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# Filling the institutional vacuum in Eastern Europe

Thorvaldur Gylfason, Inmaculada Martínez-Zarzoso and Per Magnus Wijkman



### Biographical note

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Joint publications by the three authors include "Can free trade help convert the Arab Spring into permanent peace and democracy?", *Defense and Peace Economics*, 2015, Volume, 26, Issue 3, pp. 247-270; "Free Trade Agreements, Institutions and the Exports of Eastern Partnership Countries", *Journal of Common Market Studies*, forthcoming, and "A way out of the Ukrainian quagmire", *VOXEU*, 14 June, 2014 and by Thorvaldur Gylfason and Per Magnus Wijkman, "Which conflicts can the European neighborhood policy help resolve?" in *Globalization: Strategies and Effects* Springer, 2015 edited by Carsten Kowalczyk and Bent Jesper Christensen plus a number of articles in *VoxEU*.

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The Eastern Partnership (EaP) Summit in Riga in May 2015 provides an opportunity to survey the need to remedy serious deficiencies in partner countries' progress toward the basic institutions necessary for deep and comprehensive free trade agreements. These deficiencies contributed importantly to the failure at Vilnius in November 2013. While Georgia and Moldova initialed Association Agreements with the EU at the Summit, Armenia and Ukraine chose not to. An important reason for these different choices was that Georgia and Moldova had progressed further in creating the institutional framework for a democratic-based market economy. We have shown (Gylfason *et al.* 2015) that trade agreements with the EU offer the partner countries significantly greater economic benefits than corresponding trade agreements with Russia. In particular, our paper evaluates and compares the effects of free trade agreements (FTAs) signed by EaP countries with the EU and with Russia and the role played by the quality of institutions (specifically, democracy and corruption) in fostering trade. Our results suggest that the EaP countries, with Ukraine by far the largest in the group, gain significantly from FTAs with the EU, but gain little if anything from FTAs with Russia. A DCFTA with the EU will increase export shares by 78 percent, whereas a DCFTA with Russia will not result in any significant increase in export shares for the EaP countries considered.

In order to qualify for and fully benefit from trade agreements with the European Union, the EaP countries must have institutions that foster a democratic political system and a well-functioning market economy. This article identifies some of the most striking institutional deficiencies in the partner countries, thereby suggesting where they should focus their efforts in order to qualify for deep and comprehensive free trade agreements with the EU.

## The institutional vacuum

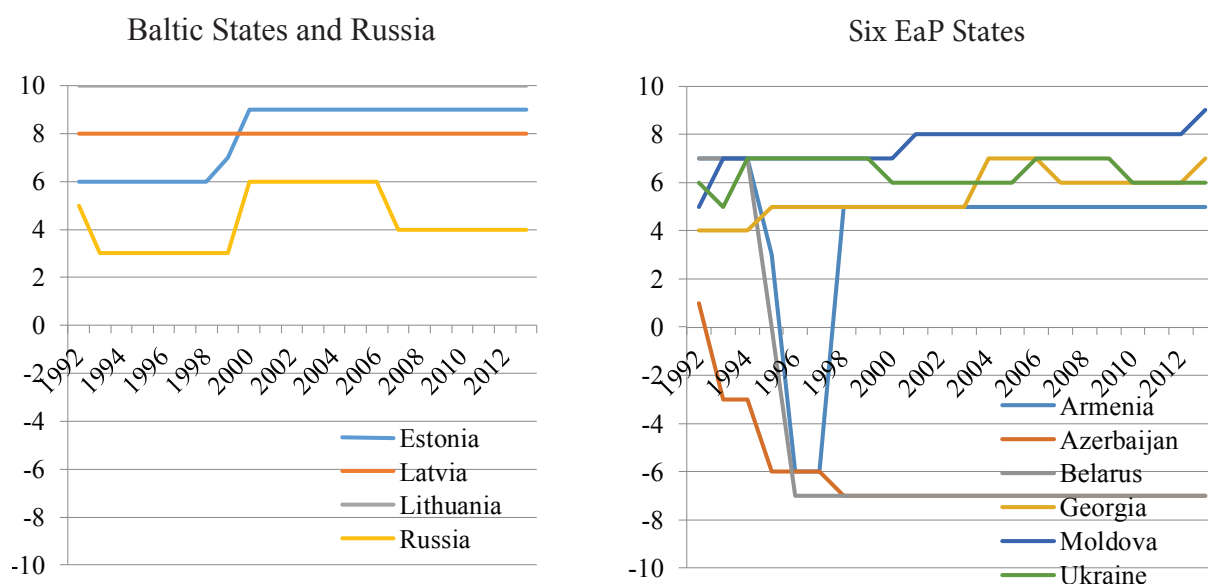
Campos and Coricelli (2002) noted that “an institutional vacuum” characterized most EaP countries for some 15 years after the collapse of the Iron Curtain in 1991.<sup>1</sup> As Soviet Republics they had been subject to central planning and state ownership of the means of production for 70 years.<sup>2</sup> After the dissolution of the Soviet Union, the three Baltic States made the transition to functioning democracy and market economy significantly faster than the six EaP countries. The three joined EU and NATO already in 2004 while only two of the six EaP States had by then started to establish democracy: Georgia with the Rose Revolution in November 2003 and Ukraine with the Orange Revolution in December 2004.

