PUBLIC POLICY, QUALITY OF INTITUTION AND ECONOMIC GROWTH IN CENTRAL AND EASTERN EUROPEAN COUNTRIES

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Abstract
This paper analyzes the relationship between economic performance and institutional development in several Central and Eastern European Countries. Our meta-argument is that the structural transformations at the levels of the quantitative variables and mechanisms are only a part of the transition processes. In order to view the big picture, the qualitative aspects related to public policies and institutions should also be considered.

We test the linkages between the quality of public policies and institutions for seven Central and Eastern European countries (Bulgaria, Poland, Czech Republic, Hungary, Slovenia, Slovakia and Romania) for a time span between 2001 and 2011. These countries are displaying a certain degree of heterogeneity in terms of economic performances and the design and implementation of public policies.

We use for our analysis the World Bank indicators from World Wide Governance Indicators.

In order to deal with the potential reverse causality issues, we employ Generalized Method of Moments Framework (GMM) by using the lagged variables as instruments. The impact of governance indicators is statistically significant even if we use several control variables: exchange rate, unemployment, current account deficit, taxes burden and price stability. The corresponding Sargan and Arellano-Bond test for zero autocorrelation in first-differenced errors tests shows that the results display a corresponding robustness. The main policy implications for our findings may be synthesized by the thesis, according to which a proper design of public policies, a high degree of their effectiveness and accountability, a stable social and political environment together with the rule of law and efficient anticorruption mechanisms are critical determinants of economic growth even in emerging markets. The impact of the government “size, economic structure and markets” mechanisms, monetary policy and price stability, ownership structure and legal rights, international exchange, freedom of exchange in capital and financial markets on economic growth is far from being negligible. Hence, the Central and Eastern European countries joining the EU should implement policies strength their institutions and to improve the quality of public decisions.

Keywords: Generalized Method of Moments, Central and Eastern European Countries, quality of public policy of institution.

1.Introduction

The Central and East European countries, during the process of enlargement of the European Union, had to face institutional transition, in order to ensure the premises of an economic growth meant to fix the discrepancies between them and the West European countries. Thus, a series of public policies have been settled in agreement with the monetary and institutional policies imposed by the European Union. In the present paper we analyse the relationship between the quality of policies and public institutions and the economic growth in seven Central and East European Countries (Bulgaria, Poland, Czech Republic, Hungary, Slovenia, Slovakia and Romania) for the period 2001-2011. There is quite a limited number of articles on this specific subject. Therefore, the present paper intends to fulfil this gap and to contribute to the already existing literature, among which Andrews, M., 2008. “The Good Governance Agenda: Beyond Indicators without Theory Oxford Development Studies” and Barro, R. J., 1997, “Determinants of economic growth: a cross-country empirical study”.
Firstly we construct a synthetic indicator for the quality of public governance. We integrate such indicator in a growth model in order to highlight the potential impact of public policies and institutions for growth. We control for exchange stocks (see exchange rates) or change in the fiscal policies (view public revenue). Secondly, we apply the model for a group of CEE countries for a time spent for the period 2001-2011. The structure of the paper is as follows. Section 2 presents the literature review and the empirical studies. In section 3 we present the approach and the methodological model of the specification. Section 4 presents the empirical results. The final section comprises conclusions.

2. Literature review and empirical studies

Several studies have reached the following conclusion: the governance quality and its indicators are positively associated with economic performance. Recent studies suggest there is a strong occasional relation between governance and economic results on the long run, on a transversal section of the countries (Barro, 1997; Hall & Jones, 1999; Kaufman & Kraay, 2002, E. Keefer, 1995, Mauro, 1995 and Acemoglu, et al, 2004.). Governance is often described in a larger sense, as the government’s efficiency, which on its turn is a multi-dimensional concept (Kaufmann et al. 1999, 2002, Kaufmann et al. 2003). Kaufmann, Kraay 3 and Mastruzzi (2005) have supported proving the relationship between governance and the six dimensions (Voice and Accountability, Political Instability and Violence, Government Effectiveness, Regulatory Burden, Rule of Law, Control of Corruption) and economic growth on the country data provided by the World Bank.

