Authors: Jessica Larsson 21154
         Julie Rondeau 21219

Stockholm School of Economics
Department of Economics

Institutional Quality in the Eastern European and Balkan Countries

Investigating economic performance, institutional quality and party membership in international political organisations

This thesis investigates the hypothesis that governing parties are positively affected by their membership in international political organisations which gives rise to better institutional quality and economic growth. We use a combination of quantitative and qualitative analyses on empirical data of 25 transition countries in the Balkans and Eastern Europe. Conducting a cluster analysis, our observations show a positive relationship between economic stability and institutional quality in the chosen countries. The resulting clusters form the base for a discussion and validation of the mentioned hypothesis. The methods of this thesis are intended to be general enough to provide the base for further discussions concerning the possible components of institutional quality.

Table of Contents

1. Purpose of the thesis

The effects of institutions on economic growth has for long been a debated topic. In recent years, the importance of institutions for economic outcome appears to have become an established fact. Indeed, it has been shown that institutions play a central role in influencing a country's economic performance (Acemoglu, Johnson & Robinson, 2004). The wide meaning of the term institution is in this context a source of discussion. North (1990, p.3) offers the following definition:

> Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic. Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change.

This definition has been well approved by researchers from many fields and implies that institutions are structures and mechanisms of social order governing the behaviour of society. The definition in itself displays the importance of institutions for economies in a transition phase, since institutions are the foundations of modern society. There is therefore great value in studying the components of institutions in order to, in a next step, determine how and by what means institutional quality can be improved. This thesis takes a step in that direction by testing the hypothesis that party membership in international political organisations for the governing parties in the Balkan and Eastern European countries affects their institutional quality. This is based on an empirical study of the correlation between institutional quality and economic growth.

Membership in international political organisations also appears in the context of democratic aid. In Sweden, this type of aid is a well debated political issue. Aid organisations often work by helping political parties achieve membership in international organisations, with the intention that the reforms undertaken to achieve such membership will lead to a more democratic state. From an institutional perspective, such reforms should also lead to an increase in the quality of political institutions within the country. Because the effects of such development are only apparent in a long term perspective, the outcomes are questioned. A study of the connection between membership in international political organisations and economic development may contribute to this debate.

2. Earlier studies

Institutions and their influence on long-term growth is a well written about topic. A multitude of potential determinants of economic performance have been tested and theorised with the purpose of explaining the prevailing per capita income differences between countries (Kourtellos, Stengos & Tan, 2009). Institutions have recurrently been highlighted in writings and research as a major factor affecting countries' economic growth. Findings by Acemoglu, Johnson and Robinson (2001) are considered a benchmark in this field. In their paper, they investigate the differences in European mortality rates in colonies to assess the effects of institutions on economic growth. Europeans adopted two different colonial strategies influencing institutions, depending on the mortality rates they faced. Where settlement was possible, Europeans developed institutions that encouraged investments, whereas in the colonies where the conditions for survival were unfavourable, they instead set up extractive states. The research reaches the conclusion that differences in colonial experience could be an important determinant of today's differences in institutions and economic growth. These results are confirmed in the work of Rodrik, Subramanian and Trebbi (2004) who estimate the contributions of institutions, trade and geography on income. The paper shows that once institutions are controlled for, trade and geographical factors are relatively insignificant and only have a weak direct influence on growth, while having a strong indirect effect by influencing the quality of institutions.

These findings created strong reactions amongst researchers in the field. Sachs and McArthur (2001) specifically respond to the first three authors. According to them, the work of Acemoglu et al. (2001) presents some limits which create bias in their evidences. The small sample of ex-colonies and the limited geographic dispersion of those countries are such limits. In their paper, Sachs and McArthur (2001) use the same data, but expand the number of countries used for their regression analysis and show that, contrary to the previous findings, geographic factors are robustly correlated with economic performance. They do not reject the hypothesis of the effect of institutions on growth, but they emphasise the influence of geographical factors. In a later analysis conducted as a response to Rodrik et al. (2004), Sachs (2003) demonstrates the direct effects of geographical factors on per capita income with a concrete example of malaria, contradicting former studies.[1]

---

[1] Rodrik, Subramanian and Trebbi wrote their paper in 2002 but published it first in 2004, which is the one referred to here.

Nonetheless, the author does not neglect the influence of institutions but comes to the conclusion that there is an underlying and complex interaction between institutions, geography and many other factors that affects the countries' economic performance. These findings are also confirmed by Kourtellos, Stengos and Tan (2009).

The importance of the institutions as determinant for differences in growth between countries remains a central and approved debate. As discussed, the writings on this topic offer substantial evidences that institutions are an essential component of economic growth. The ongoing "Institutions vs. Geography debate" (Kourtellos, et al. 2009) focuses predominantly on investigating the determinants of economic growth and more precisely how institutions affect per capita income compared to geographical factors. Knowing the influence of institutions on economic performance, investigating what factors affect institutions appears to be appropriate.

The existing studies aiming at understanding institutional quality itself are extensive and varied. Acemoglu and Johnson (2005) take a step towards exploring potential variables influencing institutions, specifically property rights and contracting institutions, but their paper is intentionally limited, leaving the need for further research (Acemoglu & Johnson, 2005). Furthermore, researchers point out that most of the papers mentioned use an aggregated value for institutions. This implies that the term of institutions as it is used in these studies is comprised of multitude components such as legal, political and social institutions. This method is debated to be subjective and ad hoc (Jellema & Roland, 2002).

Concerning literature on the specific effects of political and democratic institutions and the variables of which they consist, Acemoglu, Johnson and Robinson (2004) have somewhat touched upon this topic. They tackle the discussion from a new viewpoint, investigating the influence of political institutions on the emergence of economic institutions. They develop empirical evidence and theories that show that economic performance depends on a country's economic institutions. The discussion is taken a step further by demonstrating that these institutions are based on political institutions, which introduces a new perspective to the previous arguments. Their paper stands foremost as a framework and consequently, there is still much to investigate about how the quality of institutions can actually be improved. Jellema and Roland (2002) focus their paper on researching which of the existing components within the aggregated value for institutions is most important for

economic growth. Using multiple regression analysis, they demonstrate that institutions of checks and balances are the major determinants for long term growth, as well as a democratic and anti-authoritarian culture. More recent research also confirms the importance political and democratic institutions. For example, in his foreword for the European Bank for Reconstruction and Development's (EBRD) transition report (2009), Berglof states that, over time, understanding of transition has improved due to the growing understanding of the importance of institutions promoting democracy and governance.

What most papers leave out in the field of institutions is a discussion of what factors, in turn, affect the different components that are proven important within the concept of institutional quality. In this paper, we aim to formalise the findings of previous authors on the importance of political institutions, by discussing the effects of party membership in international political organisations. It can be debated that it is too early to conduct research in the field. Nonetheless, there is value in an investigation of what factors affect institutions within a country, since the concept has been proven important both for transition and for development. Previous findings within this field are by now extensive enough to render us a base for a discussion about more qualitative theories about the less explored factors.

3. Question formulation

There are several assumptions that have to be made in order for us to examine the causes of institutional quality and draw accurate conclusions. First, institutional quality is assumed to be an existing, measurable and analysable concept. Based on the fact that legitimate literature in the field of economics attempts to investigate the effects of institutional quality on economic growth, we assume that institutional quality is a valid concept. This leads to a second assumption. In order to give meaning to our research on the causes of institutional quality, we place the concept in a context, which is that it does, indeed, have an effect on economic growth. The reason for conceptualising the thesis in this manner is to achieve a more reasoned argumentation and analysis. By placing our questions in an existing theoretical context, we can achieve meaningful answers that are applicable to more general purposes. It is not within our purpose to investigate whether or not the method for measuring the institutional effects on economic growth is accurate and reasonable. Instead, we make a third assumption that previous literature on the topic, mainly the work done by Acemoglu, is reliable and consistent.

To move our thesis in the direction of an investigation of possible factors affecting institutional quality our principal question is:

What factors influence institutional quality in the Eastern European and Balkan countries?

In order to achieve a valuable analysis of this question we must identify countries where institutional quality can be thought of as the reason for economic changes, which is why it specifically states Eastern European and Balkan countries. The intention of the first part of our analysis is to group the studied countries according to their development based on the interdependence between the variables of institutional quality and economic growth. To enable us to generalise our findings to broader statements, we strive to discover groups of countries that are representative for further research and can be used as empirical evidence of whether a connection between institutional quality and economic growth exists. This leads us to the following two questions:

Is there a relationship between the GDP growth and the Institutional Quality Index in the Eastern European and Balkan countries?

Are there any representative cases from which we can draw general conclusions?

We further aim to single out a factor based on existing literature and our analysis in order to discover whether this chosen factor has any effect on the countries' institutional quality. We conduct this part as a detailed discussion on its validity and effects on the quality of institutions. Existing literature on the topic (EBRD, 2009, Jellema & Roland, 2002) investigate components of institutional quality. These studies come to the conclusion that democratic variables have the greatest effect on institutional quality and the development of institutions in a country. Assuming these studies are valid, we identify democratic variables as suitable for the purpose of our thesis. We add a new and angled perspective to the discussion on the potential causes of institutional quality by identifying the variable *party membership in international political organisations* as our variable of study. Because of the results in existing literature on the great effects of democratic institutions on institutional quality, and assuming democratic development is directly dependant on governmental action, it is of great interest to study the attributes of this variable for the ruling parties within our selected countries. Our principal hypothesis is thus:

The governing parties are positively affected by their membership in international political organisations which gives rise to better institutional quality.

This hypothesis is based on the assumption that democratic governing is rooted in the western way of handling politics. Given the above, we narrow our question to:

Does party membership in international political organisations affect institutional quality?

Given this hierarchy of questions, we construct a dual thesis. The first two questions lead to an inductive working process where our analysis is based on a set of observations and investigates what trends, intuitions and theories the empirical data provides. The empirical findings from the inductive part of the analysis generate the need for a deductive working process in the second step of our thesis, in which we aim to conceptualise and theorise the causes of institutional quality. Contrary to the first part's questions, the deductive questions are formulated as hypotheses.

4. Delimitation

In order to obtain a focused thesis there are several delimitations that have to be noted.

4.1 Countries and region chosen

First, we must make a choice about which countries we aim to study and use as the base for the empirical deductive investigation. There is a choice made about the region of study and the decision to eliminate countries within that region, in order to obtain the optimal sample for the purpose. The 25 countries observed in this paper are all in partnership with EBRD. EBRD is an international organisation investing in the establishment of market economies and democracy in 29 countries in Eastern Europe. The reason for choosing these specific countries lies primarily in our goal to find a pattern, and therefore a need for similarity among the countries. Given the historical background of the region we ensure similarity in multiple aspects, which contributes to a more accurate analysis, especially in its first part. Furthermore, in order to produce a valid and comprehensive study on the potential factors influencing institutional quality, there is a need to study countries in a transitional phase, experiencing changes in institutions, which also renders the region eligible. The countries in these regions have reached different stages in their development, which suggests opportunities of identifying different groups in line with the investigation of representative cases. It also suggests that

there is a reason behind the differences in development which we intend to look deeper at. Moreover, these regions are well documented by Swedish and international organisations. Politically, Sweden is well involved in the progress of these regions and countries, which facilitates the access to precise and updated information and gives us an opportunity to gain accurate insight in the variables we aim to examine. EBRD is also an organisation which has well documented progress records of these countries through its annual reports. The development of the region is recent enough to have data and values that are of high quality (See the discussion under Data), which is valuable. The central questions asked in our thesis, specifically the ones in the qualitative analysis, benefits from the quality of the data gathered.