While late starters, all six EaP countries were, furthermore, slow in developing their institutional frameworks for democracy and market economy. This resulted in significant difficulties in negotiating and implementing deep and comprehensive free trade agreements. We illustrate this late start and slow speed by comparing some relevant key statistics for each of the six EaP States with those of the three Baltic States and Russia.

## Democracy and free press

A common measure of democracy is the Polity IV Project’s Polity2 variable. It reflects the characteristics of democratic and autocratic authority in governing institutions rather than discrete and mutually exclusive forms of governance, spanning a spectrum from fully institutionalized autocracies through mixed authority regimes to fully institutionalized democracies. The spectrum is a 21-point scale ranging from minus ten (hereditary monarchy) to plus ten (consolidated democracy).<sup>3</sup>

Diagram 1. Democracy 1991-2013



Source: Polity IV project, Center for Systemic Peace website.

Note: Democratic larger than or equal to plus six. Autocratic smaller than or equal to minus six.

1 The six EaP States are Belarus, Ukraine, Moldova, Georgia, Armenia and Azerbaijan.

2 The USSR incorporated the three Baltic States and Moldova after the Molotov-Ribbentrop Pact in 1939. They differ from the other former Soviet Republics by geographic proximity to and shared history with the ‘old EU’ countries, collective memories of national institutions and the return of key emigrés upon independence. See Shleifer and Treisman (2014).

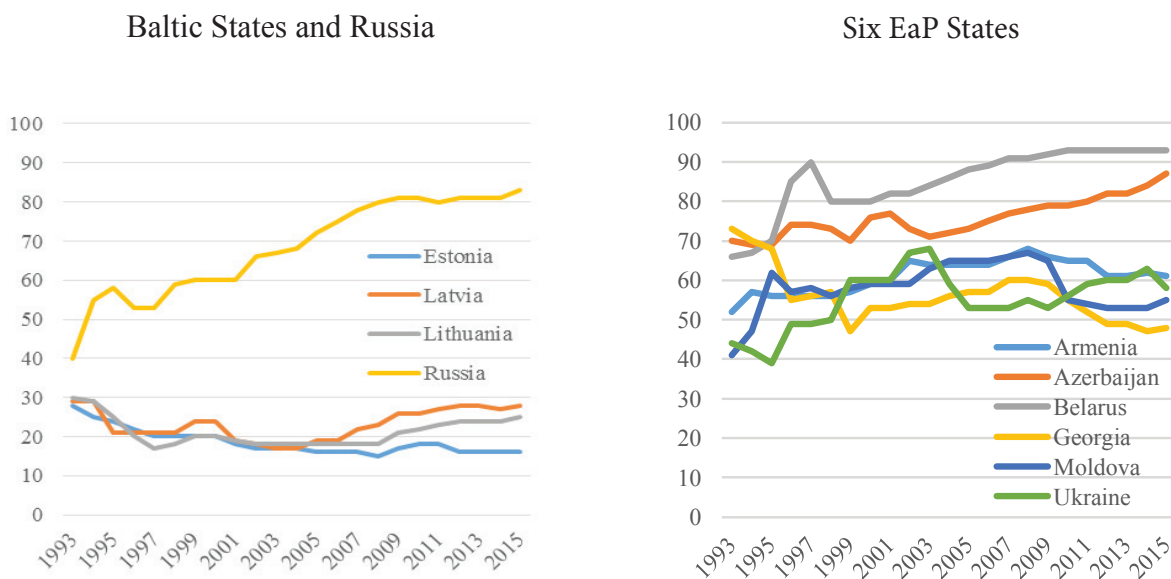
3 Countries are classified as democratic if their Polity2 score is larger than or equal to plus six, as neither democratic nor autocratic if the score lies from plus five to minus five, and as autocratic if their score is smaller than or equal to minus six.

