenue for further research it might be interesting to explore how much the 2004 enlargement round affected the deterioration of the quality of institutions in old EU members due to a negative spill-over effect and the coexistence of some lower standards in institutions, for instance in fighting corruption or anti-trust regulations in the new EU members. In addition, is the level of average EU institutional quality, and capacity for that matter, decreasing or increasing and how may this affect the global competitiveness of the EU?

At the end it is important to mention some research questions that will continue to occupy researchers as the answers still remain inconclusive. Some of them are: Are institutional convergence and the synchronisation of institutions that are driven by the deepening of the EU integration process necessarily a good development? Would EU nations/markets continue to differ and compete with regard their quality and capacity of institutions to trigger economic growth? What would be the impact of their endogenous institutions as a mirror of their imbedded culture, history, creativity and different behaviour patterns in finding multiple solutions to the equation of sustained development and competitiveness? One thing is certain: there is plenty to research into in the future.

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[10] World Governance Indicators (2008); Doing Business (2008); Transparency International Index (2008).

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