Four of EBRD's countries are consciously omitted due to several missing values in both the GDP and Institutional Quality Index measures, mainly because of the numerous civil wars in the area. Bosnia and Herzegovina, for example, suffered from a dramatic civil war between 1991 and 1995, which prevents honest statistic calculations. Difficult conditions in Estonia, Turkey and Mongolia force us to also drop these countries because of too many missing values. Why we drop the countries instead of introducing a missing value is because trying to reconstruct the data could be misleading. Besides, the method of cluster analysis is sensitive to missing values. Nevertheless, we must be aware that dropping some countries could harm our conclusions, but because of the great number of remaining countries, the probability that this happens is considered relatively low.

4.2 Time period

The second object of delimitation is the time period studied. In this thesis, the analysis is done over a specific period of time that stretches from 1991 to 2008. This period is the most appropriate time for our purpose as it covers a recent period and therefore data is easily gathered, but mainly because it is interesting in terms of transition for the countries in question in our analysis. The dissolution of the Soviet Union in 1991 forced the Eastern European and Balkan countries to autonomy, implying extraordinary changes for all sectors and thus their economic growth and institutions.

The values for 2009 have at the writing moment not yet been summarized and are primarily estimates. There is no reason to take 2009 into account due to this uncertainty factor. Again, since the aim is to find general cases it is of greater importance to have accurate measurements that are comparable than to have estimates that are likely to change. Such values would distort the end result

of our cluster analysis. Furthermore, the aim of the first part of our analysis is to decipher and depict a trend in the connection between institutional quality and economic growth, for which estimates could also cause biased results.

4.3 Variable of study

Delimitations have also been done regarding the studied variables. Only party membership in international political organisations has been picked as the base for the deductive discussion. This delimitation is made due to the difficulty of accounting for all possible influential variables. An attempt to do so is likely to give raise to a decentralized thesis. Thus, centring our analysis on one variable creates a more focused procedure. There is value in keeping the search narrowed to obtain more valid results and reach conclusions that are applicable to more general analysis on the causes of institutional quality.

Party membership in international political organisations has been chosen as a valid investigation variable based on existing literature about strong effect of democratic variables on institutional quality. Furthermore, the political interest in the issue from the Swedish government and Swedish governmental aid contributes to the interest in the question. These reasons are also reasons that render the question relevance and value, which is, as stated above, a difficulty. We will still, attempt to continuously identify the lacking account of these variables and where it is important to bear in mind the shortcomings and delimitations of this thesis.

We aim to maintain a general method by which other variables can be tested according to the same method in future studies. We believe that by focusing on only this variable we will have a greater chance to identify causes of links credibly.

5. Method

In order to investigate what variables influence institutional quality in the Balkans and Eastern Europe, we conduct our work in two steps, starting with a cluster analysis followed by a qualitative discussion. The nature of the first part of the analysis will be inductive. The discussion that follows will be based on deductive reasoning.

5.1 Inductive analysis

In the first part, our primary goal is to categorise the chosen countries into homogeneous groups, to allow us to investigate a potential correlation between their GDP growth and Institutional Quality Index (IQI). The inductive method is the most appropriate approach as it implies a working process where we move from specific observations to broader generalisations and theories. The phenomenon observed is the potential relation between GDP growth and IQI in the Eastern European and Balkan countries and we intend to draw conclusions about this relationship. The findings from the observations are then used to make broader statements and assumptions about the relation between a country's growth and the quality of its institutions.

Our purpose is to search for patterns and relationships between the countries' GPD and IQI based on data collected from EBRD's annual reports on transition economies and from the World Bank's database. The data is then processed to obtain an appropriate sample of values. As discussed in the delimitation section, several countries in the region display missing values for either their GDP growth or IQI, mainly due to civil wars. Trying to reconstruct the data could be misleading and we therefore choose not to take these countries into account.

There are several possible models to apply when investigating the relationship between institutional quality and economic growth. In our analysis, we use a four field diagram as starting point. The purpose of this diagram is to classify countries into four representative cases, i.e. cases that have general enough values to represent a group of countries, according to thei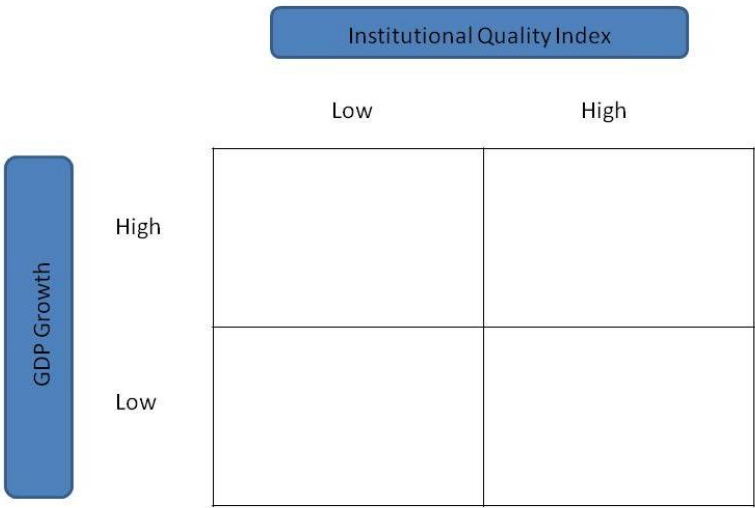r level of economic growth and institutional quality. The limitations of this method arise in the classification stage. A dilemma in this type of diagram is the

Diagram 1. The Four Field Diagram classifies the countries into four typical cases

definition of the boundaries to each field in the diagram and the resulting need of judgement in determining what values are to be considered low or high. On what basis should a decision of what is low and what is high growth or institutional quality be made? Whichever subjective assumptions we device for such a classification, the outcome of the four field diagram will be biased due to that classification system. A further problem, one that arises from the classification issue, is that it is somewhat controversial to classify these variables by the proposed method due to relative accomplishments within each country. That is, in one country a value can be considered relatively good, compared to historical values, but in comparison to another country the value is deemed as low. Our classification system if using the four field diagram will not be apt to account for such discrepancies.

Due to the limitations of the four field diagram, a cluster analysis is conducted to sort the countries into homogeneous groups with respect to their GDP growth and IQI. Unlike many other statistical procedures, the cluster analysis method is mostly used in the exploratory phase of research without a priori hypotheses, which is appropriate for the inductive part of our analysis. The method has three further advantages. Contrary to the four field diagram, the cluster analysis removes the controversy connected to defining the boundaries of the four fields. The second advantage is that the clustering method is able to provide the general cases that exist within a sample, without being bound to producing four groups. For example it is plausible that one box of the four field diagram is empty. Finally, there is greater value in analyzing the change in the variables rather than the absolute value of the two variables at a given moment, which is more easily done with the cluster analysis than the four field diagram. However, cluster analysis simply discovers structures in data without explaining or interpreting why they exist.

Ward's method is the method used when conducting our hierarchical cluster analysis. Hierarchical cluster analysis is the most appropriate when the sample is small (typically less than 250) and the researcher wishes to establish categories and analyse its membership, without knowing in advance the number of groups (Maholtra, 1995). Since we seek to identify homogeneous categories of countries without having any clear hypotheses as starting point, conducting a hierarchical cluster analysis is the most suitable. The Ward's Error Sum of Squares method seeks to identify a set of groups which both minimise within-group variation (i.e. error sum of squares) and maximise between-group variation. We apply the Squared Euclidean Distance as the similarity measure, which

helps us determine the recommended number of clusters we should work with. We do not use the simple Euclidean Distance because we want to place successively greater weight on the countries that are less similar from each other. The resulting cluster analysis enables us to make hypotheses regarding the relation between the GDP growth and the IQI in the Eastern European and Balkan countries. Unfortunately, it is important to remain aware of the degree of uncertainty existing in these conclusions. The suppression of the four countries can affect our theories. Moreover, the theories elaborated refer only to Eastern European and Balkan countries and applying them to the rest of the world should be done with precaution.

5.2 Deductive analysis

The second part of the analysis is based on the findings of the inductive part. The resulting clusters form the base for a discussion on the concept of institutional quality and the effects it has. The second part, in contrast to the first, follows a deductive method of analysing aiming to reach qualitative results. What characterises this type of reasoning is that it starts from the other side of things compared to the inductive. This implies that general theories are taken as starting points and then the analysis moves towards more specific theories in the process of analysing. We use the existing theory about the effects of separate institutions (such as legal, political, social) on the overall value of institutional quality, which states that political institutions, and especially democratic institutions, are the strongest determinants of long-term development (Jellema & Roland, 2002). The studied effects of political institutions on transition countries support these theories (EBRD, 2009). Based on these theories, we conceptualise our hypothesis and examine its validity to reach a potential confirmation. The central hypothesis in this part of the analysis is that party membership in international political organisations has positive implications for countries' institutional quality. Narrative examinations of the implications of this hypothesis and comparisons between the groups obtained in the first part of the analysis are used in order to understand the questions and theories that we propose.

We begin by choosing two clusters out of the groups of countries provided by the inductive analysis that appear to be the most controversial in their trends and extremes to one another. This is in order to base the discussion on data that is significantly different to be able to clearly observe the hypothesised effects of our variable. The discussion is then based on an investigation of whether or not the countries that appear in our two chosen clusters display the hypothesised characteristics. The

overall discussion is based on an investigation of whether or not the countries in question have ruling parties that are members in an international political organisation. Next, we define which memberships we consider to be relevant. The observed organisations are strictly political in nature. What we define as political, in turn, are organisations that concern ideological development and parliamentary organisation. We collect data for each of the parties in government in each of the countries of observation. The data consists of observations if the party in question is a member primarily of international organisations such as International Democratic Union (IDU) and Socialist International (SI), or their European equivalents, the European People's Party (EPP) and the Party of European Socialists (PES), which are the largest international ideological organisations. Since we do not want to dismiss parties as non-members only because they are not members of internationally related political organisations, we also look for memberships in regional political organisations. This, since we believe that the variable could have an effect even if the organisation is smaller than international scale.

Based on the results of this data we draw conclusions about the importance of the variable and its effects on the quality of democratic institutions, as well as provide a more general discussion on the purpose of the variable. We conclude our qualitative part with a discussion about future questions concerning the limits of this thesis, both in its definition of the variable itself and the use of the presented method.

The choice of having a qualitative discussion is due to the complexity in measuring and clearly defining what institutional quality is and what factors appear to be influential. Determining institutional quality requires legitimate judgement and the existence of informal institutions, particular to each country, makes it even more difficult. This prevents us from doing a valid statistical analysis. Nevertheless, it is important to point out the subjectivity present. Since we do not use any quantitative methods in this analysis, the conclusions we draw are based on a method that we try to keep as general as possible.

