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PAPER

The Role of Good Governance in Economic Development: Evidence from Eastern European Transition Countries

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Abstract The paper aims to evaluate the impact of main good governance indicators on GDP per capita and FDI in Eastern European Transition Countries. Empirical results confirm that Government Efficiency and Rule of Law have a positive impact on GDP per capita growth while Control of Corruption harms GDP per capita growth, so a reduction in corruption generates GDP per capita growth. The results also show that government efficiency has a positive impact on increasing the flow of foreign investment and that an increase in corruption somewhat reduces FDI flow.

Keywords: Good governance, Economic growth, Foreign investment, Eastern European Transition countries.

JEL Classification: O11, P48, P52.

Introduction

After the fall of the Berlin Wall, the "two worlds" and "two economic systems" arrived to an end. This event marked the beginning of the long and difficult path of the Eastern European countries' integration into the global economy. This ongoing transition is a unique event in history because it is a multidimensional process and it brings about radical changes such as removing any ideological and political barriers between the east and west and fundamentally changing their economic system from a centrally planned economy to an economy based on private property.

The majority of Eastern European countries in the first stages of the transition experienced rapid growth of macroeconomic indicators, but this growth often did not translate into development and did not result in a reduction in inequality (Muço and Balliu, 2018). The natural resources or any strategic state-run enterprises these

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countries had turned out to be a curse for their economic development. This is because economic growth during the transition was associated with a significant lack of good governance (Pere, 2015), which, according to Keefer (2009), means the provision of a public service which positively influences economic growth and development (Kaufman and Kraay, 2007). Good governance is a wide concept that encompasses several components such as corruption, political stability, rule of law, efficient management of public finances, etc. (Kaufman et al., 2005). Based on these facts, in this paper we analyze the impact that some of the indicators of good governance have on the economic growth of Eastern European Transition Countries. This means identifying the causes of success or failure of economic development in Eastern European transition countries as well as the weight that some of the indicators of good governance estimated by the World Bank have in the economic growth of the countries in question. This would have a positive impact on future policy orientation and would have a positive impact on the economic growth and well-being of these countries.

To achieve this objective, in this paper we have selected a data panel from 22 different countries with data ranging from 1996-2018, and as an empirical model, we have presented a panel with fixed and random effects where GDP per capita and FDI net inflow as a percentage of GDP serve as dependent variables whereas Political Stability, Lack of Violence, Government Efficiency, Rule of Law, and Control of Corruption will serve as independent variables.

The results suggest that for Eastern European Transition Countries, a reduction in the control of corruption index coupled with an improvement in the government efficiency index as well as the rule of law positively influences GDP per capita growth and FDI.

This paper is organized as follows: first, there is a brief introduction, \then we offer an overview of Eastern European transition countries and literature review, after that, we present data, methodology, and empirical analysis, and last we arrive at some conclusions.

2. Overview of Eastern European Transition Countries and literature review

The year 1989 marked the beginning of a great process of transformation of the countries of Central and Eastern Europe, aimed to pass from a planned to a market economy based on private property.

The challenges that these countries faced were numerous such as the process of macroeconomic stabilization, economic restructuring and adjustment of productive capacity, de-monopolization of the economy, and increasing market competitiveness, but above all, they had to guarantee economic development and welfare for citizens. In general, the economic development of these countries (Eastern European transition countries) over the years was characterized by high economic growth but this growth in the vast majority of these countries was not accompanied by increased welfare and equality. On the contrary, in most of these countries, this period was associated with a high level of corruption and a low level of good governance (Muço and Balliu, 2018; Pere, 2015). This suggests that corruption and misgovernance in these countries have become a “culture” and it is difficult to prevent and combat them. Other researchers in their studies considered good governance as a multidimensional process that involved

policy, system, and behavior (Liu et al., 2018; Tang et al., 2018; Jiang et al., 2017; Shi and Fang, 2010). Whereas the World Bank evaluates good governance through the Worldwide Governance Indicators using six key dimensions of governance (Voice & Accountability, Political Stability, Lack of Violence, Government Efficiency, Regulatory Quality, Rule of Law, and Control of Corruption).