Of the nine former Soviet republics the three Baltic States and Moldova have consistently high and stable scores of six or more throughout the period 1991-2013 as does Georgia since 2004 (Diagram 1). Ukraine vacillates between five and seven, dropping to six in 2010, the year Yanukovich was elected President. For comparison, Russia scores six from 2000 to 2006 and four since then. Armenia is stable at five and, like Russia, is classified as neither democratic nor autocratic. Azerbaijan and Belarus score minus seven from the late 1990s onward and are classified as autocratic. The high ranking of Georgia and Moldova contributed importantly to their governments' ability to initial the Association Agreements in Vilnius.

Our findings suggest that a one-point increase in the Polity2 score will increase exports by about twelve percent indicating that democratic reforms can play an important role in fostering trade in EaP countries (Gylfason *et al.* 2015). As an illustrative example, Russia scores four in the Polity2 data, so improving the score to six will increase trade by 24 percent. Belarus and Azerbaijan score minus seven, so for these two countries the potential for improvement is huge and hence also the possibility to benefit from trade.

Democracy is closely correlated with freedom of the press: you can't have one without the other. In Freedom House's rankings the nine former Soviet Republics and Russia form three distinct groups (Diagram 2). The press is not free in Belarus, Russia, Azerbaijan and Armenia (rankings above 60 denote not free press). Further, the rankings of all these countries but Armenia have worsened since 2005. Ukraine, Moldova and Georgia have had a "partly free press" during most of this period (rankings between 31 and 60). Moldova and Georgia have modestly improved their rankings, particularly after 2008. Only the Baltic States have had a "free press" throughout this period. In short, none of the six EaP States qualify as having had a free press since 1993, but Moldova and Georgia have recently made important progress.

Diagram 2. Freedom of the press 1993-2015



Source: Freedom of the Press (<http://www.freedomhouse.org>).

Note: Rankings above 60 denote not free press.

Together 'democracy' and 'freedom of the press' reveal a significant gap between the three Baltic States which qualify as democracies with a free press and the six EaP States, where only Georgia and Moldova qualify as democracies with a partly free press. Armenia and Ukraine are borderline cases, moving uncertainly toward functioning democracies with a barely free press. Azerbaijan and Belarus are in a class by themselves, being neither democratic nor having even a partly free press.

