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Quality of governance

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Content

1. Introduction

Empiric analyses examining the causes of differences in economic productivity between countries or groups of countries have been recently paying increasing attention to institutional factors. Institutional factors thus broaden the spectrum of variables used to explain the achieved long-term growth rates and especially persisting differences between developed and less developed economies.[1]

2. Assessing quality of governance

The spectrum of monitored indicators used in wider international comparisons is gradually extended (their range is systemically monitored especially in the World Bank research project focused on quality of governance and control of corruption) with the increasing interest in the role of institutional factors in explaining growth performance. However, quantification of qualitative factors necessary for monitoring their development in time and carrying out international comparisons poses significant problems. Due to the significance of qualitative aspects, many or even most of the data required for assessing institutional factors cannot be obtained in the form of commonly available statistical (hard) data. This is why expert survey methods are used to a certain extent (for example entrepreneur, foreign investor, public administration staff and international organisation polls or public polls). The possibility of distorted assessment especially due to current economic situation in the relevant country (assessment of qualitative characteristics tends to deteriorate with adverse economic development) is one of the major problems associated with the use of soft data. More comprehensive and elaborate methodologies therefore combine various types of data (soft and hard), as well as their sources (statistical databases, expert estimates, questionnaire surveys) (for more detail see Kadeřábková a kol., 2005, p. 37).

The following text addresses the macroeconomic side of institutional quality assessment. The assessment is based on quality of governance defined according to the Governance Matters concept. The concept created and monitored on a long-term basis by the World Bank structures governance quality assessment into six individual indicators: democracy, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. The published figures for these six indicators for the EU-25 states are used as the basis for the following analysis.

Besides the average for the EU-25, the text works with additional groups of countries with regard to the changes that occurred in the European political and economic environment after the fall of the communist regime. To be specific, the text studies the original member states (EU-15), the group of new member states since 2004 (EU-10) and within the new member states the group of post socialist countries (EU-8, i.e. excluding Cyprus and Malta). The more comprehensive approach of the new institutional economy extended by the approach of the new comparative economy is the theoretical basis for the governance quality assessment.

2.1 Aggregate indicators

A wide range of approaches to assessing the quality of the institutional environment is available, and can be used for characterising the impact of institutions on growth performance and competitiveness of the economy and even for comparing the institutional quality of various countries. The methods used in this study have been selected in view of providing data with the widest possible range of institutional characteristics and allowing comparison in time characterised as the dynamics of institutional changes. [1]

The overall understanding of the quality of governance in this text follows the definition set out by the World Bank[2] in the Governance Matters project. The World Bank has studied the concept of quality of governance for approximately two decades. According to their concept, governance is defined in a relatively broad sense as tradition and institution used to exercise power in individual countries. In keeping with this definition, three basic areas are examined. These areas address the processes according to which governments are selected, monitored and replaced; the government's ability to effectively create and implement suitable policies and finally citizens' respect and the state of institutions determining economic and social interactions among citizens. These basic areas are described by pairs of indicators.

The quality of political processes is described by the **voice and accountability** indicator, which assesses the quality of political, civic and human rights and mechanism of political processes. This indicator also reflects independence of the media. The **political instability and violence** indicator reflects the possibility of destabilising the government and the probability of overthrowing the government using institutional means or violence, including the possibility of terrorism. This indicator also shows whether changes in the government have impact not only on the continuity of policies, but also on the ability of citizens to select and replace governments and policies in a peaceful manner. The government's ability to effectively create and implement suitable policies is reflected in the **government effectiveness** indicator, which addresses not only the effectiveness and credibility of government policies, but also the productivity of the administrative authorities, their independence of political pressure, the quality of public service delivery, and the **regulatory quality** indicator reflecting the use of basic policies non-conforming with the market's functioning (price regulation, unsuitable regulation of the banking sector) and studying their impact on local and foreign investors.

The willingness of entities to observe laws, effectiveness and predictability of judicature, protection of proprietary rights, quality of enforcing contracts, functioning of the Police or the probability of violent and non-violent crime form the **rule of law** indicator. The **control of corruption** indicator expresses to what extent the public power is perceived to be exploited for personal gain, whether with regard to the major (political) and minor (bureaucratic) corruption or with regard to the ability to influence adopted policies and laws referred to by the term state control.

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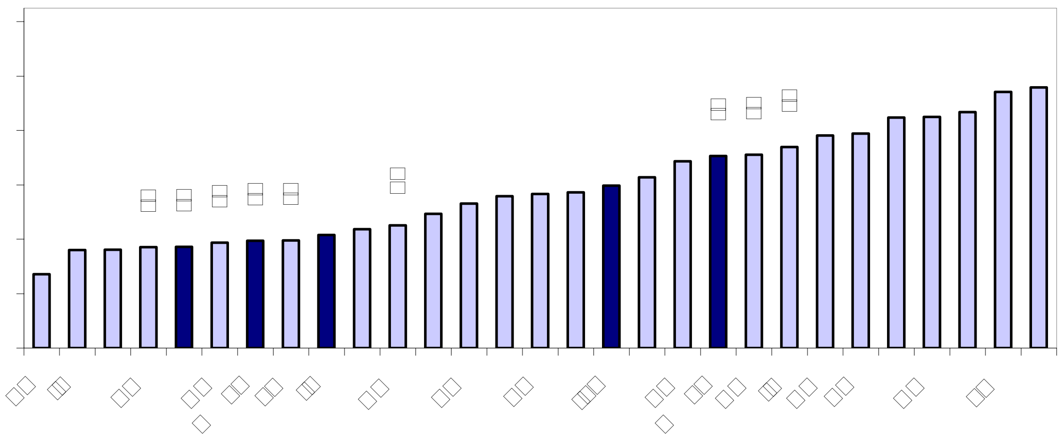
[1] The text was written in cooperation with Petr Vymětal, who deserves acknowledgment not only for providing valuable comments but also for writing certain parts of the text.

[2] Additional definitions worth mentioning include for example the somewhat different definitions created by UNDP or OECD. **UNDP** (2004) defines the term governance as a system of values, policies and institutions the society uses to control its economic, political and social affairs in relationships between the state, civic society and the private sector. Governance refers to the way in which the society organises itself, and adopts decisions for achieving mutual understanding, agreement and cooperation. Mechanisms and processes for voicing interests, mediating differences and enforcing rights and obligations are provided to citizens. It includes the rules, institutions and practices restricting or stimulating individuals, organisations and companies. Governance therefore includes social, political and economic dimension and functions across all levels of human interaction – household, town, municipality, nation, region and at the global level. The concept of governance in the **OECD** (OECD DAC, 1995) material reflects the use of political power and enforcing control within the society in relation to the administration of social and economic resources. This broad definition includes the role of public bodies, which create the environment for operating economic entities and determining distribution of benefit, as well as the origin of the relationship between the controlling and the controlled. For more detailed explanation see Vymětal (2005).

The aggregate governance quality index used to evaluate the overall quality of governance in individual countries or groups of countries comprises the six indicators referred to above, expressed as an arithmetic mean. Figure 1 arranges individual countries according to the value of their aggregate governance quality indexes and illustrates their position within the EU-25.

Figure 1: Aggregate governance quality index (year 2004)



Source: World Bank (2005), own modification.

Figure 1 shows that although none of the countries within the EU-25 achieves a negative value of the aggregate governance quality index with a range from -2.5 to +2.5, none of the countries achieve the aggregate governance quality index value 2. Comparison of individual countries and their positions is shown in the four averages included (EU-25, EU-15, EU-10, EU-8): the average for the EU-15 is higher than the average for the EU-10, which means that accepting new member states in 2004 reduced the overall quality of governance in the EU-25. The averages included allow dividing countries into a few groups, where the extreme positions have significant information value and especially in the case of the first group also great inspirational value.

The group exceeding the average for the EU-15 includes countries where the overall quality of governance can be evaluated as above the average and these countries can be considered role models of institutional organisation for other states. This group includes especially Scandinavian countries (Finland, Denmark and Sweden), Luxembourg, Netherlands, Austria, Great Britain, Germany and Ireland. The second group of countries is between the EU-15 and EU-10 averages. The third group with results lower than the EU-10 average is very interesting as it includes Cyprus, Czech Republic, Slovakia, Greece, Italy and Poland. We can therefore conclude that the quality of governance in these countries is insufficient and may be associated with an impact on the productivity of the economy and the need for changing the economic policy. The fact that the Czech Republic is included in this group is a warning signal and a strong call and incentive for making changes.