6. Data

The data used to carry out the first part of our analysis is quantitative. To perform the cluster analysis we compile data from the EBRD and the World Bank. For each country we collect the Institutional Quality Index and the GDP growth between 1991 and 2008 to create our personal

database. Differences in timing and reporting practices may cause inconsistencies among data from different sources, which is the reason for not combining data from other sources. If GDP is a satisfactory measure of growth is widely debated. GDP has several limits which distort the findings if it is interpreted as measuring welfare. In fact, GDP measures income but not equality and ignores values like social cohesion and the environment (OECD Observer, 2004). Yet, the reason for why we choose this measurement is because we take previous findings done on the topic as a starting point, (Acemoglu et al., 2004, Rodrik et al., 2004).

The variable institutional quality is represented by a large number of indicators in an attempt of studies and organisations to obtain a representative aggregated value. The Institutional Quality Index we use in our thesis is computed by EBRD as a mean of fourteen so called Transition Indicators (See Appendices). The organisation assesses progress in transition through a set of transition indicators, which have been used to track reform developments in all countries of operations since their beginning of transition. The measurement scale for the Institutional Quality indicator ranges from 1 to 4, where 1 represents low quality and often a high degree of corruption and 4 represent high quality. The reason for choosing EBRD's index as the representative indicator for institutional quality is that the organisation has developed a methodology to compute this index specific to the countries we analyse. The variables used as determinants for the index can largely be discussed, but the major advantage is the long-term partnership between EBRD and the studied countries, which enables the organisation to deploy an accurate index. We could include more factors as determinants for institutional quality but given the purpose of our thesis and the chosen region, the most appropriate is to use an index that is constructed specifically for the analysed countries.

The World Bank's GDP growth calculations are considered reliable data since they follow a precise and widely used method when computing. The Data Quality Assessment Framework has been developed by the International Monetary Fund (IMF), in collaboration with the World Bank, as a method for assessing data quality that brings together best practices and internationally accepted concepts and definitions in statistics and the calculation of GDP. Even if updates and revision over time may introduce discrepancies, the organisation attempts to present data that are consistent in definition, timing and methods. It is however worth pointing out, that there is a difference in quality between the GDP growth measurement and the IQI. Unlike the GDP measures, there is no experienced methodology for computing the IQI. This is mainly due to the difficulty in measuring

institutional quality and finding adequate components. The factors composing the IQI have been chosen arbitrarily by EBRD and even though EBRD is a serious and well-recognised organisation, being cautious is essential when working with this type of data. Also, the importance of informal institutions makes the index incomplete. The incorporation of such institutions in the index measurement requires detailed knowledge of each country. Moreover, working through our database also necessitates specific qualitative information on the countries with missing values in order to determine the cause. This step demands knowledge about the countries' historical background. The Swedish National Encyclopaedia and Jarl Hjalmarson Foundation's reports provide reliable information and are used to sort the countries.

To conduct the discussion on the deductive analysis, we use qualitative data. Existing theories on the importance of separate institutions, and the conclusions that political institutions are the most important, validate the choice of our variable of study; party membership in international political organisations. The papers of Jellema and Roland (2002) and Acemoglu and Robinson's conclusions (2006) point out the importance of political and especially democratic institutions for long term economic growth and performance. Together with reports written by the EBRD (2009) on the importance of institutions for transition, we obtain a framework for the hypothesis.

There is also a need for quantitative data in the deductive analysis. Testing our hypothesis requires knowledge about the different international political organisations and their members to conclude whether or not a given country is a member. This is available on the websites of each organisation. Information on the chosen countries' historical background is used for further discussion of the effects of the variable and the institutions it is correlated with, which is obtained from the Swedish National Encyclopaedia and the Jarl Hjalmarson Foundation. Caution and a critical perspective are needed when handling the type of information in our analysis due to possible distortions, especially if corruption in a given country is high. We try to perform our research through international databases or encyclopaedias to get around this issue. Contrary to the GDP growth and IQI, it is essential to examine many sources of information in order to get a broader perspective. Lastly, these sources are also used in the general discussion about the context of the variable in each country and in a broader perspective on democratic aid, used to briefly place our thesis in a context.

7. Analysis

7.1 Quantitative analysis

The purpose of our quantitative inductive analysis is to investigate the potential existence of a relationship between the GDP growth and the Institutional Quality Index in the Eastern European and Balkan countries. In the empirical data gathered, we then look for any representative cases from which we can draw general conclusions.

7.1.1 Cluster analysis

In order to find accurate responses to our questions, we classify the countries into homogeneous groups to enable an investigation of possible patterns in the countries' economic development. The four field diagram is the starting point of our analysis and gives us the framework for our investigation. As described earlier, through the four field diagram we wish to characterise the countries into general cases. However, the cluster analysis removes the limitations of the four field diagram by organising the observed data into meaningful structures. The cluster method provides structures based on which classification of the countries into groups that fit the four field diagram is possible.

Based on the two variables, GDP growth and IQI, the cluster method categorises the countries in the data set as displayed in the hierarchical tree to the right (Diagram 2).
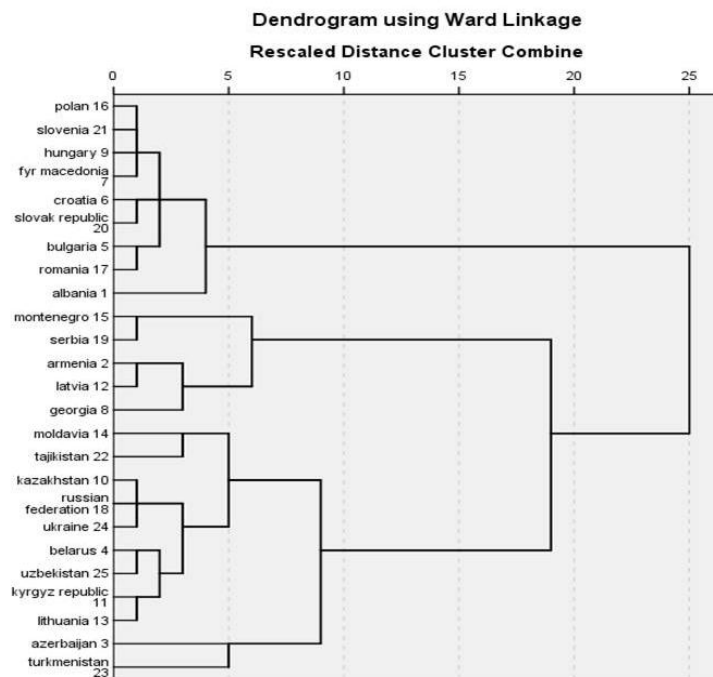

Diagram 2. The dendogram classifies the 25 countries into clusters.

15

Ward's clustering method starts with n clusters of size 1, as shown on the left vertical axis in the dendrogram. Here, n is equal to 25. Next, the two countries that are most similar are put into a cluster. This process is repeated until all the observations are included into one single cluster. Moving to the right, from the leaves to the trunk so to speak, the criterion for belonging to a certain cluster is relaxed and the boundary where to declare countries to be members of the same cluster is lowered (Wahlund, 2010). When the right vertical axis is reached, all the countries belong to the same cluster. The horizontal axis represents the linkage distances and the vertical lines represent clusters that are joined together. The position of the line on the scale indicates the distances at which clusters were joined.

7.1.2 Delimitation

The hierarchical clustering allows us to select a definition of distance and determine how many clusters best suit the data. The coefficients in the Agglomeration Schedule (See Appendices) are rewritten to disclose the changes in the coefficients as the number of cluster increases. These are shown in Table 4. There appears to be a clear demarcation point between cluster 3 and cluster 4, as the coefficient suddenly increases largely. Three groups appear to be suggested by the coefficients of the cluster analysis given that the change in coefficient slows for the following cluster. Delimitating at three clusters implies delimitating at a variance of 10.

No. of clusters	Agglomeration last step	Coefficients this step	Change
2	19 544	14 235	5 309
3	14 235	10 368	3 867
4	10 368	8 630	1 738
5	8 630	7 405	1 225
6	7 405	6 334	1 071

Table 1. Re-formed agglomeration table.

Nevertheless, for the purpose of our thesis, we choose to base the analysis on a partition of the countries into four clusters, at a variance of 6. The reason for this delimitation, at a lower variance than suggested by Table 4, is due to the purpose of investigating potential patterns between the countries. This implies a need for homogeneous groups in order to distinguish similarities and differences. Delimitation at a higher variance as suggested by the cluster analysis would generate more heterogeneous groups. In fact, dividing the countries into three clusters at a variance of 10

would have put Azerbaijan and Turkmenistan together in a bigger group despite the fact that these two countries are distinctly different in their development (Shown below in Graph 1).

This would thus defeat the purpose of the analysis. To the contrary, delimitating at a lower variance would create more homogeneous groups, but because of the small size of each cluster, the variance between the groups would be small and thus not interesting for the analysis. If the criterion for belonging to a cluster is lowered to a variance equal to 4, some countries, like Albania, would be classified in a group by itself which is also not interesting for the analysis. Yet, we need to stay aware in our analysis of the resemblance between clusters 3 and 4, since they are combined at a relatively low variance (less than ten as seen in the dendogram above).

Our partitioning at a variance of 6 results in four clusters, yielding groups of 9, 5, 2 and 9 countries as shown in Diagram 3. The validity of the delimitation in four groups lies in two aspects. First of all, as mentioned above, the size of the cluster is an important criterion for a valid categorisation where all clusters should have enough countries to be meaningful. Categorising the countries into many small clusters or few large groups makes the search for patterns difficult, since it indicates less outside heterogeneity or less inside homogeneity, respectively. Ideally the meaning of each cluster should be readily intuitive with respect to the purpose of the classification and the variables observed. In our analysis, we take the four field diagram as a starting point to our investigation which gives us the guidance for creating, if possible, four groups. The reason for using a cluster analysis is that there may not be four obvious categories. The four field diagram provides a framework for our analysis.
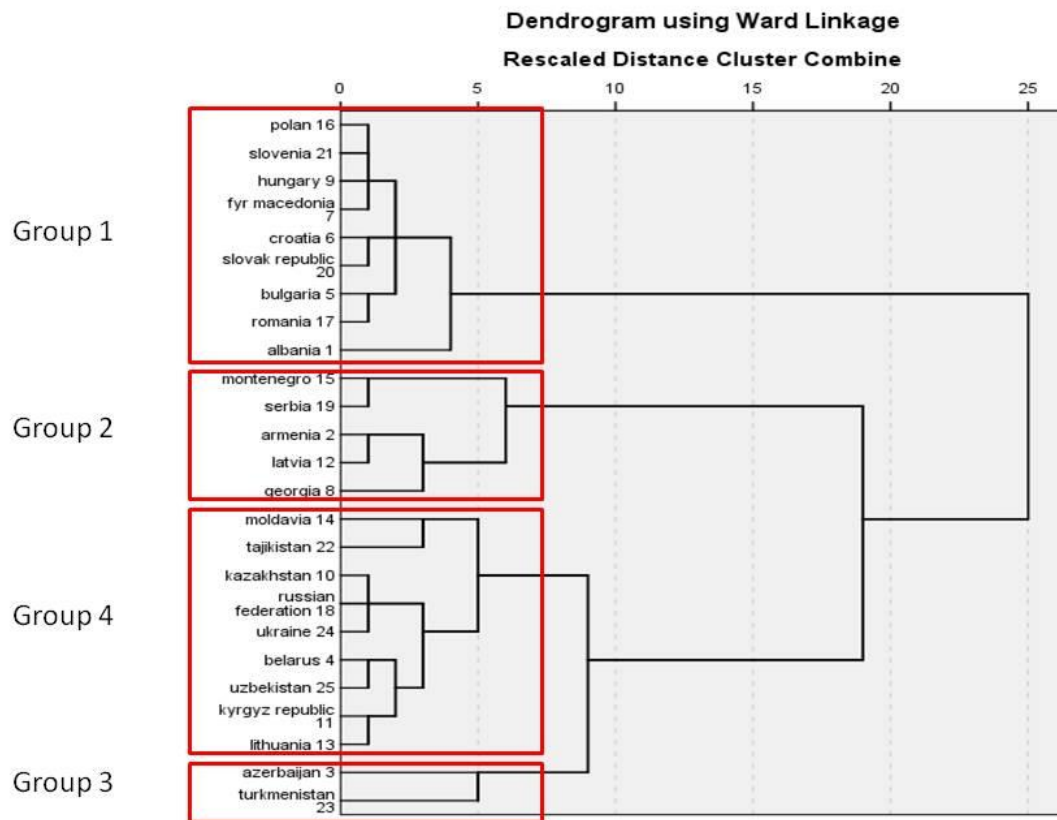
Diagram 3. The dendogram showing our partitioning in four distinct clusters.