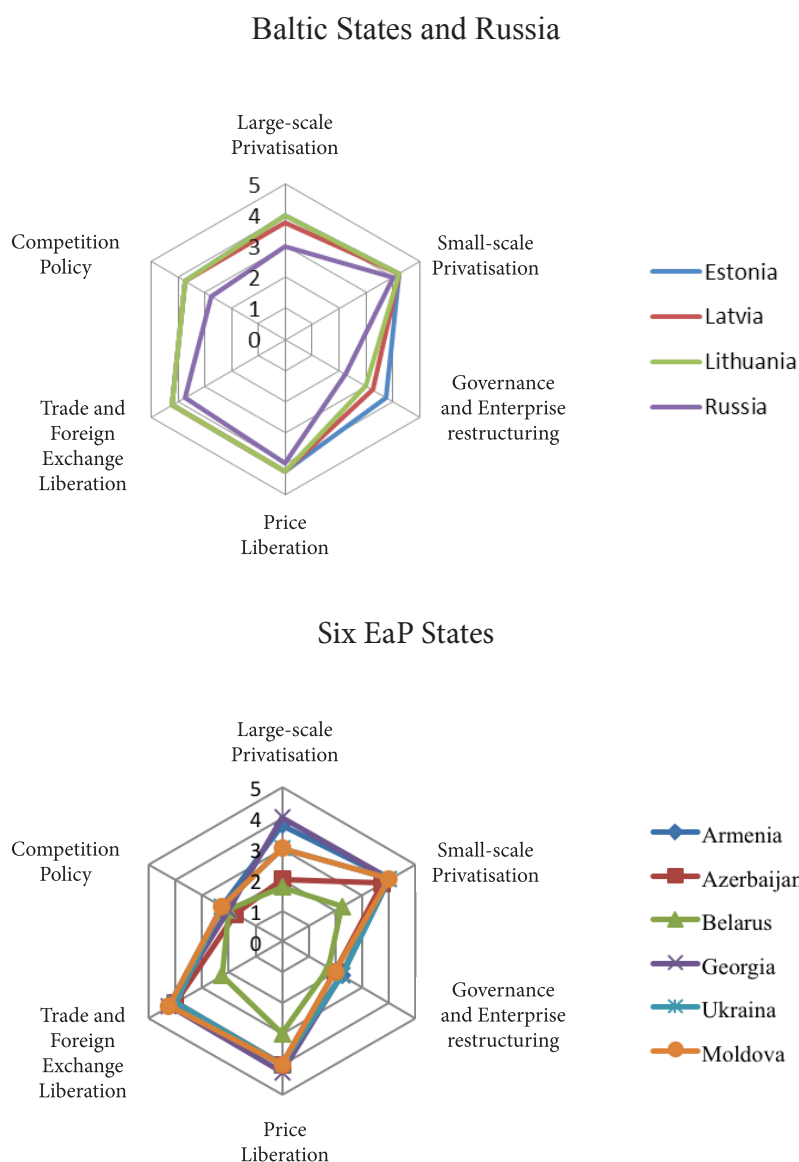
A democratic regime and a free press are interdependent institutions. We, as previously Mansfield *et al.* 2002, have shown that democracy and free trade agreements are correlated. We suggest that these two variables are key indicators of how well prepared a country is for a DCFTA with the EU.

## Transition to market economy

A functioning market economy is a precondition for a DCFTA. Compared with other formerly centrally planned economies the EaP countries lag far behind as reflected in EBRD transition indicators (Diagram 3).

Belarus remains a centrally planned economy on almost all accounts. Other EaP countries have liberalized domestic prices, foreign exchange and foreign trade dealings – the easy variables to liberalize – but have made little progress as concerns competition policy and enterprise restructuring, key variables for a DCFTA. Georgia and Moldova have progressed slightly more than the others.

Diagram 3. Key determinants of transition to market economy 2014



Source: EBRD, *Transition Report 2014*.

Note: "Transition indicators range from 1 to 4+ with 1 representing little or no change to a rigid centrally planned economy and 4+ the standards of an industrialized market economy." *Ibid.*, p. 112. We have replaced a plus sign and a minus sign by adding/subtracting 0.25 respectively.



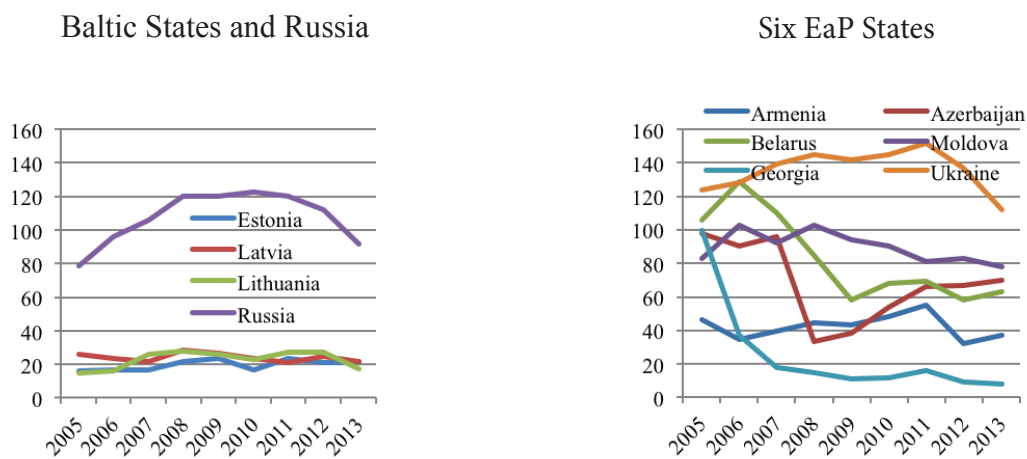
Compared with the Western Balkans, the EaP countries lie below them as a group and on par with Bosnia-Herzegovina, the slowest reformer in that group. Thus, even the most advanced EaP countries lag significantly behind the Western Balkan countries.<sup>4</sup> The ability to implement a DCFTA appears questionable in Ukraine and Armenia and problematic in Georgia and Moldova without significant foreign aid and technical assistance. It is clear that partner countries that wish to qualify for a deep and comprehensive free trade agreement with the European Union need to focus on setting up institutions and adopting legal systems for competition policy and governance and enterprise restructuring.