Figure 1 shows assessment of the situation in 2004. As the Governance Matters project has been in progress since 1996, basic trends in the development of this aggregate indicator (all data for individual countries) can be derived from the available data. Table 1 includes the development in the aggregate governance quality indicator for individual groups of countries and the Czech Republic.

Table 1: Development in the aggregate governance quality index

	1996	1998	2000	2002	2004
EU-25	1.14	1.20	1.20	1.25	1.20
EU-15	1.49	1.53	1.51	1.52	1.42
EU-10	0.62	0.71	0.73	0.85	0.86
EU-8	0.57	0.63	0.69	0.81	0.81
CZ	0.88	0.76	0.70	0.81	0.74

Note: The values stated are unweighted averages. Source: World Bank (2005), own modification.

We will begin the assessment by studying the **development in the quality of governance** and comparing this development between the EU-15 and EU-10 countries. While an obvious trend towards gradual improvement in the quality of governance can be observed in the EU-10 countries between 1996–2004, the trend in the EU-15 turns for the worse between 2002 and 2004 and this change in the trend is very significant, with values dropping virtually below the 1996 level. This is a positive situation for possible adjustment of the new member states. Although the gap remains excessively large, it has been reduced by about one quarter (from 0.87 to 0.56). This development reflects in general in the aggregate development of the indicator in the EU-25. The development of the aggregate index in the Czech Republic is documented the best in comparison of development in the CR and the EU-8. The Czech Republic is assessed in the quality of governance for 2004 below the EU-8 average for the first time in the history, and we can therefore conclude that the country has wasted the advantage it had in 1996 over the remaining transforming economies. This makes the position of the CR even more alarming than the mere comparison of 2004 assessment would suggest.

The following sections will primarily focus on the values and development of individual governance quality indicators: voice and accountability (GM 1), political instability and violence (GM 2), government effectiveness (GM 3), regulatory quality (GM 4), rule of law (GM 5) and control of corruption (GM 6). Each of the indicators will be addressed in a separate part where individual detailed data will be analysed, additional data clarifying the development or supplementing data will be presented and alternative corresponding and opposing approaches that have appeared in the literature dedicated to these topics will be presented.

Development of individual indicators from 1998[3] to 2004 provides some interesting comparisons in the EU-15 and EU-10 groups. Table 2 also shows a comparison against the development in the Czech Republic.

The decline of the aggregate governance quality indicator for the EU-15 refereed to in table 1 is a result of the following changes. While the quality of democracy (GM 1) remains virtually unchanged, the political stability (GM 2) deteriorated. Deterioration was recorded also in other individual indicators and this was due to the increased regulatory burden (GM 4) and occurrence of corrupt behaviour (GM 6). The only positive change can therefore be observed in the quality of legal environment (GM 5) and this is reflected in the deteriorated evaluation of the entire EU-15 mentioned above. The situation in the new member states is in sharp contrast to this development in the EU-15. With the exception of political stability, assessment of this group of countries improved significantly in all studied areas. However, the situation in the Czech Republic does not quite correspond with these overall results.

[3] 1998 was used because the data for the first year of research (1996) have been retrospectively revised according to the changing methodology and cannot be therefore considered fully comparable.

Table 2: Governance quality indicators

		EU-15	EU-10	CZ
GM1	1998	1.33	0.95	1.14
	2004	1.32	1.09	1.03
GM2	1998	1.24	0.90	0.97
	2004	1.00	0.82	0.84
GM3	1998	1.77	0.62	0.72
	2004	1.56	0.78	0.63
GM4	1998	1.23	0.75	0.78
	2004	1.40	1.12	0.97
GM5	1998	1.66	0.54	0.62
	2004	1.52	0.75	0.69
GM6	1998	1.93	0.48	0.35
	2004	1.73	0.59	0.30

Note: Unweighted averages of values for individual countries. Source: World Bank (2005), own modification.

Table 3: Development in the components of the aggregate governance quality index for the CR

	1998	2000	2002	2004
GM 1 voice and accountability	1.14	0.99	0.90	1.03
GM 2 political instability and violence	0.97	0.84	1.07	0.84
GM 3 government effectiveness	0.72	0.70	0.72	0.63
GM 4 regulatory quality	0.78	0.67	1.12	0.97
GM 5 rule of law	0.62	0.59	0.69	0.69
GM 6 corruption	0.35	0.40	0.36	0.30

Source: World Bank (2005), own modification.

According to the Governance Matters project, the Czech Republic in 2004 compared to 1998 was a less democratic and less politically stable country with a less efficient government, a country that successfully deals with the regulatory burden and slightly improves the quality of the rule of law. Corruption presents the most serious problem pointed out by the World Bank analyses within this project. The corrupt environment in the CR received the lowest value of all indicators within the interval from -2.5 to +2.5 and the assessment in 2004 was even worse than the values achieved in the previous research in 2002. The development in individual areas in the CR from 1998 to 2004 is documented in table 3.

One individual and not very flattering conclusion can be drawn for the Czech Republic from the details listed above: The CR behaves like a stable democracy; although it achieves worse positions than most of the EU-15 countries, it demonstrates the weakest positive development in the evaluated areas of all EU-8 countries.

2.2 Voice and accountability

The **voice and accountability** sub-index reflects the quality and progress of democratisation procedures in the politics, civic rights, human rights and independent media. Assessment of the quality of democracy will be extended by economic freedom as a key area of a democratic system, which is considered one of the basic institutional conditions of economic productivity. To do this, we will use approaches of two independent institutions, which regularly publish economic freedom indexes – The Heritage Foundation and Fraser Institute. Additional supplementary view will be provided in selected details from the World Competitiveness Yearbook IMD[4] (political parties, public administration and bureaucracy).

Firstly, we will study the values and development of the voice and accountability sub-index from the Governance Matters project. Table 4 states values of this sub-index for individual groups of countries – the structure is identical to that used in the aggregate index. The comparison in time is also included. However, note that 1996 was a preparatory year and 1998 is therefore considered the relevant year for examining the long-term development.

Table 4: Voice and accountability sub-index

	1996	1998	2000	2002	2004
EU-25	1.22	1.18	1.20	1.26	1.23
EU-15	1.45	1.33	1.31	1.42	1.32
EU-10	0.87	0.95	1.03	1.03	1.09
EU-8	0.82	0.88	0.97	1.01	1.08
CZ	1.06	1.14	0.99	0.90	1.03

Note: Unweighted averages of values for individual countries. Source: World Bank (2005), own modification.

Table 4 shows development of democratisation processes and mechanisms. The advantage of the EU-15 countries with consolidated democratic systems over the EU-10 countries remains significant but the gap between the two groups has decreased by more than a half (from 0.58 to 0.23). This is caused not only by a greater rate of the democratisation processes in the EU-10, but also by a relatively stable level of democracy in the developed European countries. The development of the Czech Republic's position (21st place ahead of Lithuania, Cyprus, Latvia and Greece) is alarming. The loss of the relatively good position (16th –18th place in 1996) suggests that the efforts to achieve the standard of Western European democracies are not successful. Virtually no change occurred between the two extreme points of the monitored period. The CR lost its initial, relatively good position and the advantage over the EU-10 countries is negligible. Comparison against the average for the transforming countries is also interesting; the CR now lags behind these countries and this further highlights a certain degree of stagnation in development of the quality of democracy.

The **economic freedom** indexes represent the basic supplementary material. The first of them - the index published by the Fraser Institute (FI) has been published in the annual study Economic Freedom of the World for more than thirty years (since 1970).

Development in the values of the economic freedom index according to the Fraser Institute moderates the adverse position of the CR mentioned above (see table 5). Although the index points out the gap in enforcing economic freedom between the new and the old EU countries, the Czech Republic is assessed at a level equal to the EU-10 average.

Table 5: Development in the values of the economic freedom index according to the Fraser Institute

	1975	1985	1995	2000	2001	2002	2003
EU-25	5.7	5.9	6.5	7.0	7.1	7.2	7.2
EU-15	5.7	6.3	7.3	7.5	7.4	7.4	7.4
EU-10	..	..	5.4	6.3	6.6	6.8	6.8
CZ	..	..	5.9	6.8	6.8	6.7	6.8

Source: Fraser Institute (2005), own modification.