7.1.3 Growth characteristics of the four groups

Investigating and profiling the clusters involves examining their similarities and differences. To understand why these particular groups are formed the cluster centroids are computed (See Appendices), based on each country's GDP growths. We draw graphs for the GDP growth variable from the created data to visualise the characteristics of the four clusters.
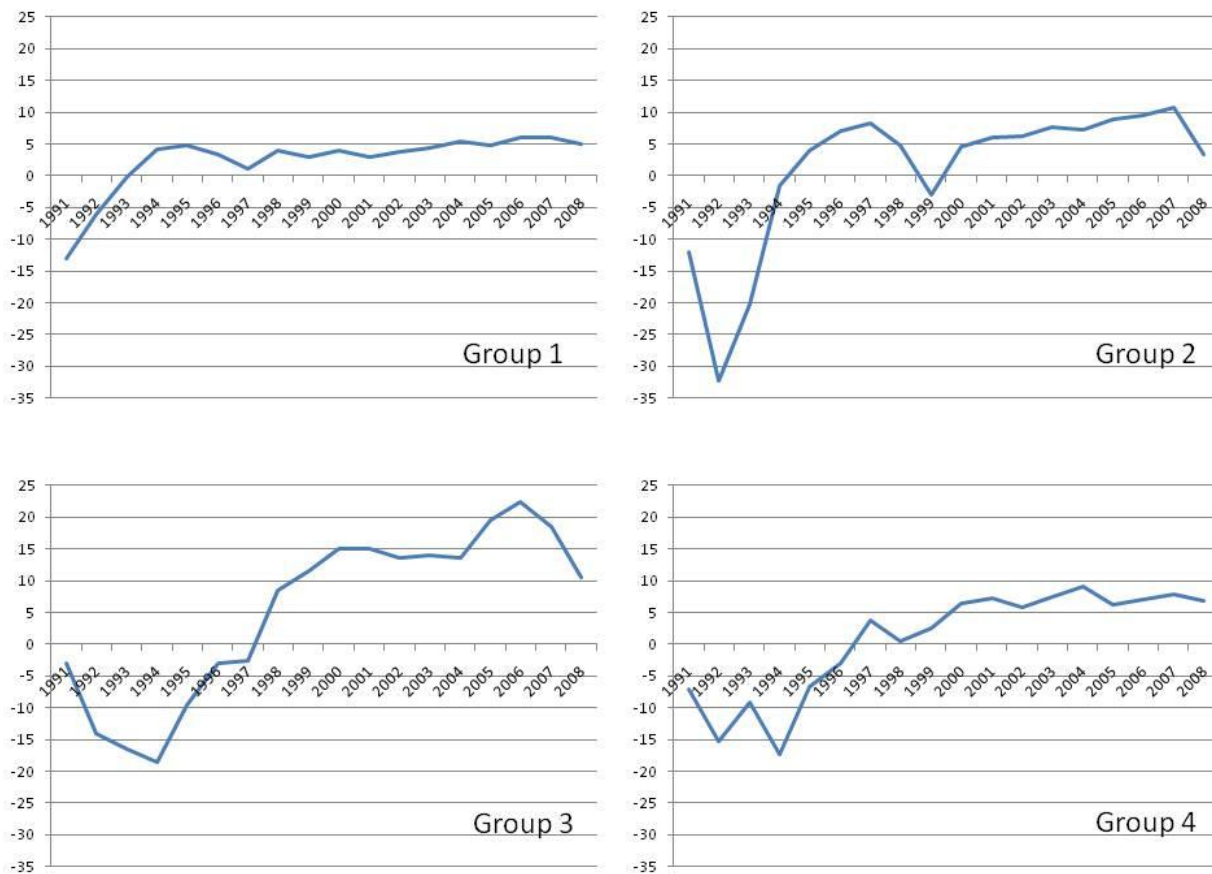
Graph 1. Graphs showing each cluster's GDP growth centroids, computed from the Agglomeration Schedule.

The general trend emerging from the above graphs can be divided into two distinct phases: a post-Soviet period and a recovery period. The post-Soviet period is characterised by negative GDP growth and takes place approximately during the first half of the nineties. The following recovery phase is characterised by increasing GDP. All four groups appear to have passed through these two stages, but the lengths of the stages differ significantly. During the post-Soviet period, the transition progresses differently for each group of countries. The Soviet Union's collapse in 1991 introduced the newly-formed Eastern European countries into a new era, while highly influencing the existing autonomous socialistic countries[2]. The changes that followed the disintegration led to a post-communist depression with a decline in production, increasing inflation and unemployment in the majority of the socialistic countries (Milanovic, 1998). The impact of the depression is especially

---

[2] By socialistic countries we in this context refer to non former Soviet countries, but these countries were indirectly influenced by the Soviet Union and communism.

apparent in the GDP growth of groups 2, 3 and 4. The first half of the 1990s is characterised by precipitous falls in GDP growth followed by rapid up goings, though constantly with a negative statistic, whereas the second period of recovery is characterised by increasing GDP.

Group 1

As shown in the figure above, Group 1 has experienced a relatively rapid recovery and achieved relative economic stability only a few years after the Soviet Union fell. The cluster's GDP growth is negative only in 1991 and 1992. What is noticeable about Group 1 is that none of the countries in this cluster are direct former Soviet countries, which may explain why the collapse appears to have had minor consequences compared to the effects displayed by the other three groups, and thus also the group's relatively positive economic development. Even if the countries were influenced by the prevailing crisis, these countries did not face the same transition epoch as those who gained autonomy after the Soviet Union's collapse. Their liberation from the socialist systems started years before so when the Soviet Union fell, the countries in Group 1 had already reached a stage of advance in their transition path (Bonnell & Breslauer, 2003).

During the second period, Group 1 reveals a clear long-term economic stability compared to the other three clusters, with growth values close to the Western countries' (Eurostat, 2010). From 1998 to 2008, the GDP growth of Group 1 lies between three and five percent. As mentioned earlier, this is not surprising: the countries in cluster 1 have been autonomous a longer period of time and are not in a transition period anymore. These countries are far ahead in their economic development. Indeed, the great majority are EU-members or candidate countries, which influences the countries both by the internal rules imposed and by the entry-criterions upheld by the EU.

Group 2

Group 2 presents the most extreme GDP growth values during the post-Soviet period. The post-Soviet period of this cluster is longer than that of Group 1 since it lasted from 1991 to 1994. This can be assumed to depend on the countries' heritage: three of the countries are former Soviet countries and two are socialistic countries, whereas all the countries in Group 1 are independent socialistic countries. In 1992 the GDP growth of Group 2 dipped at -32 percents (See Graph 1), the most negative value in our cluster sample. On the other hand, compared to cluster 3 and 4, the

period of negative growth is relatively short (from 1991 to 1994 against six or seven years for Group 3 and 4).

During the second period, Group 2 is characterised by a greater economic volatility than Group 1. After their post-Soviet period between 1991 and 1994, the countries in cluster 2 started to expand significantly, as is apparent in their increasing GDP values, until 1999, when the Kosovo War caused an observable sharp drop. In the beginning of 2000, there was a slight increase in GDP growth, ranging between five and ten percent. These are considerably high values when the fifteen EU member countries are used as benchmark where the GDP growth lies between one and three percent the past ten years (Eurostat, 2010).

Group 3

Similar to Group 2, Group 3 has highly negative GDP growth values during its post-Soviet period. It has the longest negative period of all groups (seven years), with a peak at -19 percent in 1994. What is remarkable about the two countries in this group, Azerbaijan and Turkmenistan, is that both are former Soviet countries, but neither is geographically close to Europe. They have not had the same opportunities as the European or Balkan countries in terms of trade and contact with developed and established European countries because of this geographic location (Clement, 2009). During the second period, Group 3 reveals observable increase in GDP growth during nearly ten years, reaching a peak at 22.5 percents in 2006, far above the other groups, with growth values ranging from 13 to 22.5 percent. These extreme growth values are partly due to the two countries' natural gas and oil production. Finally, it is noticeable that the countries in Group 3 do not display the same starting point as, for example, the countries in Group 1, which were far ahead in their development due to an earlier independence. In a nutshell, Group 3 can be characterised as the most extreme cluster.

Group 4

Groups 4 is characterised by high volatility in its GDP growth between 1991 and 1996, which demonstrates the lack of economic stability in the belonging countries. During its recovery period, the volatility in its GDP persisted, but less intensively. Like its post-Soviet period, its GDP curve is characterised by numerous increases followed by decreases. Nevertheless, the overall trend during

the second period is a slight increase in economic growth. Between 2000 and 2008, the GDP growth rate of Group 4 fluctuated from five to ten percents, and ended at a value of 6.8 percents.

These last two clusters are composed solely of former Soviet countries. The observed recession period is longer compared to the other two clusters due to several historical aspects. Their sudden independence from the Soviet socialism and central planning forced them to face many changes. The first challenge was the transition to a democratic government. The former Soviet countries did not possess the skills needed to establish successful democracies since the democratic process was uncommon to them, slowing down their democratisation. The second challenge was the transition from a socialistic economy to a market economy (Milanovic, 1998). All these changes have had consequences on the countries' economic growth, which is apparent in the differences in the stages of the GDP growth variable compared to the other two clusters.