The next two variables confirm Georgia's and Moldova's positions as front-runners in negotiating DCFTAs.<sup>5</sup>

## Ease of doing business

The World Bank's assessments of the ease of doing business rank the six EaP States between 80<sup>th</sup> and 120<sup>th</sup> place (the number 1 indicates the greatest ease of doing business) between 2005 and 2013. Only Georgia improved dramatically after 2005 and ranked as number 8 in the world in 2013, surpassing even Estonia (Diagram 4).<sup>6</sup>

Diagram 4. Ease of doing business 2005-2013



Source: World Bank, *Ease of doing Business, Annual assessments since 2004*.

Note: The greater the ease of doing business, the lower the index.

Moldova improved consistently, albeit slightly. Other countries retained their poor ranks. Firms in Ukraine, as in Russia, experienced *increasing* difficulties of doing business until 2011 and were no better off in 2013 than in 2005. The business environment in these two countries remained a bureaucratic nightmare. The ease of doing business is a key factor in attracting foreign direct investment.

4 Croatia acceded to the EU in 2013.

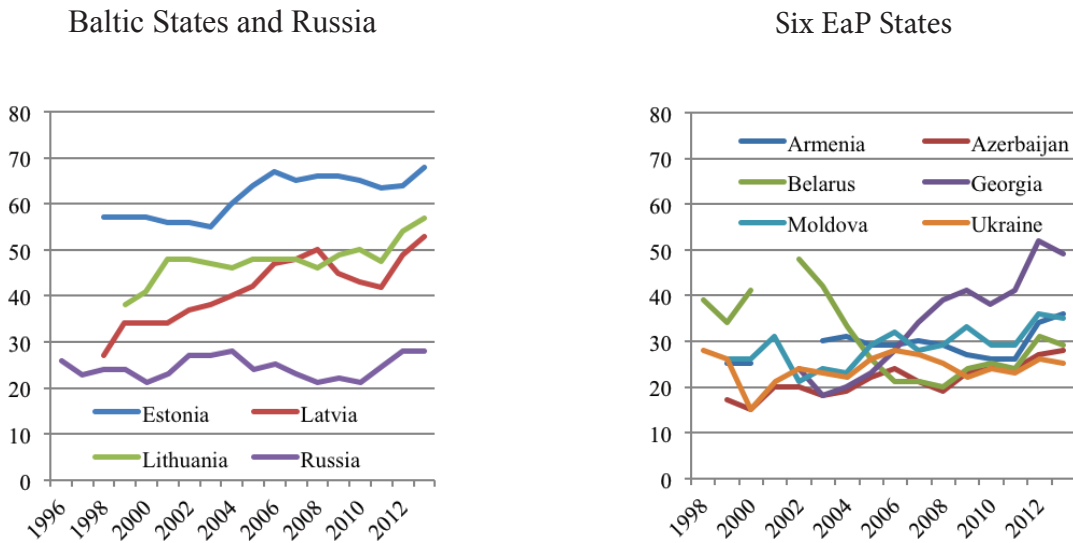
5 Belarus and Azerbaijan are disqualified for a DCFTA since they are not members of WTO and not democracies.

6 See Gylfason and Hochreiter (2009). Developments in the other two Baltic States were similar to those in Estonia – consistently low since 2005, between 15<sup>th</sup> and 20<sup>th</sup> place.