[4] The IMD research excludes 4 economies: Cyprus, Lithuania, Latvia and Malta. This is why averages are calculated without these countries, i.e. as an average for 21 countries in the EU-25 indicator and an average for 6 countries in the EU-10 indicator.

Table 6: Economic freedom index - Heritage Foundation

	EU-25	EU-15	EU-10	Czech Republic
1996	2.60	2.29	3.05	2.33
1997	2.50	2.21	2.94	2.29
1998	2.47	2.20	2.88	2.43
1999	2.43	2.18	2.80	2.14
2000	2.40	2.17	2.73	2.20
2001	2.26	2.10	2.48	2.10
2002	2.26	2.13	2.46	2.29
2003	2.23	2.10	2.43	2.35
2004	2.21	2.11	2.38	2.39
2005	2.17	2.09	2.30	2.36

Source: Heritage Foundation (2005).

The second economic freedom index has been published by the Heritage Foundation – HF since 1995. This index includes a broad spectrum of institutional factors determining economic freedom. Economic freedom is defined as a lack of governmental pressure or restriction with regard to production, distribution or consumption of assets and services exceeding the level of the essential (vital) need to protect and maintain the freedom. All countries worldwide apply certain restrictions or pressure (through taxation or providing public assets) but these restrictions of pressure must not exceed a certain minimum limit to violate human rights. Despite this, governments restrict or enforce certain behaviour, production, consumption or distribution, people's behaviour changes and the change is rarely for the better. Unlike the FI index, examination of the economic freedom index according to HF (see table 6) confirms to a great extent not only CR's lagging behind but especially its stagnation – the value of the index remains virtually unchanged. The gap between the EU-15 and EU-10 decreased during the monitored period. Development in the index for the Czech Republic stagnates and as the remaining transforming countries develop, the CR lags behind. This places the CR among countries with values below the European average.

2.3 Political instability and violence

The **political instability and violence** indicator reflects the potential for upsetting the stability and monitors the likelihood of violence used to solve political disputes (from the threat of putsch to settling personal conflicts in the politics and the threat of civil war. extremism and terrorism). Political risk indexes published by the Political Risk Service Group (PRSG) and political instability risk indicators from the IMD 2004 research will be used as supplementary indicators.

The values of the political stability sub-index are included in table 7. Once again the table shows a clear difference between the developed European countries with consolidated political systems and the new member states. Nonetheless, examination of the EU-15 and EU-10 averages reveals that despite a certain decrease in the values of this index, the former candidate countries were the only to record some progress over the last few years and thus were able to catch up with the developed European countries to a certain extent. We can only guess the reasons behind this development. After excluding the threat of a civil war or a putsch, the threat of terrorism remains as the factor that significantly decreased this indicator. The decrease in the index for the EU-15 is obvious in 2002, as well as in 2004, when the entire Europe was affected by this development.

Table 7: Political instability and violence sub-index

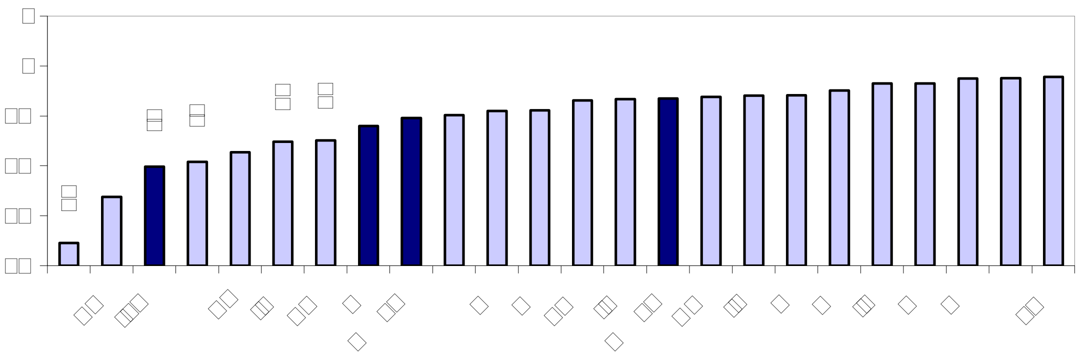
	1996	1998	2000	2002	2004
EU-25	1.01	1.10	1.10	1.09	0.93
EU-15	1.15	1.24	1.30	1.14	1.00
EU-10	0.80	0.90	0.80	1.01	0.82
EU-8	0.82	0.89	0.78	1.03	0.80
CZ	1.08	0.97	0.84	1.07	0.84

Note: Unweighted averages of values for individual countries. Source: World Bank (2005), own modification.

This may suggest that no progress occurred due to the more intense perception of the threat of terrorism. However, this explanation applies only to a certain extent. Countries more actively involved in the global fight against terrorism perceive terrorism as a threat more sensitively (especially in the case of Great Britain). On the other hand, the deterioration of the index is also caused by a variety of other factors – political instability, scandals in the politics and internal conflicts (Italy, Poland) or increasing extremism on both wings of the political spectrum. Although the Czech Republic achieves a slightly better results in this comparison than in the democracy sub-index (19th place in 2004), it has lost its favourable position from the mid 90s (13th place in 1996).

Another supplementary factor – the IMD assessment strives to answer the question whether the risk of **political instability** is or is not high. A score of 10 means a low risk, while zero is a high risk. The results are shown in Figure 2. Logically, these risks are higher in transitional economies where the societies have not sufficiently absorbed the democratic principles. Although the Czech Republic is above the EU-10 average, this average is significantly affected by the negative assessment of Poland (2.91) and Slovakia (4.76). We can therefore conclude that countries achieving values of this index higher than seven can be considered politically stable and the CR (7.60) meets this condition.

Figure 2: Political instability risk (year 2004)



Source: IMD (2004), own modification.

2.4 Government effectiveness

The **government effectiveness** sub-index includes a variety of variables related especially to the quality of bureaucracy and public services. Although the gap between the EU-15 and EU-10 countries decreases over time, this development is not rapid. This suggests that the government effectiveness in the new member states represents a serious and persistent problem. While developed countries strive to deal with their extensive bureaucracy, the EU-10 countries need to tackle ineffective bureaucracy, poor structure of public expenses and institutional failures, and the quality of public services is continuously lagging behind.

The Czech Republic did not achieve any significant progress during the monitored period and lost its advantage over the EU-10, as well as EU-8 countries and its current position is worse than the average positions for these groups. The fall to the end of the line (23rd place ahead of Italy and Poland) further documents the poor efficiency of the administrative authorities, numerous delays and repeated institutional failures associated with activities of the state and the public sector. This also reflects in poor management of the growing public debt, inflexible enforcement and implementation of changes in public policies, and corruption in the state administration (see table 8).

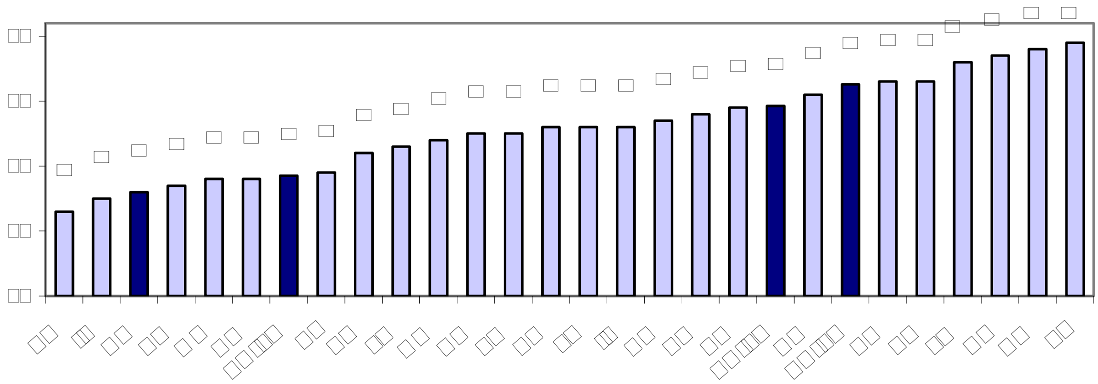
Table 8: Government effectiveness sub-index

	1996	1998	2000	2002	2004
EU-25	1.29	1.31	1.25	1.36	1.25
EU-15	1.74	1.77	1.64	1.74	1.56
EU-10	0.62	0.62	0.66	0.79	0.78
EU-8	0.45	0.49	0.59	0.71	0.72
CZ	0.78	0.72	0.70	0.72	0.63

Note: Unweighted averages of values for individual countries. Source: World Bank (2005), own modification.