7.1.4 Institutional quality characteristics of the four groups

In order to investigate the potential relationship between the GDP growth and the IQI in the chosen region, we go on to compute the cluster centroids for each group's IQI, our second variable of analysis (See Appendices), and draw graphs to visualise the evolution of the variable.
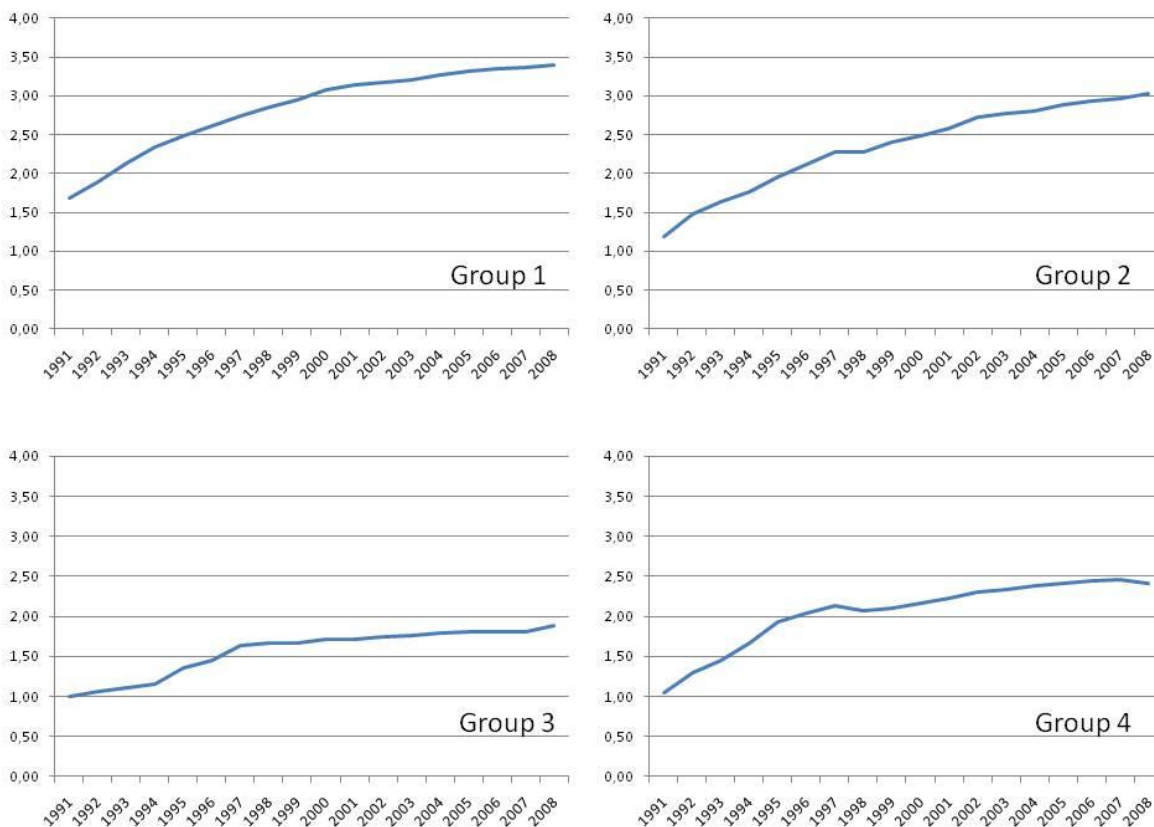
Graph 2. The four groups' IQI development between 1991 and 2008

The general trend standing out from *Graph 2* is an increasing IQI between 1991 and 2008 for all groups, implying that the quality of their institutions has ameliorated during this period.

Group 1

Group 1 has an IQI curve above all other groups. The values lie between 1.7 and 3.4 during the chosen period of study, this last value being significantly high on a scale of one to four. Interestingly, Group 1 is also the most stabile of all the groups, regarding its GDP development. From 1991 to 2000, the group's IQI increased rapidly. As shown in Graph 2 its IQI values nearly doubled in nine years, starting at 1.6 and ending at 3.1 in 2000. This implies an important amelioration of the quality of the included countries. The disintegration of the Soviet Union forced the former Soviet countries, as well as the socialistic countries, to reform the totality of their system, which had considerable consequences on the countries' institutions (Bonnell & Breslauer, 2003). At that time, it is important to recall that the countries in Group 1 were already a good way ahead of the other countries in their development toward democratisation. This is apparent on their IQI curve. After 2000, the index continues to increase but significantly less than during the previous nine years. Between 2000 and 2008, it increases with 0.4. In 2008, Group 1 reaches an IQI of 3.4, which is the highest value of all four groups.

Group 2

Group 2 is observed here to have the second best development of IQI, ranging from 1.2 to 3 between 1991 and 2008. In 1991, the IQI starts at a notably lower value than Group 1. The countries in Group 2 are a combination of former-Soviet countries and socialistic countries, which should explain the lower curve. The quality of the institutions during the Soviet epoch was minimal and when independence was gained, the former Soviet countries had to recover from this system.

Group 3

Group 3, the cluster with the most extreme values in GDP growth, presents the lowest IQI values between 1991 and 2008. Its IQI evolution can be divided into three phases, as we can see from Graph 2. The first phase, from 1991 to 1994, is characterised by a minimal increase in IQI, with values growing from 1 to 1.15. In contrast to the first stage, the IQI increases rather quickly during a

second period, from 1995 to 1997, and reaches a value of 1.6. When the observable third stage is reached in 1998, the IQI values continue to increase but significantly less rapidly. There appears to be stagnation at an IQI between approximately 1.7 and 1.9, which is relatively low compared to the other three groups at the same time period. High corruption and wars with the neighbouring countries are factors that strongly affect a country's IQI. Turkmenistan, for example, held its first multi-candidates presidential election in 2006 which was still suspected to be falsified. Azerbaijan has a history of conflicts with its neighbour Armenia, which should negatively influence its institutions (CIA, 2010).

Group 4

Group 4 is observed to lie just below Group 2 and above Group 3. Their IQI starts at the same level as Group 3, at a value of 1, but increases much faster between 1991 and 1997 and reaches 2.14. Between 1997 and 1998, there is a slight decrease. Then, the curve continues to increase slightly, with values ranging from 2 to 2.5, and ends 2.42 in 2008. Like Group 3, Group 4 is composed solely of former Soviet countries, but what differentiates this group is that half of the countries are Eastern European countries whereas the second half is Central Asian countries. The values of IQI in this group could lead to a conclusion that, as some existing literature claims, geography appears to play an important role in determining the IQI, as it does on incomes (See Sachs, 2001).

7.1.5 Discussion

We combine our observations on the clusters' GDP growth and IQI development to enable a search for relationships. Based on the data and graphs computed, we clearly see that Group 1 has the most stable GDP growth between 1991 and 2008. Interestingly, Group 1 also presents the highest IQI. During this same period of time and contrary to Group 1, Group 3 is characterised by extremely high growth in GDP but also high instability. Concerning its IQI development, we noticed that Group 3 has the lowest values compared to the other groups. The economies of Group 3 grow extremely fast without having a major influence on the quality of their institutions. Given the framework that we provide by the four field diagram, Group 1 and 3 are easily placed due to these clear characteristics. Group 2 and 4 are somewhat more difficult to label. Here again comes the dilemma in the four field diagram regarding at what values to draw the boundaries for what is

considered to be high or low. Groups 2 and 4 appear to be in between the two other groups and thus the four field diagram is not precisely applicable (See below).

Our observations show that evidently high GDP growth does not necessarily imply high IQI. This is one of the limits of the GDP as a measure since it does not take welfare or income inequalities into account. Knowing that our starting point in the literature claims that institutions of high quality lead to positive economic growth (North, 1990, Acemoglu, Johnson & Robinson, 2005), it is remarkable to see that this does not appear to be the case for Group 3. Instead, Group 3 presents the highest GDP growth percentages while having the lowest IQI values. On the other hand, the theory is confirmed in the characteristics of Group 1. These observations lead us to the conclusion that it is rather a stable development of the GDP growth variable that is apparent in association with higher values for IQI. Therefore, we draw the conclusion that there is a relationship between *economic stability* and institutional quality in Eastern European and Balkan countries. Placing our finding into the four field diagram reveals the diagram below:
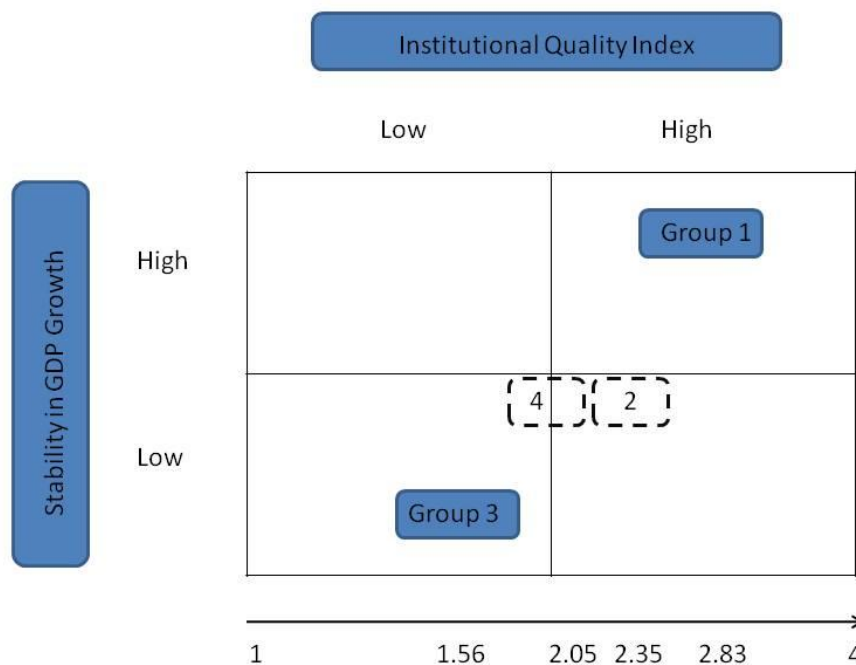

Diagram 4. The groups are placed into the Four Field Diagram

25

These observations alter the framework of the four field diagram to incorporate economic stability. Group 2 and Group 4 are placed in the centre of the diagram in dotted boxes to show that these two groups do not clearly belong to any field. Because these two clusters require too much subjectivity in labelling them, we choose to drop Groups 2 and 4 and not take them into account in the next part of our analysis. Groups 2 and 4 would not contribute to our search for a pattern since they do not have any specific characteristics. What is important to stress is the subjectivity in our diagram. Judgement of the stability of a country is very subjective, especially for Group 2 and 4. Therefore, their resulting placement in the diagram is very uncertain.

7.1.6 Concluding remarks

Former studies state the importance of well-functioning institutions to a country's economic performance. In this part of our analysis, we wanted to investigate if a relationship between economic growth and institutional quality was present in Eastern European and Balkan countries. Through the use of the cluster analysis, two general cases were discovered and investigated. The results also revealed a new angle. According to our observations and analyses, we expand past theories by stating that there is a strong correlation between *economic stability* and institutional quality in the chosen countries.

7.2 Qualitative analysis

In the inductive part of our analysis, we have demonstrated that high institutional quality leads to economic stability in Eastern European and Balkan countries. Given the formulated conclusion, a qualitative discussion on what factors affect the quality of countries' institutions is necessary to fulfil the purpose of our thesis.