## Corruption and social trust

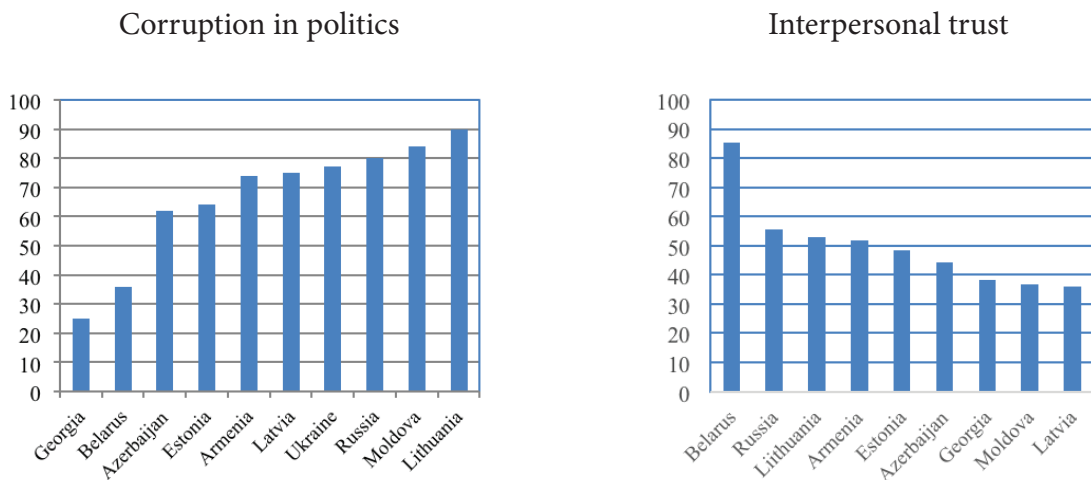
Corruption, rampant in most of these countries as a result of poor governance and bad habits, distorts investment and production decisions and seriously impedes economic growth. Diagram 5 shows corruption as perceived by Transparency International on a scale from 0 (deeply corrupt) to 100 (squeaky clean). Georgia significantly reduced corruption since 2000 and is now close to Latvia (55<sup>th</sup> place) and Lithuania (49<sup>th</sup> place) although still far behind Estonia (28<sup>th</sup> place).<sup>7</sup> Belarus, Azerbaijan and Ukraine, like Russia, ranked consistently between a poor 100<sup>th</sup> and 140<sup>th</sup> place among the 180 or so countries examined by Transparency International. With the remarkable exception of Georgia, the EaP States have failed to reduce corruption since 2005. Developments in Ukraine have demonstrated both the importance of this task and the difficulty of achieving it.

Diagram 5. Corruption 1996-2013



Source: Transparency International (<http://www.transparency.org>).  
 Note: The less corrupt the country is perceived to be, the higher the index.

Diagram 6. Perceived corruption and trust 2012



Source: Gallup and World Values Survey (Medrano, 2015).

<sup>7</sup> The drop registered by Armenia in 2012 and 2013 probably reflects the then ongoing negotiations for a DCFTA (Sekarev, 2013). It is unlikely to be sustained.

A recent Gallup poll (Diagram 6) asked a large sample of voters in 129 countries: “Is corruption widespread throughout the government of [your country], or not?” Only a quarter of respondents in Georgia consider their government corrupt compared with three quarters or more in Armenia, Latvia, Ukraine, Russia, Moldova and Lithuania (left panel). Corruption not only limits foreign direct investment, it also distorts domestic investment.

The World Values Survey (Medrano, 2015) maps interpersonal trust by asking: “Do you think that most people can be trusted?” and by compiling an internationally comparable trust index defined as

$$\text{TRUST INDEX} = 100 + (\% \text{ Most people can be trusted}) - (\% \text{ Can't be too careful})$$

Scores below 100 reflect lack of trust while scores above 100 signal that those who trust others outnumber those who do not. The low level of interpersonal trust in the ten countries under review<sup>8</sup> is striking (right panel) compared with interpersonal trust of 118 to 148 in Scandinavia, for example.