Additional indicators are obtained from two sources: the Global Competitiveness Report 2004–2005 by the World Economic Forum and the data published in the World Competitiveness Yearbook 2004 by IMD. The first source provides indexes that assess wasting public resources and the transparency of the government's decision making, with values recorded in Figures 3 and 4. The first index assesses whether the public expenses in the economy are used for essential goods and services not provided by the market (value 7) or whether public expenses are wasted (value 1). The second index evaluates whether the government informs companies about changes in policies or regulations sufficiently (value 7) or insufficiently (value 1).

Figure 3: Wasting public resources (year 2004)



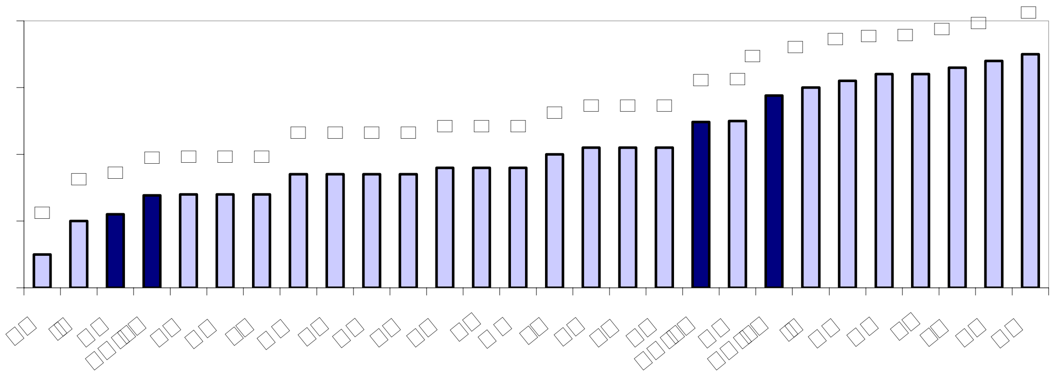
Source: WEF (2004), own modification.

As the Figures show, the Czech Republic's position in both cases is less than gratifying. Our government is evaluated as wasteful and non-transparent. The CR's position on the 23rd place only ahead of Italy and Poland in both cases confirms the assessment according to GM.

2.5 Regulatory quality

The level of regulation and its quality is one of the basic institutional characteristics. Monitoring of regulatory quality is therefore a major signal for the economic policy with regard to the efforts focused on increasing competitiveness. Regulation is generally considered necessary as long as it does not prevent free enterprise. The regulatory burden sub-index GM assesses the regulatory quality but not the level of regulation (see table 9).

Figure 4: Transparency of government's decision making (year 2004)



Source: WEF (2004), own modification.

Table 9: Regulatory quality sub-index

	1996	1998	2000	2002	2004
EU-25	1.10	1.03	1.11	1.36	1.29
EU-15	1.41	1.23	1.36	1.58	1.40
EU-10	0.63	0.75	0.74	1.03	1.12
EU-8	0.67	0.72	0.73	0.99	1.08
CZ	1.18	0.78	0.67	1.12	0.97

Note: Unweighted averages of values for individual countries. Source: World Bank (2005), own modification.

The table clearly shows how the EU-10 countries are starting to catch up with the old EU member states, decreasing the difference from the initial value of 0.78 in 1996 to 0.28 in 2004. Despite this significant improvement a number of problems persist – excessive regulation in certain sectors, non-transparent and complicated taxation systems, and market-unfriendly activities on individual markets. In addition, it is necessary to bear in mind that from the worldwide perspective the entire Europe appears over-regulated.

The situation in the Czech Republic does not warrant great optimism and its favourable initial position rapidly deteriorated (a fall from the 13th place in 1996 to the 20th place in 1998 within the EU-25). The situation improved after 2000 – the major banks and companies with majority share owned by the state were sold, the VAT rate was reduced and certain modifications were introduced in individual markets (telecommunication. power engineering). Despite this improvement, the CR remains on the 12th place even in 2004. Regulation of the labour market, of rent and prices of energies are seen as a persisting problem and this may lead to further deterioration in the position of the Czech economy.

Indicators from three sources were selected as additional regulatory quality indicators – from the Global Competitiveness Report 2004–2005, from the data published in the World Competitiveness Yearbook 2004 and from regulation assessment by the Fraser Institute in Economic Freedom in the World 2005. The state regulation[5] and obstacles to business indexes are obtained from the first source, price control issues, labour market regulation and legal regulation are adopted from the second source. Data on credit market regulation, labour market regulation and commercial regulation are adopted from the economic freedom index by FI. Table 10 presents data from the IMD.

Table 10: Additional regulatory quality indicators for 2004

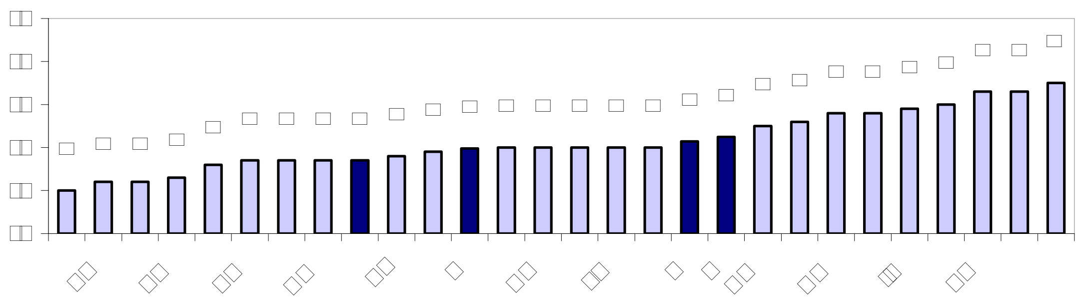
	Price control	Labour market regulation	Legal regulation of financial institutions
EU-25	7.07	4.32	6.86
EU-15	7.21	4.20	7.17
EU-10	6.75	4.63	6.09
CZ	7.65 (11)	4.05 (32)	6.25 (38)

Note: The data from IMD does not include results for Cyprus, Lithuania, Latvia and Malta and the averages are calculated without these countries. The figures stated in brackets express the CR's position in the group of 104 countries. Source: IMD (2004), own modification.

The data from the IMD show regulatory quality differing throughout various areas in the European Union. Prices are mainly deregulated and the Czech Republic is evaluated at a level not only above the EU-10 average, but also above the EU-15 average. What's more, the gap between the old and the new member states is not significant. The same applies to the labour market regulation, though at a very different level. The indexes show that the conditions on the labour markets throughout Europe are over-regulated and the difference of more than three and a half points for the Czech Republic in the price regulation and the labour market regulation assessment is a sad confirmation of this fact. Interestingly, the EU-10 countries have less regulated labour markets than the EU-15 states.

The situation in the financial sector regulation is satisfactory and the Czech Republic plays a progressive role within the EU-10 slightly lagging behind the EU-15. Nonetheless, the level of regulation in European financial markets is higher compared to financial markets worldwide and the Czech Republic's position in the sample of 60 countries confirms this fact. The CR is on the 11th place in price control, on the 32nd place in the labour market regulation and as far as the 38th place in the financial market regulation.

Figure 5: Adjustment to the state regulation (year 2004)

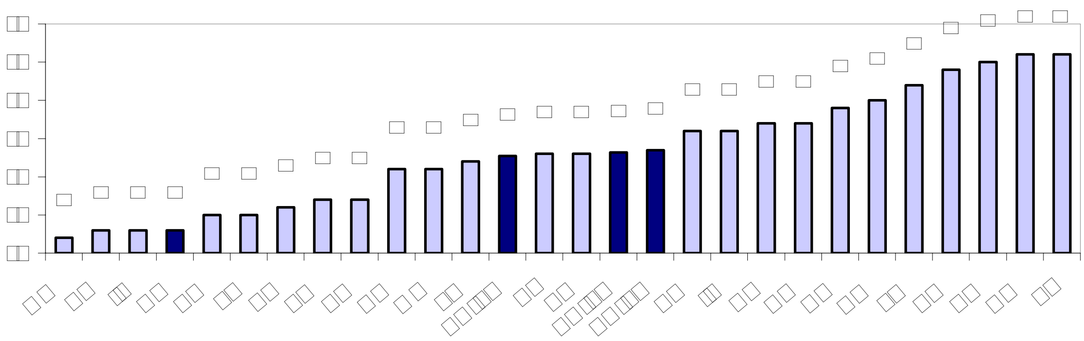


Source: WEF (2004), own modification.