The concept of governance has been used and extremely disseminated by the World Bank at the end of the 1980’s. The concept has been developed further on by the community of researchers, consultants and managers of international institutions. However, governance is still a vague concept and it moves "Catch-all" (Banegas and Meyer , 2002) . M.C. Smouts offers the following definition (1998, p. 89):
- Governance is not a system of rules or activities, but a process;
- Governance is not based on domination, but on accomodation;
- Governance involves both private and public factors;
- Governance is not formal and is based on continuous interactions.

At the present moment there is no unanimity in respect to the definition of governance. Some approaches define governance as a variety of mechanisms and sets of rules through which citizens and groups of citizens protect their rights and interests. However, and ample definition of the quality of governance is given by the World Bank, which sees it as the way in which power is being exercised in order to develop economic and social resources of a certain country. In other words, governance, through its six dimensions, may be defined as a catalyser of human development that leads to sustainability, economic growth on the long run and an efficiency of institutions and policies promoted by each country on its own.

The World Bank best defines the measurement indicators of quality / efficiency of governance; hence we may state that World Bank indicators are composition indicators in which all six dimensions of governance are to be found: Control of Corruption, Government Effectiveness, Political Stability and Absence of Violence/Terrorism, Regulatory Quality, Voice and Accountability, Rules of Law. These six indicators are composed ones, out of which other derived indicators are constructed.

In order to understand the policies developed in the Central and East European countries we need to present certain definitions of public policies, as found in the literature review. The concept of public policy has an entire series of definitions, starting from the simplest one – what governments choose to do or not to do (Dye, 1992, p. 4.) --, to the most instrumentalist one: a course of action with a precise purpose, followed by an actor or a group of actors in approaching a certain issue (Anderson, 1994, p. 5.). A generalist approach, starting from the French origin of the term (politiques publiques) we find in the following definition: A public policy is a network of decisions connected between them regarding the choice of the objectives, the means and the resources assigned in achieving the goals in specific situations” (Miroiu, 2001, p. 9).

2.1. Methodological approach and model specification

The empirical approach of the present paper will monitor the quality of public policies and institutions, defined by the governance indicator with the six dimensions, ie. Voice and Accountability, Political Instability and Violence, Government Effectiveness, Regulatory Burden, Rule of Law, Control of Corruption. However, the CEE member states are examined as a whole, and at the same time, divided into two periods of analysis 2001-2011 and 2008-2011.
The data used in the paper have been collected from the governance indicators of the World Bank. The World Bank uses governance indicators, a set of data developed by Kaufmann et al. (2005), which is in fact a set of international measures containing the six dimensions of governance for 105 countries. The governance variable present in this paper comprises the two components: the institutional one (cmc, va, ps) and the political one (ge, rq, rl).

The methodology used in estimating the results is Panel GMM systemic, estimators Arellano and Bond (1995), as well as Blundell and Bond the applicability of which is imposed in the following situations (Roodman, D., 2006):

- There is a time horizon (T) not very long and a data sampling quite large (N).
- There is a linear relation between the two variables.
- The independent variables included in the model do not fully fulfil the condition regarding exogeneity, meaning that they may be correlated with information from the past and it is extremely possible to be correlated with information from the present, in respect to the error term.
- The variables may include fixed individual effects.
- There is a possibility to exist heterogeneity between variables at the individual level between the same group, but not between groups, as well as autocorrelation.

In our data base we analyse seven countries Central and East European (N) on a period of 11 years (T), and the literature review offers many arguments indicating the fact that the model of dynamic panel is made especially to control fluctuations from the dynamic model for situations in which T is lower than N (Baltagi 2008, Bond 2002).