Greater ease of doing business, less corruption and increased social trust are essential to attract investment, especially foreign direct investment. Here, Georgia, alone among the EaP States, has registered noticeable progress.

## Conclusion

Transition to democracy and to market economy has been late and slow in most EaP States. Progress in each of these two fields tends to be interdependent. Georgia and Moldova lead in terms of democracy and a free press and score well ahead of the others in ease of doing business and low levels of corruption. While further efforts are needed in competition policy, governance and enterprise restructuring, they are off to a good start. Armenia and Ukraine are borderline cases as concerns transition to both democracy and market economy and score poorly in terms of corruption and trust. Armenia, with low scores on democracy and free press and significant corruption, chose not to sign. After initial difficulties, Ukraine signed its DCFTA in June 2014 and now needs peace and quiet to focus its efforts on institution building. The prospects for this are poor. Belarus and Azerbaijan do not yet qualify for a DCFTA at all being centrally planned economies, non-members of WTO, highly corrupt and autarchic.

It is likely that the European Union will focus its efforts on institution-building as a prerequisite for successful implementation of DCFTAs in Moldova and Georgia while supporting Ukraine to achieve normal relations with Russia. Greater efforts to foster democracy and a free press in Azerbaijan and Belarus are necessary first steps should these countries wish to negotiate a similar agreement with the EU. In all countries significant financial and technical assistance will be necessary to strengthen and improve the structure and functioning of a market economy. A successful transformation is a bottom-up process, requiring involvement and ownership of stakeholders such as members of the business community, trade unions, non-governmental organizations, media and political parties. It thus presupposes democratic institutions. There is no shortcut to a DCFTA.

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8 A comparable trust index for Ukraine is not available.

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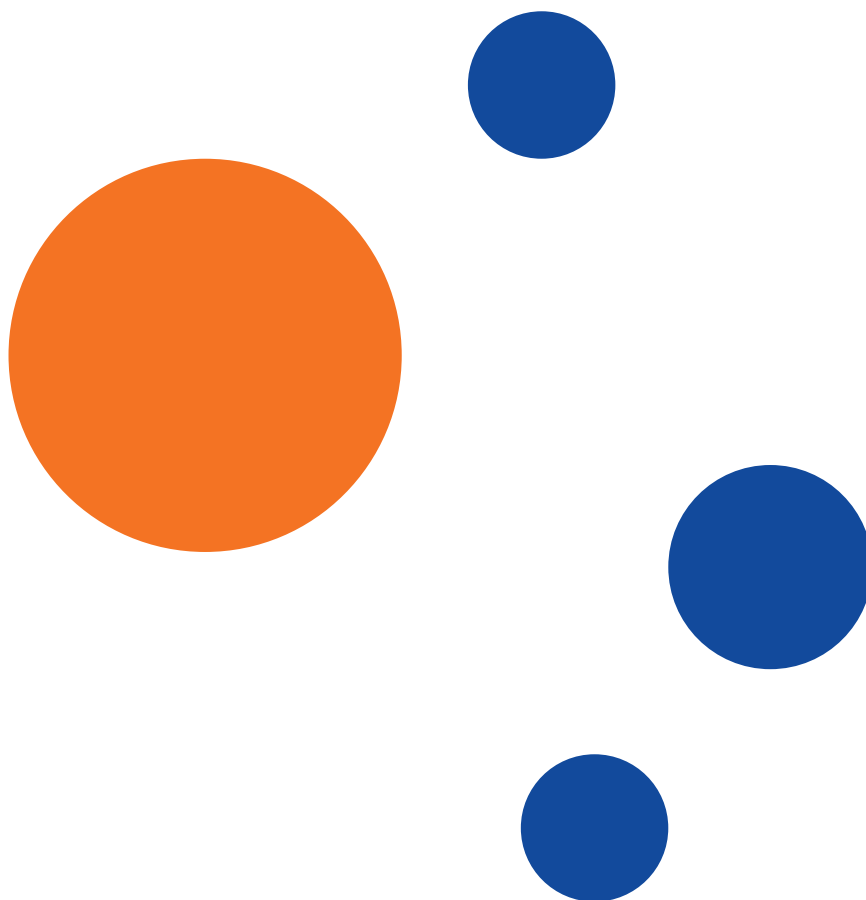


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