Various economists argue that good governance is one of the main factors that stimulate not only the strengthening of democracy in a country but also its economic development (Kaufmann et al., 2010; Dixit, 2009; Kaufmann et al., 2005; Olson et al. al., 2000; Herbst, 2000; Collier, 1999). Besides, it positively stimulates human development in overall (Davis, 2017); it has a positive impact on a country's economic growth and on reducing multidimensional poverty (Jidra and Vaz, 2019; Chong and Calderón, 2000; Levine, 1997); it reduces bureaucracy which stimulates economic growth (Rauch and Evans, 2000), as well as it improves fiscal revenues and ensures a better redistribution of them for the welfare of the whole community (Pribesh et al., 2011).

Good governance also serves to attract foreign tourists and to develop tourism in overall (Detotto et al., 2017), as well as to improve the business climate as it is related to the rule of law and government efficiency (Ishiyama, 2019).Good Governance is closely linked to institutions and improving their quality stimulates an increase in domestic and foreign private investments (Brunetti et al., 1997; Knack and Keefer, 1995) and the latter, according to Barro (1991), are stimulated by political stability as well.

Good governance is also positively associated with low levels of corruption which, according to (Dreher and Schneider, 2010; Kaufmann, 2010; Del Monte and Pagani, 2008; Abed and Davoodi, 2002; Tanzi and Davoodi, 2002; Friedman et al., 2000; Mauro, 1995), stimulates economic growth. Other studies view corruption as a stimulus to the economy as it fights bureaucracy and helps entrepreneurs to bypass the inefficient regulations (Leff, 1964; Acemoglu and Verdier, 2000; Huntington, 2002; Rock and Bonnett, 2004).

Wilson (2016) in his study on China, believes that the quality of governance promoted the transformation of the industrial structure by hindering the primary industry and encouraging the tertiary industry but beyond that, it doesn't have a positive effect on GDP growth. Chang (2003) argues that the economic development of a country should not be measured only by good governance, but there are a series of other factors because economic development, according to him, is the result of a combination of other factors.

Regarding developing countries, various studies of neo-institutionalist economists on the linkage between good governance and economic growth came up with two different theories regarding the role of good governance in economic growth (Kauffman, 2005; Knack and Keefer, 1995; Rodrick, 1995).

The first connects the economic development of a country with the proper functioning of institutions. According to them, the lack of economic development is related to the lack of good governance or the failure of a state in the fight against corruption, non-guarantee of property rights, market distortion, or lack of democracy. The second theory developed by Rodrik (1995) concerns the ability of the state to

implement social change and pursue a voluntary policy of economic development. The transition of developing countries towards a capitalist system comparable to that of developed countries cannot operate without the establishment of efficient institutions concerning the distribution of political power in such countries. Conversely, those countries would face state failure as a result of a mismatch between institutions and economic policy of development (Mira and Hammadache, 2017).

3. Data, methodology and empirical analysis

The data used in this study allow us to calculate the impact of good governance indicators on economic growth in Eastern European transition countries so that we can assess whether there are changes in the impact of countries with different stages and economic growth, as well as the impact of these indicators on foreign direct investment.

To conduct this study we have created a data panel with 22 countries that are considered Eastern European Transition economies, including here those countries that are already part of the European Union, respectively: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia, as well as those outside the EU and aspiring to join in the future such as Albania, Armenia, Belarus, Bosnia and Herzegovina, Georgia, Kosovo, North Macedonia, Moldova, Montenegro, Serbia, and Ukraine. Historical data for these countries range from 1996 to 2018. The number of observations in the panel goes from 469 to 493. We didn't include earlier data concerning some of the countries in this study because such data is not available. So we preferred to have a balanced data panel.

The data considered are macro variables and all have been taken from the World Bank. This choice was made to have homogenized data.

Based on the studies of Shao (2016) and Fayissa and Nsiah (2013), GDP per capita constant price is used as a variable of economic growth, which will be the first dependent variable, whereas FDI to GDP, i.e. Foreign Investments as a percentage of GDP will be the second dependent variable.