GMM is the most frequent used methodology in the literature of economic growth for control panel data heterogeneity. Generalized Method of Moments Framework allows researchers to solve issues related to series correlation, heterogeneity and endogeneity of certain explicative variables. In the present paper the advantages of using GMM compared to other systems is given by the high number of countries under analyzed and the short period of time. However, we intend to analyse the quality impact of public policies and institutions upon the economic growth in Central and East European countries. In the absence of a theoretic model to offer a clear explanation of these determinants, we will build the following regression that includes these elements:

\[ \text{GDPpc}=\alpha+\beta\text{gov}+\gamma\text{er}+\delta\text{tr}+\varepsilon \]

where:
- Economic growth is given by GDP per capita.
- GOV- is the governance indicator (VA, PS, GE, RQ, RL, CC).
- ER- exchange rates.
- TR- fiscal revenues.

The model’s specification takes into consideration an effect such as the “J-curve” curve and an effect as the Laffer curve. Thus, on the short-run, the ongoing trade operations have fixed contractual prices, the growth of the exchange rate will lead to a growth of the trade deficit and imports become more expensive.

On the long-run the growth of the exchange rate will lead to a compression of imports and stimulation of exports, thus reducing the trade deficit and resulting a positive impact on the economic growth. Hence we expect a “U-shape” effect induced towards the rate of exchange upon the output, effect preserved both on full simple level, as well as on the period of crisis.

The existence of this effect reflects the “J-curve” of depreciation of local currency upon the current account under the conditions of growth for the economies from the sample. In order to understand the “J-curve” effect, we will present its description, as presented in the literature review: the term expresses a relation between the exchange rate for the currency of a certain country and its commercial trade balance. Basically, the decrease of the exchange rate of a country, or the currency price, makes the currency less expensive to be “bought”. With a “cheaper” currency, the internal production price is lower and the imported products price is higher, making an increase in exports to other countries and a balance of imports from foreign producers. Thus the economy moves from commercial deficit to commercial surplus. However, in the first months after a drop in the exchange rate, the trade balance moves in another direction, with any trade deficit it goes up and with any commercial surplus it goes down. This happens because the imported and exported quantities do not change on the short-run, but prices do. As one pays more for the same quantity of imported products, and one gets less on the same quantity of exported goods, total expenses for imports will grow, total incomes from the exported goods will decrease, and the movement is towards trade deficit. Once these quantities are adjusted on the long-run, only then we will observe a movement in the direction of commercial surplus.

In respect to the fiscal pressing, we notice the “reverse U-shape” effect, which inhibits the economic growth, proving most probably a “Laffer” curve effect. Thus the “Laffer” curve shapes the dynamics of the state budget’s fiscal...
incomes, according to the medium fiscal pressing in the economy. Hence we notice that the higher the fiscal pressure, the lower the profitability in net terms on the level of economic agents. It also decreases their possibility to invest. There is also a “Laffer” curve effect on public incomes collected after reaching the peak, public incomes drop, resulting the state’s possibility to raise budget deficit, moving towards an inhibiting effect on fiscal pressure.

In this non-linear model, the dependent variable is the economic activity represented by the growth of the GDP. It is used to measure the influence of governemental activities upon economic growth and development. On the other hand, there are six independent explicable variables which describe the governance dimensions. VA refers to the fact that citizens take part at the selection and monitoring of their government. PS surprises is the government is vulnerable to change through violent or non-constitutional means. GE variable represents the capacity of public workers, the quality of public services, as well as the credibility of the government’s involvment to apply the policies assumed. RQ focuses on weather the promoted polici are “market-friendly” in business and trade. RL includes putting into practice of the rights of property, norms predictability that rule the social and economic interactions. The last dimension of the governance variable, CC, refers to the fact that there are proves about “Ultima componenta a variabilei de guvernare, CC se referă la faptul dacă există dovezi de “exercise of public power for private gain” in the business environment and in the larger public life. Moreover, the model includes a constant and a variable that represent the financial crisis started in 2008. In the case in which the crisis’ influence advances during the time analysed, it takes the value 1, otherwise, 0. In our model we also control two main determinants of growth: exchange rate and tax revenue.