Figure 5 evaluates the ease of adjusting to the state regulation (higher values mean easier adjustment). The gap between the old and the new EU member states in this indicator is influences by the situation in the Baltic states, i.e. the second place for Estonia with evaluation higher than the EU-15 average by more than one point. What's more, besides Poland, the group of countries with high regulation includes Belgium and France; Italy received the worst evaluation. Despite these circumstances, the gap between the EU-15 and EU-10 remains, even though it is not significant. The position of the Czech Republic is below the average for the new member states.

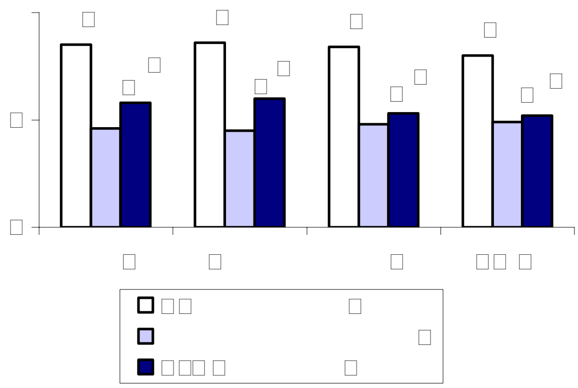
Figure 6 assesses the difficulty of starting business. The EU-15 and EU-10 averages do not differ significantly but the index values divide the countries into three groups. Of the countries with transitional economies traditionally Estonia and surprisingly Hungary are included in the highest group with five or more points and the lowest group with less than four points includes the Czech Republic (3.30). Only Greece achieves worse results within the EU-25. Evaluation included in the economic freedom index completed by the Fraser Institute is used as the last additional indicator. The FI assesses three components with regard to regulation restricting freedom: credit market regulation, labour market regulation and commercial regulation. Figure 7 compares these three components of regulation in aggregates for EU-25, EU-15, EU-10 and the Czech Republic. This comparison confirms the comments mentioned previously.

Figure 6: Obstacles to business (year 2004)



Source: WEF (2004), own modification.

Figure 7: Regulation restricting freedom according to the Fraser Institute (year 2004)



Source: Fraser Institute (2005), own modification.

2.6 Rule of law

Structure of the **rule of law** is one of the most important institutional characteristics of modern societies. Definition of the basic formal rules in the legal order creates boundaries for actions of economic entities. The legal order quality sub-index GM includes mainly the level of proprietary right protection and the ability to enforce contracts.

Indicators of institutional interactions in the EU-15 are considered unproblematic. Despite the deterioration during the last four years, the legal order quality indicator supports the theory that the developed countries have consolidated political and legal systems. This deterioration may be related to some antiterrorist legal measures. The EU-10 is reducing the large gap by improving the quality of legislation especially in accordance with the aquis communitaire associated with joining the EU. The initial difference of 1.33 decreased during the last year of the survey to 0.77 but it still represents a significant gap. The Czech Republic has maintained virtually constant index value, left its 17th place from the beginning of the period and now ranks just ahead of Cyprus and Poland. The legal order quality in the Czech Republic is evaluated on a long-term basis as one of the most serious institutional problems.

Table 11: Rule of law sub-index

	1996	1998	2000	2002	2004
EU-25	1.14	1.21	1.25	1.22	1.21
EU-15	1.67	1.66	1.67	1.56	1.52
EU-10	0.34	0.54	0.62	0.70	0.75
EU-8	0.35	0.48	0.55	0.65	0.68
CZ	0.64	0.62	0.59	0.69	0.69

Note: Unweighted averages of values for individual countries. Source: World Bank (2005), own modification.

Table 12: Compliance of legal order in transitional economies with the OECD legislative principles

Very high compliance	No countries
High compliance	Armenia, Kazakhstan, Lithuania, Latvia, Hungary, Macedonia, Moldavia, Poland and Russia
Medium compliance	Albania, Bulgaria, Czech Republic, Estonia, Croatia, Kyrgyz Republic, Serbia and Monte Negro, Slovakia, Slovenia and Uzbekistan
Low compliance	Bosnia and Herzegovina, Georgia, Romania and Turkmenistan
Very low compliance	Azerbaijan, Belarus, Tajikistan and Ukraine

□ □ □□□

Materials of the European Bank for Reconstruction and Development (EBRD) are the first additional resource for assessing the legal order quality. In 2005 EBRD published the Composite Country Law Index and rating of transitional economies reflecting the level of compliance of their legal orders with the OECD legislative principles of corporate governance (see table 12). The Composite Country Law Index evaluates the overall level of commercial and financial law.

When commenting on this table, it is impossible not to state that the data confirm the previous statements on the (poor) quality of the Czech legal order. The fact that countries such as Russia, Armenia or Kazakhstan achieve greater compliance than the CR is alarming. The data listed in table 16 divide the EU-8 countries into two groups, with Lithuania, Latvia. Hungary and surprisingly also Poland included in the better group and on the other hand surprisingly Estonia together with the CR, Slovenia and Slovakia in the second group.

Table 13: Overall level of commercial and financial law in transitional EU countries in 2005

HU	EE	SI	LT
68	66	65	64
LV	CZ	SK	PL
62	61	60	58

Source: EBRD (2005).

Legal quality indicators selected from the IMD survey are used as yet another supplementary assessment. These indicators assess to what extent the current **legal framework** restricts or supports competition among companies and how this issue is addressed by **newly adopted** legislation (see table 14). This assessment shows the significant lagging in the legal quality of the new member states compared to the original EU-15 and the large gap between the Czech Republic and the EU-10, although the difference in new legislation is smaller than in the existing legislation. However, this slightly more optimistic evaluation is shown in a different light in view of the fact that the 46th place held by the CR in the group of 60 countries is only very slightly better than the 47th place.

Table 14: Supplementary indicators of legal quality for 2004

	Existing legal framework	New legislation
EU-25	4.93	5.24
EU-15	5.18	5.37
EU-10	4.32	4.93
CZ	3.55 (47)	4.70 (46)

Note: The data from IMD does not include results for Cyprus, Lithuania, Latvia and Malta and the averages are calculated without these countries. The figures stated in brackets express the CR's position in the group of 104 countries. Source: IMD (2004), own modification.

2.7 Control of corruption

Unlike the previous institutional characteristics on functioning of formal institutions, the corruption indicator includes assessment of informal institutions and in actual fact assesses the state of morals and development in the society. The effort to measure corruption is a reflection rather than an indicator of institutional conditions. Corruption (defined as exercising public power for private gain) is reflected in the political process, as well as the judicial system but is also an economic phenomenon. Corruption in the economic sphere reflects especially the state's inability to implement the basic functions because it weakens the effectiveness of economic policies and as such is a symptom of weakness of economic structures and institutions. Corrupt environment decreases the country's credibility for foreign investors, reduces the efficiency of resource utilization and thus decreases the economic productivity. Corrupt environment and corrupt behaviour are supported by insufficiently clear division between the state and the market, the public and the private sphere and excessive and non-systemic regulation. The corruption control sub-index (see table 15) is based on the forms of corruption divided into major and minor corruption and supplemented by the so-called state control.