7.2.1 Existing theories as base

Recent literature states that it is the variable of institutional quality itself that should be subject of analysis, since most existing literature assumes an aggregate value for this variable (EBRD, 2009). The ability to analyse and measure institutions, and understand the magnitude of their influence, has improved dramatically over the past years. The concept of institution has generally been determined to have three components: political, legal and social. Jellema and Roland (2002) attempt in their paper to assess which institution influences economic growth the most using a technique called

"principal components analysis", which uses "institutional clustering" (Jellema & Roland, 2002). Their results not only show that political institutions appear to be the most important institution for long-term growth, but also that these are intertwined with a democratic and participatory culture. Effects of international institutions could be considered a fourth component of institutional quality, based on the results of Jellema and Roland (2002), in that integration places significant demands on a country's economic, political and social institutions. Thus international integration and institutions have a direct effect on domestic institutions. According to the same study, open trade policies need to be accompanied by a strong institutional framework domestically. The link between domestic institutional reform and integration into the world economy is thus of vital importance to transition countries.

Research by both Grosjean and Senik (2007) and Acemoglu and Robinson (2006) also determine the partial importance of cultural institutions and though the most important institutions for long-term growth are the political, new political institutions need to be based on values and beliefs that are supported by a large part of a country's population. In order to achieve long term development and stable growth the domestic cultural institutions appear therefore also to be an influential factor. The influence of governmental institutions on cultural institutions is evident, and a deeper look on the effects political ideologies have on culture and cultural beliefs could be of interest in further studies.

Acemoglu and Robinson (2006) emphasise that a society's economic institutions, which they state are determinant of economic performance, depend on the distribution of political power. Key determinants of political power are political institutions, notably the institutions of democracy. Given this, we form our hypothesis that variables related to political, and specifically to democratic, institutions should be of importance in determining an aggregated value for institutional quality, and that such variables will have effects on economic growth.

7.2.3 Hypothesis

Based on the discussion above, regarding existing literature which stress that democratic institutions appear to have the greatest effect on institutional quality, we deduce the following hypothesis:

Governing parties are positively affected by their membership in international political organisations which gives rise to higher institutional quality.

We choose to isolate the variable of party membership and investigate its significance, as a determinant of political institutions. We base our hypothesis on the assumption that such membership ameliorates the quality of the democratic institutions by influencing the governing party through the decision processes and the values of the other party members. This should then lead to democratic development and further to economic growth.

Furthermore, given the importance of international institutions, we draw the conclusion that international political organisations should have a great impact on domestic institutions. Therefore, we assume that the membership of the governing parties in international political organisations has a considerable effect on institutional quality.

We assume that studies that pinpoint political institutions as among the most important are true, and thus we chose to isolate a variable that could be significant for these particular institutions.

7.2.4 Observations

The two groups

Our deductive analysis comes to the conclusion that the transition countries in our study indeed have features within the two variables (IQI and GDP growth) that cause them to be grouped together. The resulting groups are the empirical base upon which we from here on test our hypothesis. Given the attributes that the groups display, and because we are interested in determining obvious deviations, the two most extreme groups are of greater interest in our discussion. This leaves us with group 1 and 3. These two groups have almost the opposite attributes: in Group 1, the countries have experienced a stable development of their GDP growth variable over the later part of the time period, accompanied by a relatively high IQI value. Compared to Group 3, where even in the latest measures of GDP growth, the variable is very volatile and the IQI values remain relatively low. The attributes of Group 3, should be taken into consideration. It is notable that there are only two countries within this group. This could suggest that the group is not appropriate as a base of analysis, since it may be argued that it does not provide a general example, or an understanding of the average attributes of the group. This may be the case, but as stated above, the purpose of our analysis is to determine if our chosen variable can be observed to have an effect. Within that hypothesis we place no limitation as to the number of observations. The groups provided by the cluster analysis are a tool to sort the data and to strengthen our reasoning, by

showing that the average of a group displays the characteristics which we believe party membership induces. This gives the conclusions a more general nature. It is therefore not a constraint that Group 3 consists of two countries. The hypothesis can just as easily and with as much validity be studied on any number of countries.

GDP growth

Our hypothesis states that institutional quality should affect economic growth. Therefore, we need to provide a definition of economic growth. Given macroeconomic theories of economic growth, and comparing to the economic development in more developed countries, we conclude that it rather is stability than actual growth that is the appropriate definition. This reasoning is supported by our observations in the inductive analysis. By this we mean that it is not the fact that the change in growth is increasing in comparison to previous years and measures, but rather that the growth is stable over time. A stable growth means a stable economy, which in turns means stable development and a stable country. This provides good opportunities for industrial development and investment, as the future is considered relatively predictable. In comparison, it cannot be considered positive when a country's growth shoots through the roof one year, and the next dives deeply in comparison to the previous. Such statistics suggest a volatile economy and should, by macroeconomic reasoning, discourage investment and productivity. It is the change over time that is interesting. In these results, we observe a phenomenon within the two groups that is quite extreme and diverse concerning stability. In Group 1 we observe stable GDP growth in the later time period, while the GDP growth of Group 3 is very volatile over the whole time period. Given our analysis of the variable of economic performance, our observations show that Group 1 has the type of economic growth that we consider positive.

Correlations between IQI and GDP growth

In our hypothesis we state that higher institutional quality should lead to economic growth. By this we imply that the higher the IQI, the more stable the growth over time should be. More elaborately, we believe that better institutions, which based on our analysis has to be defined as "the higher the measured aggregated value the better", will lead to a more stable economic development of transition countries. We deduce this hypothesis from the premises of the studies on the positive effects of institutions on economic growth and the increased interest of this particular field of

economics. Studies, such as that provided by Acemoglu, render the base of this premise. In an analysis of the observations provided by our empirical data as to whether this type of connection is evident reveals in the quantitative inductive analysis that a correlation between the two observed variables is indeed suggested. The values for GDP in Groups 1 are relatively stable in the later period of the observed time period. This combined with the relatively high values of IQI for this group, of above 3 from year 2000 and on, can be assumed to show that the two variables display what we consider good values in the same period. With existing theories of a relationship in mind, the positive values in the two variables can be assumed to be a result of each other. This in contrast to the values of Group 3, which show the opposite relationship and hence lower values in both variables. This leads to the validation of the hypothesis that a higher value of IQI will result in a more stable development in GDP as concluded in the inductive reasoning and observations. Countries in transition phase develop differently, as observed by the GDP growth variable of our two groups. The analysis of institutional development in the sample implies that changes in institutions can be used to affect the nature of that development.

Membership

We hypothesise that party membership in international political organisations is a variable that can affect the quality of political and democratic institutions within a country. Given the definition of the variable as solely political organisations with ideological and parliamentary agendas (See method for further definition), we observe membership as follows for Group 1 and 3:

The results show that for all of the countries in Group 1 the governmental parties are members. Furthermore, they are all members in larger international political organisations. For Group 3 neither of the countries have parties that are members in either of the

Group 1	Membership
Poland	EPP
Solvenia	SI
Hungary	SI
Fyr Macedonia	IDU
Coratia	SI
Slovak republic	IDU
Bulgaria	SI
Romania	EPP
Armania	SI
Group 3	Membership
Azerbajan	No membership
Turkmenistan	No membership

Table 2. Party membership for the countries in Groups 1 and 3

potential organisations as defined, neither international nor regional. Furthermore, no oppositional parties are members of any relevant organisation either. The implications of these results are several.

First, from the observations made for IQI for our two groups, we see that the values are consistently higher for Group 1 where all countries are members, while the values are in comparison much lower for Group 3 where no country is member. Given the theory that political and democratic institutions are the ones with the greatest effect on the aggregated value of IQI, it can be thought that changes in this variable can be attributed more to changes in the quality of these particular institutions than in others. Our observations strengthen this hypothesis and the results can be thought to mean that the higher values for Group 1 can be attributed partly to the fact that they are indeed members of international political organisations. This based on the analysis of the variable of membership as being a strong enough potential factor to affect political and democratic institutions. This implies that memberships indeed can be thought to have an effect on the quality of political and democratic institutions, which in turn affect economic performance.

Second, if these connections are assumed to be valid, the hypothesis that economic performance can be improved through international cooperation and membership is plausible. Our hypothesis aims to target the effects on ideological behaviour in the thought that political institutions in transition countries will increase in quality when polices and decisions are made based on the processes and values of the western democratic society. As stated by Jellema and Roland (2002), it is not only the economy, but also the institutions that are in transition. Guidance towards these types of processes is difficult to achieve, but membership in international political organisations can be thought to be one way. Given the results of our study of membership and the observed values for IQI, this hints at the possibility that membership is a forum for influence. The thought that parties in transition countries are influenced by the processes and policies of the western parties with which they have the opportunity to interact in the environment of these organisations is strengthened, by the results of our analysis.

7.2.5 Conclusion

The hypothesis that party membership in international political organisations affects institutional quality is given support through our analysis in several ways. First, there is empirical evidence of a correlation between IQI and stable GDP growth, which is evident in the results of the deductive analysis. Second, the correlations are revealed to be positive. Given higher values for IQI, a

stabilization of GDP growth is apparent. Given the observed development of the two variables for Group 1 and Group 3, the effects of institutions are concluded to be plausible. Third, based on existing literature and studies, party membership in international political organisations is believed to affect the IQI. Seeing the results from membership of the transition countries, we conclude that the variable indeed is valid to have an effect on IQI and indirectly on GDP. This based on the observation that membership is apparent in Group 1 where the values for IQI are high and values for Group 3 are relatively low and no country holds membership. Therefore our hypothesis that political and democratic institutions has effect on changes in the IQI value is confirmed, based on the premises of our assumptions.

7.2.6 Generalisation

Over time, understanding of transition has improved in the academic and policy-making communities. Today, conceptual models and massive amounts of data on improving quality and accumulated experience can provide guidance on policy choices (EBRD, 2009). Acemoglu and Robinson (2006) reach the conclusion in their paper that the "degree to which different policies lead to different institutions, in turn lead to different development paths" (Acemoglu & Robinson, 2006). Based on such considerations, there is further relevance in studying the variables behind the aggregated variable IQI. A dissimilation of the variable can lead to increased understanding of what can be done in benefit for economic development and economic stabilization and growth in transition countries. For example, EU accession has played a crucial role in supporting far-reaching institutional reforms in the countries of Central Eastern Europe (Ashford, 2003). As we hypothesize, membership in international political organisations can validly be thought to affect the decision processes and actions of governments. EU is such an example. The requirements of member states to be allowed membership in international political organisations often lead to reform in order to fulfil these requirements. This is evidence of a change in processes within the countries that we believe is the result of the membership. For example, Hungary, which is in Group 1, performed a harmonizing process following the agreement with EU for future partnership, which was achieved in 2004 (NE, 2010) and has recently displayed a great increase in GDP growth and decreases in inflation, followed by increases in foreign direct investment. Slovenia, also in Group 1, is one of the most successfully developed transition economies and has since their membership in EU, also in 2004, pushed through reforms to privatize the banking and telecommunication sectors. For both of these countries, their membership in international political organisations had provided

support in achieving the reforms and processes necessary for EU membership, which in turn has provided great stability for the countries (NE, 2010, Lorenzon, 2010). This can be compared to the development of the countries in Group 3, which again are described by the most extreme opposite in the cluster analysis. Azerbaijan, for example has continuously experienced unstable economic development, which can be connected to the unstable political situation within the country, which is in turn unstable due to disagreements between political parties domestically (NE, 2010). As Acemoglu and Robinson concludes (2006), countries within similar regions develop differently, which may be due to their differently developed political institutions.