The role of the exchange rate in the process of economic growth in the Central and East European countries is given by its flexible behaviour, resulting a tight correlation between the real exchange rates and the nominal ones. The effects of tax revenues upon the economic growth in the CEE countries are seen from a double perspective: in certain countries it has been expresses the possibility to increase taxes in order to regulate budget deficit, and in other cases it has been enlarged the tax base and reduced the rates through fiscal reform.

3. Empirical results and comments

In the present study the time period under analyzed for the Central and East European countries is 2001-2011. In order to show how the financial crisis has affected the governance quality of public institutions and to see if it has significantly influenced the economic growth, we have developed a CEE analysis for the time 2008-2011. The first sample has 74 observations and the second sample 28 observations. The validity period of the instruments is tested with the help of the Sargan test to over-identify restrictions and series of correlations. The dynamic data panel are valid is the estimator is consistent. As seen in Table 1, the equation presents consistent estimations, with no correlation series for the GMM estimator. The Sargan test proves that there are no problems related to validity out of the instruments used in the present equation. The results are reported in Table 1:

<table>
<thead>
<tr>
<th>Variable</th>
<th>2001-2011</th>
<th>2008-2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>0.069*** (0.016)</td>
<td>0.031 (0.034)</td>
</tr>
<tr>
<td>Exchange rate</td>
<td>3.572*** (0.283)</td>
<td>1.196*** (0.448)</td>
</tr>
<tr>
<td>Exchange rate 2</td>
<td>-3.154*** (0.270)</td>
<td>-1.725*** (0.455)</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>0.378*** (0.104)</td>
<td>0.432*** (0.137)</td>
</tr>
<tr>
<td>Tax revenue 2</td>
<td>-0.497*** (0.115)</td>
<td>-0.409** (0.180)</td>
</tr>
</tbody>
</table>

Panel observation: 7(2001-2011); 7(2008-2011)
Number of observation: 74(2001-2011); 28(2008-2011)
Wald chi2 410.82(2001-2011); 71.12 (2008-2011)
Prob> chi2 0.000 (2001-2011); 0.000(2008-2011)
The synthetic indicator of public governance quality exercises a positive and significant statistic impact of 1% upon the economic growth for the time analysed. However this impact dissipates for the sub-period 2008-2011, showing perturbations inducted by the crisis upon economic dynamics.

Other results connected to financial development and economic growth:
- GOV has a positive impact for the GDPpc variable, translated into economic growth in the Central and East European countries;
- exchange rate and tax revenue influences in the same measure the economic growth of these countries;
- in the second period marked by the burst of the economic crises, the governance variable with its six dimensions keeps a positive but insignificant impact upon economic growth.

In order to understand the highlighted situation in the second period in which the Central and East European countries are, we have chosen to make an individual presentation of the way in which economic crises has evolved.

Slovenia and Slovakia share a common destiny: that of having obtained their independence through the dissolution of two political entities, large multi-national states, Yougoslavia and Czechoslovakia, in the early 90’s. The transition was a rough one, especially in the case of Slovakia. The integration process was a long one and it led to becoming members of the EU on 1 Mai 2004, in the same time with Slovenia. The people from these two countries have been some of the most eager ones to be part of the European Union: approx. 90% of the Referendum votes have been pro EU. The two countries have twin deficits, but reasonable ones. Slovenia’s, is one with the macro-characteristics of other member states; in 2006 productivity was of 84.7% of the EU average, and 75.8% in prices. The unemployment rate dropped and inflation is controlled. The integration and convergence process of Slovenia allowed it to perfectly integrate in the EU in Mai 2004 and in the Euro zone on 1 January 2007. Slovenia has built an economy which is not fully dependent on exports or foreign capital. Slovakia suffered because of the delay in the process of integration and convergence. Their macro-economic characteristics prove that these two countries represent important economies in the Central and East European zone, but still under the European average. The unemployment level and poverty are still high. However, Slovakia relies quite a lot on exports and once the crises installed, it will affect the economic process in the long-run. Slovenia and Slovakia face a crisis the characteristics of which are very much similar to those of the western countries, and less alike their Eastern neighbours.