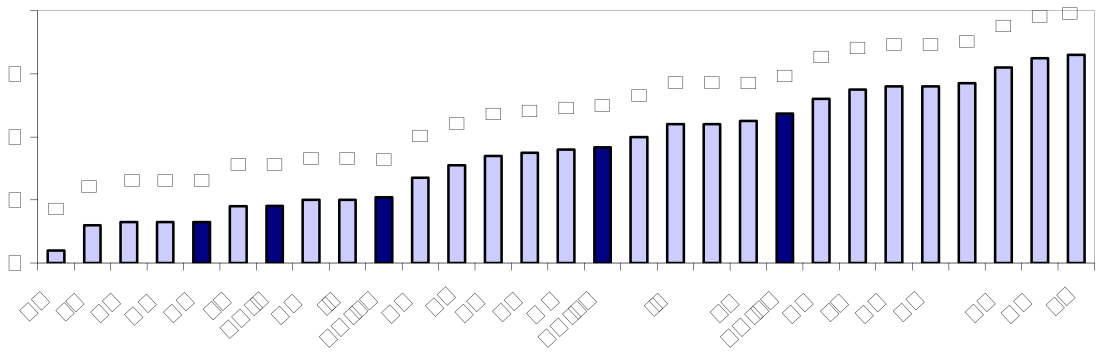
Table 15: Corruption control sub-index

	1996	1998	2000	2002	2004
EU-25	1.10	1.35	1.30	1.24	1.27
EU-15	1.54	1.93	1.80	1.71	1.73
EU-10	0.44	0.48	0.55	0.53	0.59
EU-8	0.31	0.34	0.52	0.45	0.49
CZ	0.55	0.35	0.38	0.38	0.30

Note: Unweighted averages of values for individual countries. Source: World Bank (2005), own modification.

Table 15 shows that corruption does not pose a serious problem in the EU member states. Although there are significant differences between individual states (the best Finland achieved the value of 2.53 and the worst Greece the value of 0.56), the EU-15 average is relatively high. The situation in the EU-10 countries is significantly worse. Not only does corruption control lack effectiveness, but the development also suggests the long-term character and strong roots of corruption in these countries. The corruption control indexes for the Czech Republic deteriorated during the entire monitored period. The CR is on the 23rd place and is ahead of Latvia and Poland only.

Figure 8: Corruption perception index for 2005



Source: Transparency International (2005).

Materials of **Transparency International**, a private non-government and non-profit organisation that has engaged in the fight against corruption on a long-term basis, are used as the first supplementary source. TI annually publishes the Corruption Perception Index (CPI) for an increasing circle of countries, allowing international comparison. Figure 16 states the current values for corrupt environments in individual countries and table 19 shows development of CPI during 1999–2004.

Figure 8 arranges the EU-25 states in an order from the least to the most corrupt countries. Transparency International considers situations when the CPI value is less than five points cases with corruption out of control. The Figure shows that the average corruption index value for the EU increased by more than one point after the new member states joined the EU and that the average CPI value for the new member states is just above the critical threshold of five points (5.08) and when Cyprus and Malta are excluded, the average value for post-communist countries falls below this threshold (the EU-8 average is 4.81). Greece is the only one of the EU-15 states with the value below the critical threshold of five points and Italy achieved a borderline value. The group of countries with strong corruption includes the Czech Republic with the CPI value of 4.3.

Table 16: Aggregate corruption indicator

	1999	2000	2001	2002	2003	2004
EU-25	6.01	5.98	5.97	5.99	6.30	6.58
EU-15	7.58	7.57	7.55	7.56	7.71	7.69
EU-10	3.66	3.58	3.60	3.64	4.20	4.93
EU-8	4.58	4.48	4.50	4.55	4.49	4.64
CZ	4.60	4.30	3.90	3.70	3.90	4.20

Source: Transparency International (2005), own calculations.

The situation in the EU-25 states can be documented not only by the CPI value for 2005, but also on a long-term basis because the values of corruption perception for most European countries have been monitored for ten years. We can therefore examine the development of the CPI values over a longer period of time (see table 16). The table clearly shows the advantage of the EU-15 states over the new member states, especially in the EU-8 group, where no significant improving trend can be noted. Changes in the aggregate indicators over the last 5 years are very small. The Czech Republic did not exceed the critical threshold of five points even once during the entire monitored period. Although the improvement compared to 2002 is only minor, it is nonetheless commendable. The fact that only small changes occur in general confirms that informal institutions can be reformed only with great difficulties and through a long-term process.

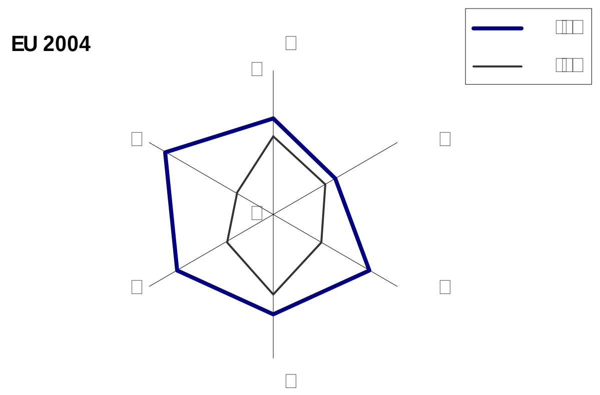
The CPI index compiled according to expert surveys is supplemented by the **Global Corruption Barometer** survey based on a public opinion poll. The purpose of this survey is to establish how people in individual countries perceive corruption, what experiences with corruption they have and what their expectations of the future development in corruption are. Transparency International carried out this survey for the first time in 2003 in 48 countries and extended the sample to 69 countries in 2005. This survey identified corruption as one of the most pressing problems the relevant countries need to solve, alongside with terrorism, unemployment and high inflation. Corruption in the Czech Republic was even placed immediately after unemployment, which is generally considered the greatest problem. Political parties with 4.0 evaluation on the five-point scale (1 – the lowest corruption. 5 – extreme corruption) are considered the most corrupt institutions, followed by the parliament with 3.7 points and the Police and judicature, both with 3.6 points. The Czech Republic differs significantly only in the opinion on the Police, which is considered as the second most corrupt institution after political parties. With regard to the impact of corruption, people in general believe that corruption influences mainly the political life, rather than conditions for conducting business or personal life. However, compared to other countries people in the Czech Republic believe that corruption significantly influences also the conditions for conducting business. The general public remains mainly pessimistic regarding the development in corruption and expects corruption to grow slightly or maintain the same level. Interesting answers were obtained to questions regarding bribes. While ten percent from all respondents from the selected sample admitted to offering a bribe during the last year, this percentage for the Czech Republic was 21. This result further confirms the low CPI index value.

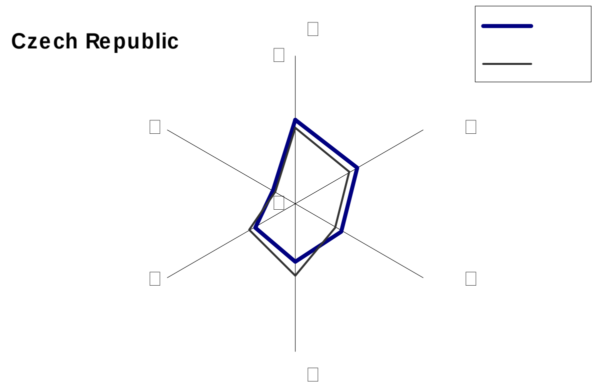
3. Dynamics of institutional changes

Overall evaluation of the dynamics of institutional changes (quality of governance) focuses on two major aspects. Firstly, the progress of the catching-up process (adjustment) in the EU-10 states in respect of the EU-15 countries, expressed by differences in assessment of individual institutional characteristics, is studied. These differences are summarised in table 17. The second aspect examines the change in the assessment of the Czech Republic between 1998 and 2004, which reflects the dynamics of institutional changes listed in Figure 9.

The table shows the rate of catching up and differences between indicators for the EU-10 and EU-15 states. The greatest differences appear especially in political stability, while smaller differences can be observed in democracy and regulatory burden. The process of adjusting in these areas is progressing well, as the EU-10 states are democratic and politically stable. In the case of the regulatory burden the problem stems from the significantly higher regulation burden in the European Union compared to other economically developed countries (such as the USA or Japan), while the indicator assesses the quality rather than the extent of regulation. This means that the gap signals wasted opportunities for transformation processes for the EU-10 states. Significant differences, whether initial or final, can be observed in government effectiveness and legal order. The assumption of relatively fast adjustment of legal orders as a result of the necessary harmonisation or legal standards in the EU-10 states prior to joining the EU has proved wrong. Similarly to government effectiveness, the time frame[5] required for serious institutional changes is of a medium-term character. Corruption control is the indicator with the worst evaluation. Corruption control represents a very serious problem for the EU-10 states and its solution requires a permanent, long-term and most importantly systemic approach. The extent of the current problems is illustrated in Figure 9.

Figure 9: Governance quality indicators GM1 – GM6





Note: The values stated are unweighted averages. Source: World Bank (2005), own modification.