For Swedish politics the subject of democratic and political aid is well represented, none the least by the democratic aid organisations tied to each of the main political parties. Their focus is to educate domestic political parties in developing and undemocratic countries on democratic processes. This is often done by aiding the governmental parties in achieving membership in international political organisations. This serves two purposes. First it renders the party in question credibility in their own country and will hopefully lead to their election for parliament. Second, it is a way to educate the politically active in an undemocratic country on the processes of democratic parties and states (Ashford, 2003). These ideas further stress the importance of the variable we have chosen to study in our thesis. Given the abstract nature of political and democratic aid, education has been identified as a relatively quantifiable method of process. The theory that we present in this thesis, is also an input on the debate of the measurability of democratic aid. This is a process in which we are just in the beginning at the moment and may be subject to change over time, as the process is further refined.

Given the characteristics of each of the groups we described in the empirical quantitative study, our method was to narrow down the sample to the two most extreme groups. As stated in the discussion around this method, this is not necessary; we can look at all of the groups with the same premises. The reason was to achieve a more solid argument and clearer result. However, now that we have argued a valid connection, a more general process of investigation is applicable to any country. The issue that arises when using a more general method is the factor of comparison. Given that the method presented in our thesis is performed on one single country, the process of comparison and validation would most likely be different. Instead, the effects of membership in international political organisations should be evident in a historic context, in that the nature of the decisions, policies and reforms of the country changes over time. Furthermore, other variables can

be hypothesized to be included in the aggregated value of IQI and studied in the same manner as in our thesis. The steps are general enough to produce a valid investigation for other variables. The variable we have used here also provides points of discussion. The delimitations made concerning this variable may be argued, and we acknowledge that further studies concerning the effects of memberships in all types of international organisations is a natural next step. Questions arise as to the effects of all types of organisations. Given stated effects of international integration, it is clearly a relevant subject of further study.

Further questions that arise are whether or not the method that we present here will yield similar results when performed on other samples. Due to the abstract nature of the variable of institutional quality in itself, and the great number of factors that are not possible to control for in studies such as ours, the results of studies performed similarly may yield other results, due to unpredicted effects of other, omitted factors. On the other hand, the general nature of the process should yield more general results, and independence.

8. Conclusions

Through the use of an inductive work process, empirical data on IQI and GDP growth for the Eastern European and Balkan countries has provided us with results that support existing literature on the subject of their correlation. Our observations reveal trends of stability in GDP growth and better economic performance in combination with trends of high values for IQI on a given scale. Given these results, on the premises of existing literature on institutional quality, the variable of party membership in international political organisations is validly proven as a variable which indirectly affects economic performance. The attributes of two chosen groups given by a cluster analysis provide the base for a deductive conceptualisation of a connection between membership and the values for IQI as these are higher for membership countries. Based on the memberships of the governing parties in the group displaying stable GDP growth values and the non-membership of the group displaying volatile GDP growth, our hypothesis is confirmed.

Knowing the key role of institutions in determining a country's economic performance, it is of great value to understand the determinants of institutions. Today, many countries find themselves in a transition phase where their institutions matter more than ever. Understanding how the development of these transition countries can be affected toward democracy and well-functioning

34

market economies is essential. The implications of our findings on the role of international political organisations are important. The developed member countries play a key role as models for future development through their values and decisions. Nevertheless, a multitude of factors influence institutions and their quality, implying that there are many important issues uncovered by this paper, which offer fruitful topics for future studies. With this thesis, we have taken a first step toward investigating one of the factors affecting institutional quality, but there is still a lot to learn.

9. Summary

In this paper, we investigate the relationship between economic performance, institutional quality and party membership in international political organisations. We base our study on 25 Eastern European and Balkan countries which are members of the EBRD. We conduct a quantitative analysis, using a clustering procedure, to search for a potential relationship between GDP growth and institutional quality in Eastern European and Balkan countries. From our observations, we draw the conclusion that the variable *economic stability* has a positive correlation to the institutional quality index, rather than simple GDP growth. Two clusters are of particular interest for our thesis, as they constitute contrasting general cases. In the second, more qualitative part, we aim to examine what factors influence institutional quality. We test the hypothesis that a party membership in international political organisations is beneficial for the country's institutions. The two clusters resulting from our first part are further discussed and investigated in order to seek for differences in their party membership. Through our discussion and observations, the hypothesis is confirmed: party membership does affect the quality of a country's institutions.

10. References

Acemoglu, D. and Johnson, S. (2005),"Unbundling Institutions", *Journal of Political Economy* 113(5), 949-989

Acemoglu, D., Johnson, S. and Robinson, J. (2001), "The Colonial Origins of Comparative Development: An Empirical Investigation", *American Economic Review* 91(5), 1369-1401

Acemoglu, D., Johnson, S. and Robinson, J. (2004) *Institutions as the Fundamental Cause of Long-Run Growth*. Cambridge, MA: National Bureau of Economic Research. NBER Working Paper No. 10481.

Acemoglu, D. and Robinson, J. (2006), *A Framework for Studying Institutional Persistence and Change*. London: European Bank for Reconstruction and Development. Working Paper Series.

Ashford, N. (2003), *Principles for a Free Society*. Stockholm: Jarl Hjalmarson Stiftelsen. 2nd edn.

Bonnell, V. E. and Breslauer, G. (2003), *Soviet and Post-Soviet Area Studies*. Berkeley, CA: University of California. Working Paper Series.

CIA (2009), *The World Factbook*. Washington D.C.: Central Intelligence Agency

Clement, V. (2009), Creating Space for Civil Society in Turkmenistan. Monterey, CA: Naval Postgraduate School. Working Paper Series.

EBRD (2009), *Economic Statistics and Forecasts*. London: European Bank for Reconstruction and Development. Transition Report. Available at: http://www.ebrd.com/country/sector/econo/stats/index.htm (Accessed 16th of March 2010)

EBRD (2009), *What drives growth in the transition countries? Institutions, Markets and Economic Performance*. London: European Bank for Reconstruction and Development. Transition report.

European People's Party (2010), *Member Parties*. Available at:
http://www.epp.eu/memberparties.php?hoofdmenuID=3 (Accessed: 25th of March 2010)

Eurostat (2009), *Real GDP growth rate*. Luxembourg: European Commission Eurostat. Available at:
http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=fr&pcode=tsieb020 (Accessed: 24th of April 2010)

Grosjean, P. and Senik, C. (2007), *Should market liberalisation precede democracy? Causal relations between political preferences and development*. Bonn: Institute for the Study of Labor. IZA Discussion Papers No 2889.

International Democratic Union (2010), *Member Parties*. Available at: http://www.idu.org/member.aspx (Accessed: 25th of March 2010)

Jarl Hjalmarson Stiftelsen (2010), *Country information*. Available at: http://www.hjalmarsonstiftelsen.se (Accessed: 27th of March 2010)

Jellema, J. and Roland, G. (2002), *Institutional Clusters and Economic Performance*. Berkeley, CA: University of California. Working Paper Series.

Kourtellos, A., Thanasis, S. and Tan, C. M. (2009), *Do Institutions Rule? The Role of Heterogeneity in the Institutions vs. Geography Debate*. Medford, MA: Tufts University, Department of Economics. Discussion Paper No. 0735.

Lorenzon, E. (2010), Project Manager at Jarl Hjalmarson Stiftelsen. Interview, 5th of February 2010

Malhotra, N. K. (1995), *Marketing Research: An Applied Orientation*. Upper Saddle River, NJ: Prentice Hall. 2nd edn.

McArthur, J. W. and Sachs, J. D. (2001), *Institutions and Geography: Comment on Acemoglu, Johnson and Robinson 2000*. Cambridge, MA: National Bureau of Economic Research. NBER Working Paper No. 8114.

Milanovic, B. (1998), *Income, Inequality, and Poverty during the Transition from Planned to Market Economy*. Washington DC: World Bank publication

North, D. (1990), *Institutions, institutional change, and economic performance*. New York: Cambridge University Press

OECD Observer (2004), "Is GDP a satisfactory measure of growth?" *OECD Observer,* No. 246-247. Available at: http://www.oecdobserver.org/news/fullstory.php/aid/1518/ (Accessed 10th of April 2010)

Party of European Socialists (2010), *Member Parties*. Available at: http://www.pes.org/fr/au-sujet-du-pse/membres-du-pse/partis (Accessed: 25th of March 2010)

Rodrik, D., Subramanian, A. and Trebbi, F. (2004), *Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development*. Cambridge, MA: National Bureau of Economic Research. NBER Working Paper No. 9305 (Revised version of 2002).

Sachs, J. D. (2003), *Institutions Don't Rule: Direct Effect of Geography on Per Capita Income*. Cambridge, MA: National Bureau of Economic Research. NBER Working Paper No. 9490

Socialist International (2010), *Member Parties*. Available at: http://socialistinternational.org/viewArticle.cfm?ArticlePageID=931 (Accessed: 25th of March 2010)

Swedish National Encyclopedia (2010), *Country information*. Available at: http://www.ne.se (Accessed: 27th of March 2010)

Wahlund, R (2010), Director of the Center for Media and Economic Psychology, Mail interview, 26th of February 2010

The World Data Bank (2010), *World Development Indicators and Global Development*. Washington D.C.: The World Bank Group. Available at: http://databank.worldbank.org/ddp/home.do (Accessed 16th of March 2010)

Appendices

List of the fourteen Transition Indicators (Source: EBRD)

1. Large scale privatisation
2. Small scale privatisation
3. Enterprise restructuring
4. Price liberalisation
5. Trade and Forex system
6. Competition Policy
7. Banking reform and interest rate liberalisation
8. Securities markets and non-bank financial institutions
9. Overall infrastructure reform
10. Telecommunications
11. Railway
12. Electric power
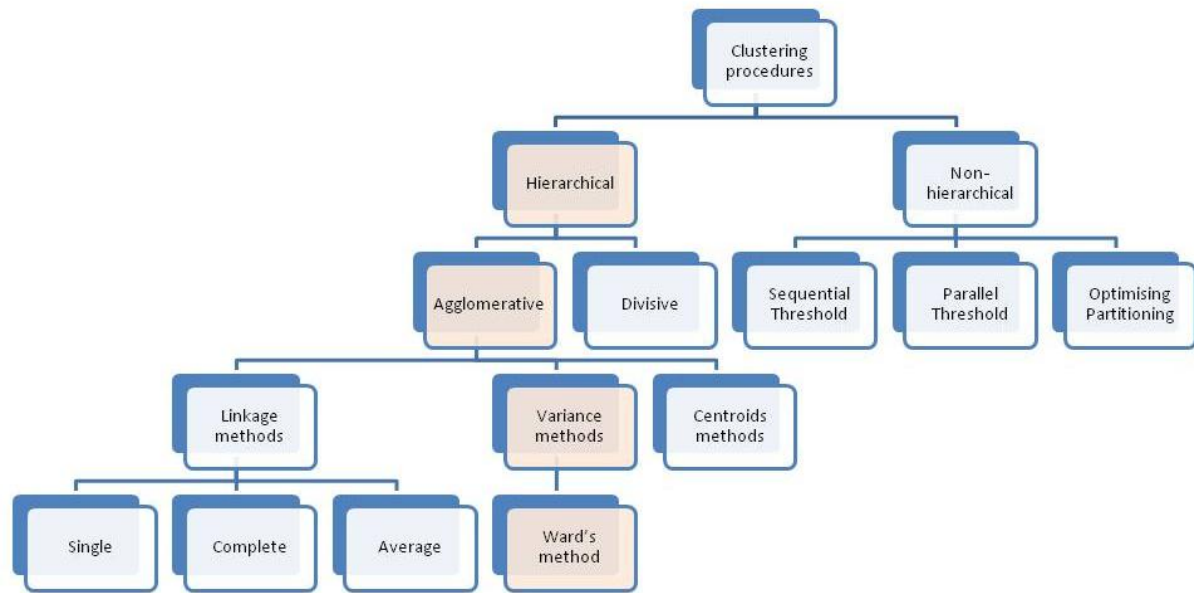13. Roads
14. Water and waste water