The Worldwide Governance Indicators stimulated (evaluated or calculated) and published by the World Bank as Political Stability[1], Government Efficiency[2], Rule of Law[3], and Control of Corruption4 have been used as independent variables. All the

[1] Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism. The estimate gives the country's score on the aggregate indicator, in units of standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

[2] Government Efficiency deals with perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. The estimate gives the country's score on the aggregate indicator, in units of standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

[3] Rule of Law deals with perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. The estimate gives the country's score on the aggregate indicator, in units of standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

[4] Control of Corruption deals with perceptions of the extent to which public power is exercised for private

above variables were taken into account in the study of Kurtz and Schrank (2007) or that of Setayesh and Daryaei (2017).

This study does not include two Worldwide Governance indicators, such is Voice & Accountability[5] and Regulatory Quality[6], as the focus of this study is economic growth and not welfare in overall. Similar models may have problems with heterogeneity, but given the fact that our study is with panel data, it is enough to include "fixed effects" to solve the above problem.

In the following, we will look at the empirical results of the impact that the various good governance indicators have on economic growth and on the private and foreign investment.

Table 1 Impact of good governance indicators on GDP per capita

Dep. Var: l_GDP per capita constant 2010	**Fixed Effects**				**Random Effects (GLS)**			
	Coef.	Stan. Errors	t - ratio	P-value	Coef.	Stan. Errors	t - ratio	P-value
Const	8,77052	0,0158705	552,6	<0,0001***	8,76526	0,0868082	101,0	<0,0001***
Govern_ Efficiency	0,738268	0,0635969	11,61	<0,0001***	0,747854	0,0630442	11,861	<0,0001***
Rule of Law	0,0371572	0,0394632	10,41	<0,0001***	0,0470865	0,0394614	6,786	<0,0001***
Control of Corruption	−0,0254225	0,0597092	−7,42	0,0029***	-0,0121419	0,0595170	-2,204	0,0083***
Political Stability	0,0330971	0,0344826	0,9598	0,3376	0,0253106	0,0342275	0,7395	0,4596
Observation (groups)	493 (22)				493 (22)			
R-square LSDV	0,931009	R-Square cor.		0,390053	Sum Sq. Res.	0,803068	St. err. Reg.	0,485780
F – Stat (25, 467)	252,0781	P-Crit. (F)		5,4e-253	Hannan-Quin	701,4112	P.Crit	1,07471e-073
Stat. Durbin -Watson	0,185307				0,185307			

*: 10%, **: 5%, ***: 1%

Stat F(4, 467) = 74,66, p-critic = P(F(4, 467) > 74,66) = 6,7596e-049, Stat test F(21, 467) = 69,1624, p-critic= P(F(21, 467) > 69,1624) = 1,14041e-128

Chi-square(4) = 346,353, Breusch-Pagan -H_0 Var.grad. ind.= 0, Stat test. Hi_{sq} Chi-square (1) = 2513,88, p-critic = 0, Hausman Test - H_0 Val. GLS is conv. Stat test. Chi- square (4)_ 9,92605, p.crit = 0,0416919

gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. Estimate gives the country's score on the aggregate indicator, in units of standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

[5] Voice and Accountability deal with perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media. The estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

[6] Regulatory Quality deals with perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. The estimate gives the country's score on the aggregate indicator, in units of standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

From the first table, we notice that the Government Efficiency and Rule of Law indicator has a positive impact on GDP per capita growth of the countries under consideration, while Control of Corruption harms GDP per capita growth. The results are robust even though we use different estimates (GLS and *Fixed effect*).

The results are coherent with the economic literature that good governance, increase of government efficiency and rule of law, as well as a reduction in corruption, lead to the economic growth of countries (Kaufmann et al., 2010; Dixit, 2009; Olson et al., 2000; Herbst, 2000).

As for the model in overall, we can say that it is robust, F stat is significant, and R^2=0.39. And the Hausman Test confirms that GLS estimator is consistent.