Table 17: Differences in governance quality indicators between the EU-15 and the EU-10

	1998	2000	2002	2004
Voice and accountability	- 0.38	- 0.28	- 0.39	- 0.23
Political instability and violence	- 0.34	- 0.50	- 0.13	- 0.18
Government effectiveness	- 1.15	- 0.98	- 0.95	- 0.78
Regulatory quality	- 0.48	- 0.62	- 0.55	- 0.28
Rule of law	- 1.12	- 1.06	- 0.86	- 0.77
Control of corruption	- 1.45	- 1.25	- 1.18	- 1.13

Source: World Bank (2005), own modification.

[5] These relationships are explained in a greater detail in the work of Vymětal and Žák (2005a).

The progress of the catching-up process (adjustment) in the Czech Republic displays very low dynamics of institutional changes during the monitored period. On the one hand, this is caused by implementing the basic democratic and political changes before 1998. On the other hand, in the case of other characteristic this leads to the conclusion that the Czech Republic has not succeeded in adjusting promptly with regard to increasing the institutional quality.

3.1 Analysis of the dynamics of institutional changes

The approach to examining the dynamics of institutional changes is based on the theoretical concept of the comparative institutional economy, especially on the classification of five types of a capitalistic society (see Amable, 2003): market economy of the Anglo-Saxon character, socially democratic economy, Asian capitalistic model, European continental capitalism and Southern European capitalism.[6]

The dynamics of institutional changes are expressed by the change in the aggregate institutional quality indicator between 1998 and 2004, and the change in the share of public expenses in the GDP during the same period. The share of public expenses in the GDP was used as an indicator describing the level of state intervention and the related institutional burden. The dynamics in the case of the EU-15 countries are minimal and the initial data allow classification according to the models listed above. In the case of the new EU member states, very different trends in the dynamics of institutional changes leading to movement (transfer) between individual capitalistic economy types can be observed from 1998 to 2004.

Figures 10 (for 1998) and 11 (for 2004) show the positions of individual countries according to the share of public expenses as a percentage of the gross domestic product, defined as an indicator reflecting the level of intervention by the state and state institutions in economic development, and according to the aggregate institutional quality indicator. Both Figures allow identification of individual groups of the EU-15 states according to different types of capitalism because their positions during 1998–2004 remain unchanged or change very insignificantly.

The following classification of the individual EU-15 states in four types (groups) of capitalism according to Amable (2003):

- Market economies (Anglo-Saxon model) – IR, LU, UK;
- Socially democratic economies – DK, FI, SE;
- European continental capitalism – BE, FR, DE, NE, AT;
- Southern European capitalism – IT, PT, GR, ES;

The EU-10 states are not classified in these groups because their positions with regard to the transition processes are considered temporary. Changes in these positions are

[6] The theoretical and methodological basis for the analysis of dynamics of institutional changes in the international comparison arise from the key concepts of the new institutional economy, differentiated by two divisions – historic and comparative institutionalism. When assessing the significance of institutions for the economic productivity, **historic institutionalism** starts from the traditional concept of the new institutional economy. **Comparative institutionalism** works with various models of a capitalistic economy as a description of the reality and as means for finding procedures for formulating economic policy objectives in institutional quality (the quality of institutions for performing administration), with regard to the necessity of changes (institutional reforms), urgency of changes and directions of adjustment. For a detailed overview of the theoretical basis for the approaches referred to above see Žák, Vymětal (2006).

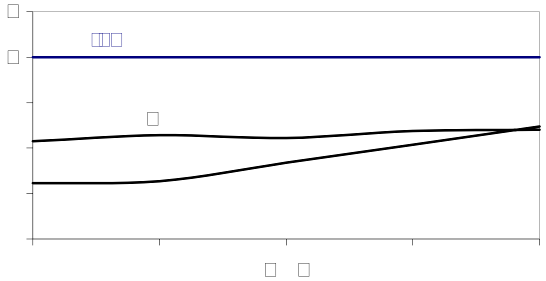
institutional and can be described according to their direction and extent.

Figure 12 shows positions of the individual EU-10 states between 1998 and 2004. The arrows illustrate the direction and their size of the dynamics of institutional changes. The following trends can be identified based on assessment of the direction and extent of institutional changes that occurred in the EU-10 states during 1998–2004:

- Six of the new member states in total display strong dynamics of institutional changes as measured by the aggregate institutional quality indicator, i.e. the share of public expenses in GDP. This group includes especially Slovakia and Baltic states (see group A of the EU-8 states in Figure 13) with clear tendencies towards the Anglo-Saxon capitalism model. The group furthermore includes Cyprus, heading from the Anglo-Saxon type to the Central European type, and Malta with tendencies towards the socially democratic system of the Nordic character;
- The dynamics of institutional changes in the remaining four countries – the Czech Republic, Hungary, Poland and Slovenia (further referred to as group B) display minor, negligible movement towards the Mediterranean capitalism;
- The Czech Republic did not record any significant institutional changes in the monitored indicators during the relevant period.

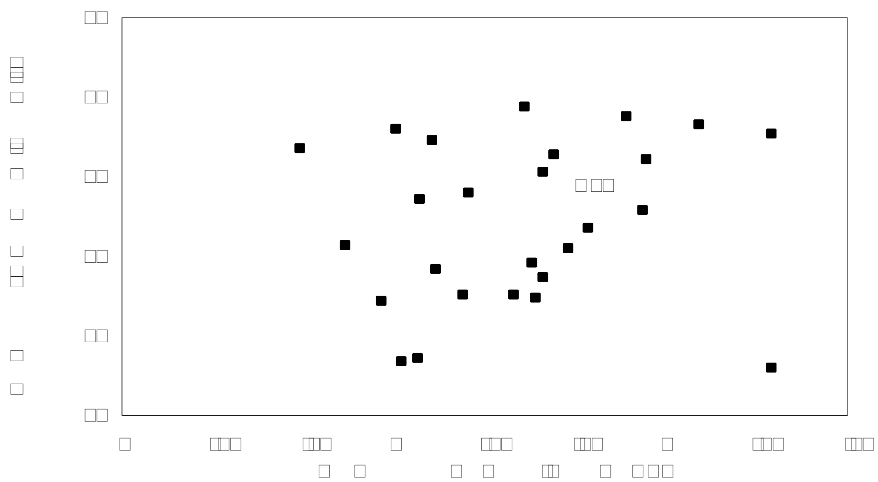
Figure 13 illustrates gradual approach of the group A countries towards the EU-15 average, while the improvement in the group B countries is minimal or non-existent.

Figure 13: Aggregate institutional quality indicator for the EU-8 compared to the EU-15



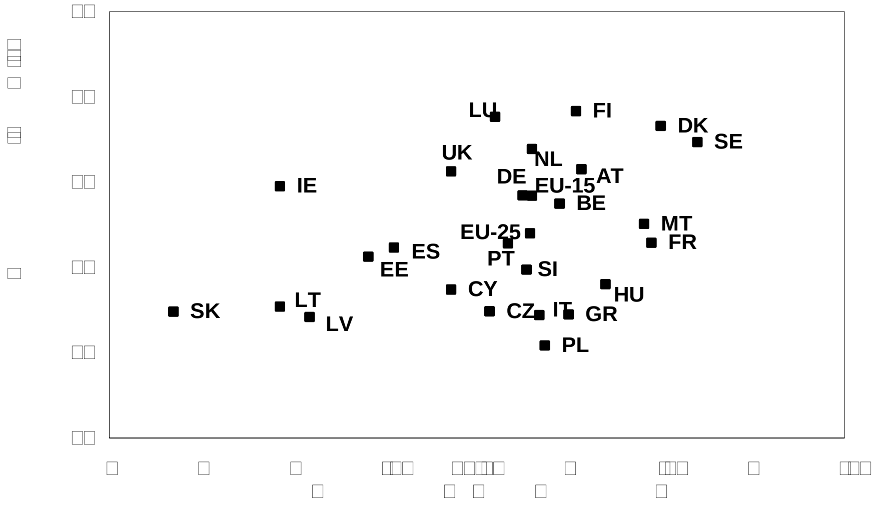
Source: World Bank (2005), own modification.