Romania and Hungary represent the economies mostly affected by the crisis. Their public and current account deficits, their economic slips from the transition periods, all have been worsened by the depreciation of their currencies. The two countries are very much susceptible to enter payment default. Hungary is one of the very first countries to allow foreign investments in their capital, their political stability and quality of labour force have attracted foreign investors, but their opening and free trade happened too fast and the IMF had to interfere in order to avoid payment issues. Hungary relies very much on its trade with the Western countries, especially with Germany and Austria, and its current account deficit continued to get worse. In 2006 Hungary promised to improve its public deficit, which represents the basis for the weakening of Hungary’s economy. Romania passed through a very long and chaotic transition in order to get to have a market economy, balancing between periods of economic boom and recession, marked by social movements. It came back to a stable economic growth in 2001, but inflation is still high. The low productivity of work and late opening of the economy have attracted quite late the foreign investors, which are still at a low level. Romania maintains a high deficit in current account, financed from the trade deficit in foreign currency. The depreciation of the Romanian and Hungarian national currencies in June 2008 (+25 % vs. Euro) increases their debt. In 2008 Hungary’s foreign debt was of 103% of the GDP, and in Romania of 52% of the GDP. Still, a quarter of Hungary’s foreign debt is on the short-run, hence it is difficult to pay a debt in foreign currency, as it continues to grow. The consequence of the appreciation of Euro in respect to the multitude of debt may lead to a crisis in the balance of payments.

Poland and the Czech Republic represent for the moment the countries less affected by the crisis in the Central and Eastern Europe. Their economic growth remained positive in 2009. This resistance may be explained partially through their trade deficits and current account deficits lower than those of their neighbours. But the
Depreciation of the Polish currency and the deadlock of the Czech exports may penalise these countries. In 1992 Poland, and in 1996 the Czech Republic have been the first economies to come out of the recession by applying the shock therapy. In respect to the privatization, the Government opened the national capital. Since 1997, these countries started to be more open to foreign investments, especially the Czech Republic, which entered the European economic circuit and became lately one of the countries from Central and Eastern Europe with the largest exports. Poland, which in the beginning was one of the countries with the heaviest debts, managed to control its public debt and stay financially independent abroad. The proximity to Germany and Austria allowed the country to easier and deeper integrate in the European economy. The number of direct foreign investments is incredibly large in these two countries, without making their external debt increase, which proves the fact that they took advantage on the foreign investments, without becoming financially dependent. The Czech Republic and Poland may face similar problems to the ones in the western countries, as other Central and East European countries, especially the decline in trade may cause problems to an exporting country such as the Czech Republic, although the depreciation of its national currency may counteract this effect.

4. Conclusion

Through this paper it has been established a positive connection between economic growth and the quality of public institutions, hence the Central and East European countries should implement the rule of law, should create efficient control mechanisms against corruption, i.e. the adoption of a European legislation is useful in order to support these mechanisms, but not enough as it should be taken into consideration the implementation effort; the efficiency of the governance means that the design of public policies should be in a certain accordance with the policies promoted by the European Union.

In this paper, it is aimed to investigate the empirical relationship between dimensions of governance and the economic growth. For this purpose, mentioned six components are employed to measure this economic influence. In conclusion, the quality of policies and institutions from the Central and East European countries is significant for the explanation of the differences in rates of development between the 7 countries that represent the object of our study. The study has however some limitations. The economic growth has been influenced in some countries such as the case of Romania and Bulgaria, by the fact that they have become members of the European Union quite late, i.e. in 2007.

REFERENCES:


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