Table 2 Impact of good governance indicators on FDI

Dep. Var: FDI net inflow in % of GDP	**Fixed Effects**				**Random Effects (GLS)**			
	Coef.	Stan. Errors	t - ratio	P-value	Coef.	Stan. Errors	t - ratio	P-value
Const	0,0548457	0,0036527	15,01	<0,0001***	0,0529891	0,00601787	8,805	<0,0001***
Government Efficiency	0,0337846	0,0142762	2,367	0,0184**	0,0256229	0,0119335	2,147	0,0318**
Control of Corruption	-0,0469315	0,0138443	-3,390	0,0008***	-0,0351881	0,0123772	2,843	0,0045***
Political Stability	0,00104897	0,00801615	0,1309	0,8959	0,000613127	0,00692040	0,08860	0,9294
Observation (groups)	469 (22)				469 (22)			
R-square LSDV	0,215223	R-Square cor.		0,27348	Sum Sq. Res.	0,216508	St. err. Reg.	0,053548
F – Stat F(24, 444)	5,07358	P-Crit. (F)		5,19e-13	Hannan-Quin	701,4112	P.Crit	0,0294441
Stat. Durbin – Watson	1,522578				1,522578			

*: 10%, **: 5%, ***: 1%

Stat F(3, 444) = 4,16127, p-critic = P(F(3, 444) > 4,16127) = 0,00634787, Stat test F(21, 444) = 5,6558, p-critic= P(F(21, 444) > 5,6558) = 1,35751e-013

Chi-square(3) = 8,9885, Breusch-Pagan -H_0 Var.grad. ind.= 0, Stat test. Chi-square (3) = 3,84078 con p-critic = 3,44892e-028 , Hausman Test - H_0 Val. GLS is conv. Stat test. Chi- square (3) = 3,84078, p.crit = 0,279178

In the second model, Foreign Direct Investment, net inflows (% of GDP) is used as the dependent variable whereas Government Efficiency, Control of Corruption, and Political Stability are used as explanatory variables to verify whether foreign investments are influenced by government efficiency, corruption, and political stability, or rather whether foreign companies choose to invest or not in countries with good governance. In this model, all the explanatory variables are used with a lag value of 1(one) as foreign investors assess a foreign country carefully before investing in it.

From model number 2, we see that Government Efficiency has a positive sign and is significant, that is to say, good governance efficiency has a positive impact on the increase in foreign investment flows. Whereas the Control of Corruption variable has a negative sign and is significant, which shows that the increase in corruption somewhat reduces the FDI flows.

The variable Political Stability is not significant, so it does not influence FDI and the coefficient before the explanatory variable in question is very low, almost negligible. This is probably because foreign companies generally move production to one of the Eastern European transition countries. After all, they stand to benefit from labor costs, the fiscal system, transport costs and time, or population size. A foreign company is not interested in the political structure of a country, the only thing they are interested in is high government efficiency and low corruption.

If we will see the importance of this model in overall even in this case we can say that it is robust, F stat is significant whereas R^2 is very low. The Hausman Test confirms that the GLS estimator is consistent.

Conclusion

The results achieved in this paper suggest that a country's different policies should continuously aim to improve governance efficiency, to control and reduce corruption, and to improve the rule of law as these would have a positive impact on sustainable economic development in Eastern European transition countries.

The empirical analysis of panel models featuring fixed and random effects revealed that corruption, which in the vast majority of Eastern European Transition Countries has been present at a relatively high level, has a negative effect on both in GDP per capita growth and curbs foreign investment.The empirical analysis also confirmed that Government Efficiency and Rule of Law have a positive impact on GDP per capita growth.

Government Efficiency, in addition to its positive role in GDP per capita growth, plays an important role in increasing foreign investment. Another interesting result of this paper is the fact that even though there is a positive correlation between political stability and GDP per capita growth, this indicator is not significant. So, good governance efficiency and a reduction in corruption, influence the economic development of a country, which in a way leads to the political stability of that country. The political implication of this study is the fact that good governance plays an important role in the economic growth of transition countries, be it those which are considered to have completed the transition Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia, as well as those countries that are still considered to be transition countries such as Albania, Armenia, Belarus, Bosnia and Herzegovina, Georgia, Kosovo, North Macedonia, Moldova, Montenegro, Serbia, Russia, and Ukraine.

In conclusion, the fight against corruption and the improvement of the rule of law index are considered priority to GDP growth and also increase of foreign investment for Eastern European Transition Countries.

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