Figure 10: Relationship between the institutional quality indicator and the share of public expenditure in GDP for 1998



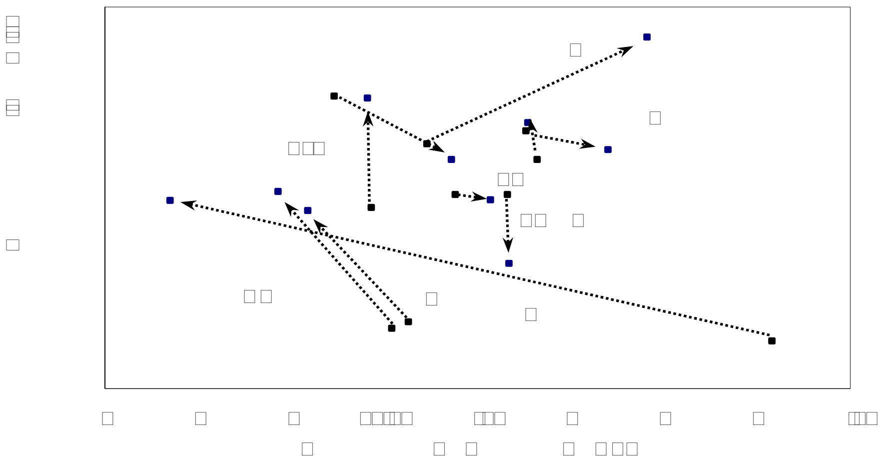
Source: World Bank (2005), the author's modification.

Figure 11: Relationship between the institutional quality indicator and the share of public expenditure in GDP



Source: World Bank (2005), own modification.

Figure 12: Dynamics of institutional changes in the EU-10 during 1998–2004



Note: Malta and Slovenia for 2000. Source: World Bank (2005), own modification.

3.2 Dynamics of changes and competitiveness

The dynamics of institutional changes in the EU-8 states reflect their overall reforming efforts. The success of alternative models of capitalism is illustrated in the assessment according to the Growth Competitiveness Index (GCI) by the World Economic Forum. The data for individual countries for 2004 is stated in Figure 14.

Table 18: Average GCI value in 2005 according to the types of capitalism

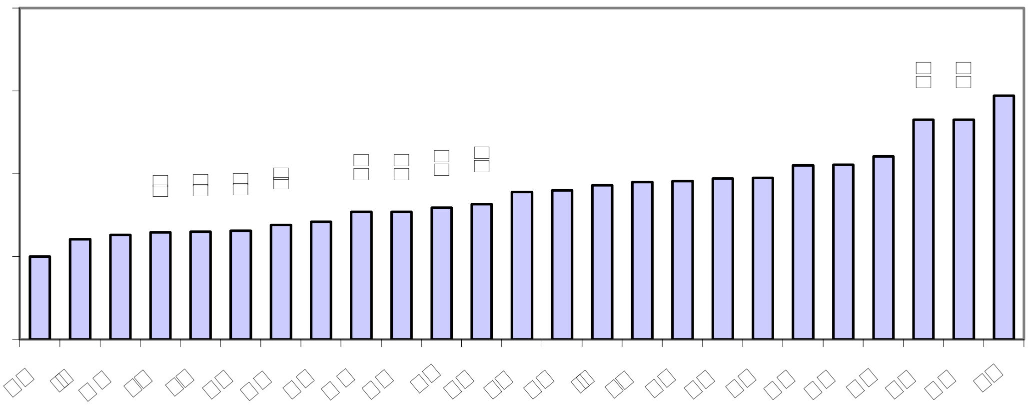
	Average GCI for group of countries
Socially democratic economies	5.75
Market economies	4.96
European continental capitalism	4.93
Southern European capitalism	4.55

Source: WEF (2004), own modification.

Table 18 states the average values for the EU-15 states according to the four types of European capitalism listed above and arranges individual countries in an order according to the competitiveness index values. The table shows a relatively significant advantage of the Nordic, socially democratic economies and a relatively significant negative difference in the countries with Mediterranean capitalism.

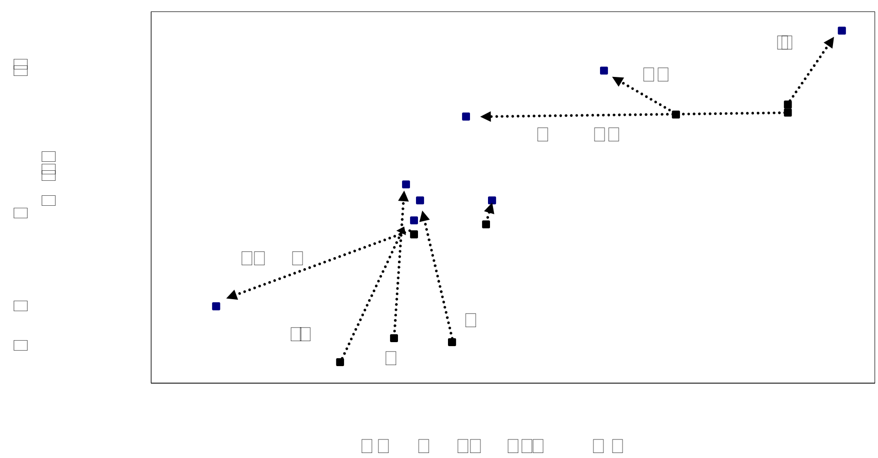
In the case of the EU-8 states. Figure 15 combines the dynamics of institutional changes during 1996–2004 with the dynamics of competitiveness between 2000 and 2004. In group A, Estonia, Latvia and Lithuania recorded a parallel increase in the institutional quality and competitiveness, while in group B the competitiveness decreased sharply. Slovakia is an exception in group A, while the Czech Republic is an exception in group B. The competitiveness of Slovakia deteriorated slightly, even though this deterioration is not significant compared to the fall in group B. The Czech Republic's position stagnates.

Figure 14: Average GCI value in 2004



Source: WEF (2004), own modification.

Figure 15: Dynamics of institutional changes of EU-8 and competitiveness (2000–2004)



Source: World Economic Forum (2005). World Bank (2005), own modification.

4. Conclusion

An analysis of institutional quality in the European Union member states carried out mainly according to materials of the World Bank (Governance Matters) and comparison of various groups of member states (EU-15, EU-10, EU-8) with the Czech Republic show that although the **institutional environment** in the Czech Republic falls short of the average for the EU-15 countries, no significant tendency towards qualitative changes occurred during the monitored period. The group of monitored indicators shows that the CR does not have any significant problems with enforcing democracy or political stability. However, the assessment of government effectiveness and regulatory quality reveals some problems. Besides lagging behind, the process of institutional adjustment in the Czech Republic is stagnating and this clearly indicates the urgent need for institutional changes.

The **quality of legal environment** in the CR is an institutional characteristic where the worst results were achieved. Desired rectification in this aspect, which should mainly include greater independence of courts, increased quality of new legislation and improved law enforceability, should ensure significant improvement in the institutional environment. This also applies to the last examined topic – fight against corruption. The Czech Republic has been assessed on a long-term basis as a country with a high **degree of corruption**. What's more, the situation in the CR is described as corruption beyond control. The long-term existence of this problem affects significantly not only the economy, but indirectly also the overall social climate in the country. The most serious problems associated with the corruption environment are found in public funds and political decision making. Although the results of all completed studies predominantly have a character of soft data and need to be perceived as such, they clearly show the following: given the general consensus regarding the impact of the institutional environment on performance and competitiveness of the economy, the Czech Republic faces a major challenge in the urgent need to cultivate the local institutional environment.

Various types of capitalist societies can be identified from the perspective of **comparative institutional economics**. The following classification can be applied to the European Union member states: market economy of the Anglo-Saxon character, socially democratic economy, European continental capitalism, and Southern European capitalism. The completed analysis of the quality of governance in EU-25 countries confirms that this classification of different types of capitalism can also be applied in connection with institutional quality. The development of institutional characteristics in EU-15 countries, which can be described as relatively stable, matches individual countries on a long-term basis to particular types. However, significant institutional changes can be observed in certain EU-10 countries, where the dynamics of institutional changes affect the classification of particular countries under the types listed above. Individual types of capitalism are characterised by different levels of competitiveness. The dynamics of institutional changes in EU-10 countries lead to the movement of most of these countries between individual types of capitalism and their subsequent transition to different conditions for competitiveness. The Czech Republic did not display any significant institutional changes during the monitored period. The CR can be classified under Southern European capitalism with regard to its institutional quality, i.e. a type of capitalism characterised by the lowest level of competitiveness.

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