Diagram 1. The different existing clustering procedures. (Source: Maholtra, 1995)

Agglomeration Schedule

Stage	Cluster Combined		Coefficients	Stage Cluster First Appears		Next Stage
	Cluster 1	Cluster 2		Cluster 1	Cluster 2	
1	16	21	52,911	0	0	4
2	15	19	129,573	0	0	21
3	6	20	207,838	0	0	13
4	9	16	305,165	0	1	8
5	4	25	436,518	0	0	12
6	5	17	609,221	0	0	14
7	10	18	787,566	0	0	9
8	7	9	1011,943	0	4	13
9	10	24	1240,784	7	0	16
10	11	13	1479,537	0	0	12
11	2	12	1732,984	0	0	17
12	4	11	2093,655	5	10	16
13	6	7	2460,027	3	8	14
14	5	6	2846,117	6	13	18
15	14	22	3323,951	0	0	19
16	4	10	3928,860	12	9	19
17	2	8	4575,295	11	0	21
18	1	5	5320,421	0	14	24
19	4	14	6333,769	16	15	22
20	3	23	7404,683	0	0	22
21	2	15	8630,120	17	2	23
22	3	4	10368,037	20	19	23
23	2	3	14235,335	21	22	24
24	1	2	19544,359	18	23	0

Table 1. The Agglomeration Schedule. Stage 1 combines the two countries which have the lowest distance and continues until all the countries are combined into a single cluster. The coefficients indicate at what distance level an existing cluster is combined with the next cluster or country. These coefficients correspond to a distance in the dendogram and are used to define the suitable number of clusters.

Cluster Membership

Case	5 Clusters	4 Clusters	3 Clusters	2 Clusters
1:albania	1	1	1	1
2:armenia	2	2	2	2
3:azerbaijan	3	3	3	2
4:belarus	4	4	3	2
5:bulgaria	1	1	1	1
6:croatia	1	1	1	1
7:fyr macedonia	1	1	1	1
8:georgia	2	2	2	2
9:hungary	1	1	1	1
10:kazakhstan	4	4	3	2
11:kyrgyz republic	4	4	3	2
12:latvia	2	2	2	2
13:lithuania	4	4	3	2
14:moldavia	4	4	3	2
15:montenegro	5	2	2	2
16:polan	1	1	1	1
17:romania	1	1	1	1
18:russian federation	4	4	3	2
19:serbia	5	2	2	2
20:slovak republic	1	1	1	1
21:slovenia	1	1	1	1
22:tajikistan	4	4	3	2
23:turkmenistan	3	3	3	2
24:ukraine	4	4	3	2
25:uzbekistan	4	4	3	2

Table 2. The Cluster Membership Table shows which countries are in which cluster, depending on the number of clusters.

Final Cluster Centers

	Cluster			
	1	2	3	4
GDP91	-13	-12	-3	-7
GDP92	-6	-32	-14	-15
GDP93	0	-20	-17	-9
GDP94	4	-2	-19	-17
GDP95	5	4	-10	-7
GDP96	3	7	-3	-3
GDP97	1	8	-3	4
GDP98	4	5	9	1
GDP99	3	-3	12	3
GDP00	4	5	15	6
GDP01	3	6	15	7
GDP02	3,8	6,2	13,5	5,8
GDP03	4,4	7,7	14,0	7,5
GDP04	5,3	7,3	13,5	9,1
GDP05	4,8	8,8	19,5	6,3
GDP06	5,9	9,5	22,5	7,1
GDP07	6,0	10,7	18,5	7,9
GDP08	5,0	3,3	10,5	6,8

Table 3. Cluster centroids for the GDP growth.

Final Cluster Centers

	Cluster			
	1	2	3	4
I91	1,69	1,19	1,00	1,05
I92	1,89	1,48	1,06	1,29
I93	2,13	1,64	1,10	1,45
I94	2,35	1,76	1,15	1,67
I95	2,49	1,96	1,36	1,93
I96	2,62	2,12	1,45	2,04
I97	2,74	2,28	1,63	2,14
I98	2,86	2,28	1,67	2,08
I99	2,95	2,41	1,67	2,10
I00	3,08	2,48	1,71	2,16
I01	3,14	2,58	1,71	2,23
I02	3,18	2,73	1,75	2,30
I03	3,21	2,77	1,76	2,34
I04	3,27	2,81	1,80	2,38
I05	3,31	2,89	1,81	2,41
I06	3,35	2,93	1,81	2,44
I07	3,37	2,97	1,81	2,46
I08	3,40	3,02	1,88	2,42

Table 4. Cluster centroids for the IQI.
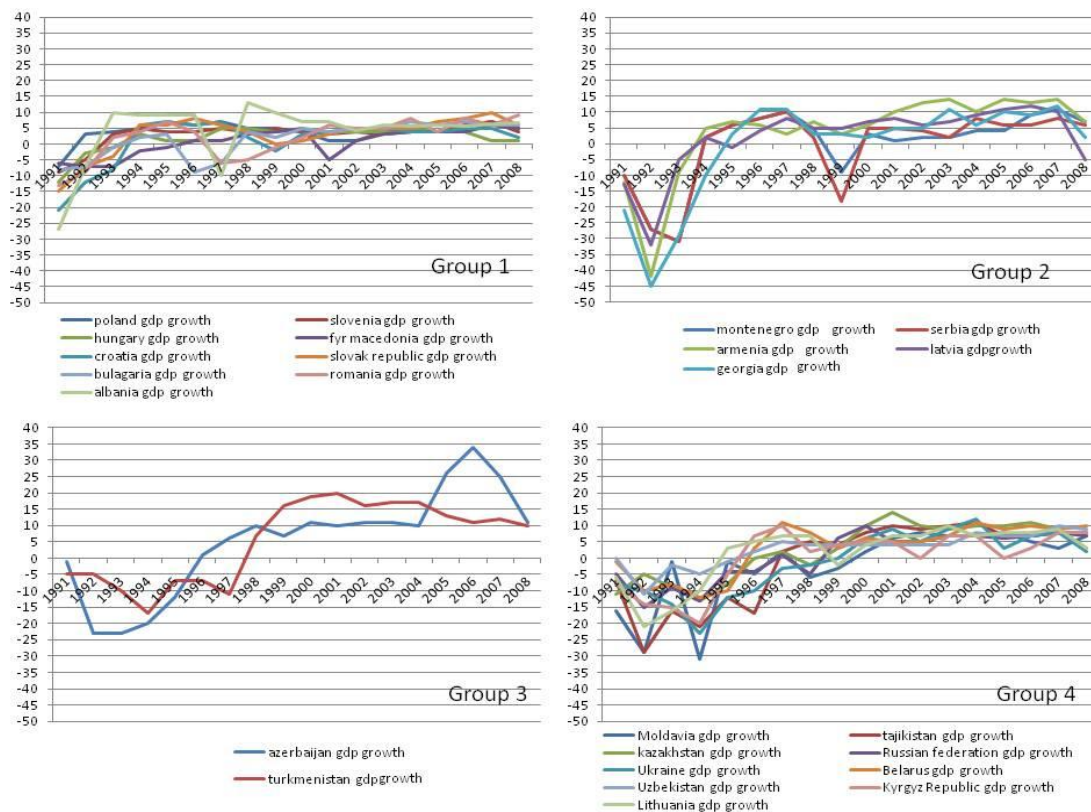
Graph 1. GDP growth between 1991 and 2008, by country.
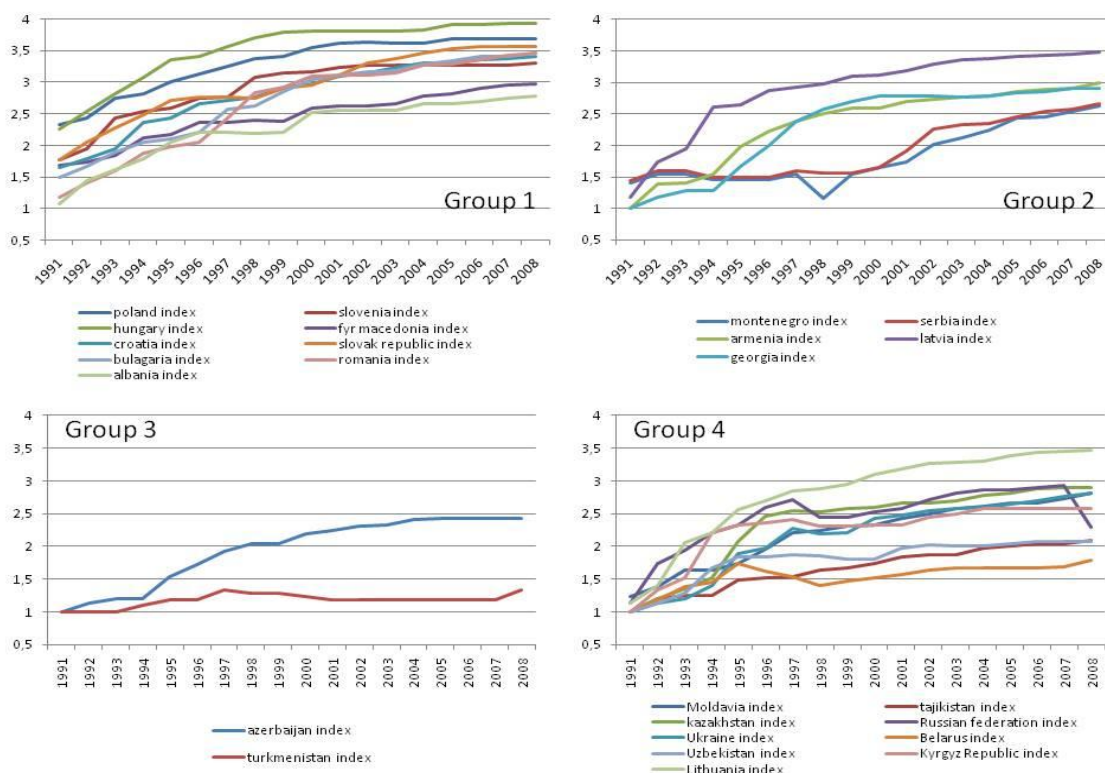
Graph 2. IQI between 1991 and 2008, by country.