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Synthesis Report: WP7. Dynamics of institutional convergence

Marina Gruševaja*

*Halle Institute for Economic Research (IWH)

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Marina Gruševaja, marina.grusevaja@iwh-halle.de
Halle Institute for Economic Research (IWH)
www.iwh-halle.de

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Synthesis Report: WP7. Dynamics of institutional convergence[1]

Content

[1] Andrea Gauselmann – IWH, Germany; Judit Kalman – IE CERS HAS, Hungary; Radoslaw Markowski – EUROREG, Poland; Felix North – IWH, Germany; Eva Ozsvald – IE CERS HAS, Hungary; Marek Tiits - Institute of Baltic Studies, Estonia;

Executive summary

In recent years, research on economic development processes has paid increasing attention to the role of institutional factors. In the context of EU integration, a number of studies have included analyses of institutional factors related to the implementation of particular EU policies such as the European Cohesion policy (Ederveen et al, 2006, Daude and Stein 2007). However, there is strong variation in CEEC institutional contexts and in the degree of institutional convergence towards EU norms. A comprehensive view on the varied extent of institutional convergence towards European institutions in CEECs and the relationship this has with economic, social and territorial cohesion in the EU, was missing.

The accession strategy for the EU enlargement so far has been built on the formal ex ante harmonisation of institutions. The institutional underpinning of market economies is a "clearly delineated system of property rights, a regulatory apparatus curbing the worst forms of fraud, anti-competitive behaviour, and moral hazard, a moderately cohesive society exhibiting trust and social cooperation, social and political institutions that mitigate risk and manage social conflicts, the rule of law and clean government" (Rodrik 2000, p. 2). Establishing of effective, appropriate, market supporting institutions has been regarded as the necessary condition for an internal common market and it is reflected in the European Union law (acqui communautaire). The EU's institutional framework is assumed to be effective in the first place because it enables an internal common market free of distortion and then it might help to foster the trend to further economic integration and cohesion within the EU. This unified institutional environment, however, has been established in the Old EU member states by interjurisdictional bargaining procedure, by informal contracts and cooperation, and a mutual learning process over a long period of time. To this best (praxis proven) coherent combination of effective economic and political institutions (including the profile of governments) Central and Eastern European countries also had to converge partly before and partly after the EU accession to ensure macroeconomic stability and to enhance economic growth. The research of this work package aimed to gain a better understanding of the positive and negative dynamics of institutional convergence within the European Union and their impact on economic, territorial and social cohesion of the CEE region as part of the EU.

Task 1: The impact of European institutional convergence on growth and cohesion.

Research of the first task was aimed to provide a unified approach to institutional convergence in Central- and Eastern European countries towards EU norms (related to the acquis communautaire) and to answer the question whether EU accession contributed to GDP growth in these countries. There are two major and novel results. First, while the CEE countries showed some degree of institutional convergence towards EU norms in the 1990s this process stagnated in the 2000s. Second, we found that apart from the first years of transition, when growth in the region was still sluggish as a consequence of the deep transition recession, there is a little evidence that institutional convergence towards EU norms was a driving force of growth and cohesion in the CEECs.

Task 2: The persistence of institutional diversity in the new Member States of the EU.

In this task we aimed to provide analysis of persistence on institutional diversity despite institutional ex ante harmonization focusing on the CEECs' corporate governance (CG) issues. From a theoretical perspective we used the model of extended varieties of capitalism (Noelke and Vliegenhart, 2009) going back to the original theory of Varieties of Capitalism (VoC) (Hall and Soskice, 2001). The model suggests that financial system and corporate governance structure have a highly explanatory power when explaining the differences in market economies and that the two aspects are tightly interlinked. Noelke and Vliegenhart (2009) introduced the concept of „dependent market economies" (VoC-DME) and pointed at the far-reaching consequences heavy FDI dependence has on the other institutional building blocks and competitive advantage in these countries.

Our assessment of corporate governance in CEE-3 (Poland, Hungary and the Czech Republic) revealed the impact of national peculiarities of CG that lead to differences in institutional development. Looking at the impact of the EU regulation in terms of institutional convergence we found that the legislation in the CEE-3 duly followed the European initiatives. In all the three countries Company Laws were updated. We found that despite initial similarities within the CEE-3 group Poland took in the development of the equity markets the divergent trajectory as compared to the Czech Republic and Hungary. With the booming Warsaw Stock Exchange (WSE) and visible efforts to enhance several elements of good CG practices (such as regulations affecting transparency and minority shareholder rights) to internationally approved standards, Poland follows a more market-oriented road, in contrast to the Czech Republic and Hungary.

Further, a high inward FDI flow in CEEC led to foreign ownership of firms and influenced internal corporate governance in these countries. Thus, we conducted tests to see, whether foreign ownership and in particular its impact on internal corporate governance structures affects financial restraints of firms in CEEC. In our empirical analysis we focused on the distribution of decision power over financing and investment between MNEs' headquarters and foreign subsidiaries and its' influence on the foreign affiliates' financial restrictions. The main take away from our results is, that, in order to alleviate financial frictions, one should think of allocating as much power as possible to the subsidiary. However, - according to our results - headquarters of multinational enterprises have not (yet) given much decision power to their foreign subsidiaries in CEEC at all.

Task 3: The impact of EU-wide coordinated policies and structural reforms on cohesion.

In the task 3 we focused our research on the impact of EU-wide coordinated policies on cohesion. The institutionalized relation of territorial focused European Union (EU) cohesion policies and the coordinated policies (Lisbon Strategy, Europe 2020) went through many changes in the past 10-15 years. Expectations in 2005-2006 indicated that the "*Lisbonisation of Cohesion Policy*" could on the one hand promote the fulfilment of comprehensive Lisbon goals, while shifting the focus of cohesion policy from traditional alleviation of regional disparities to enhancing human resources and the knowledge intensive economic activities in prospective competitive parts of the economy. This relationship however has hardly been investigated. Our paper explored the reasons behind these changes and processes, their implementation and impact on Lisbon & Europe 2020 targets and cohesion outcomes, putting special emphasis on effectiveness of governance and on institutional issues as institutional weaknesses might lead to rent-seeking and inappropriate policies.

We found that regarding cohesion policy several research results highlight that its effectiveness and contribution to growth and convergence largely depends on the general quality of the institutional environment in which it operates, i.e. not only the institutional and administrative structure of its execution within the member state, the governance mechanisms and culture within its public sector, but also the ease of doing business (as reflected by complex indices e.g. in World Economic Forum reports) and the general macroeconomic environment, such as openness to trade and investment opportunities. At the same time this is an endogenous condition for policy effectiveness, as Cohesion Policy also tries to improve the business environment, attractiveness and socio-economic fabric of places in cohesion countries. The institutional environment and the way it affects effective absorption of EU funds is especially important in CEEs given their transition experience, however they started to show differences since EU accession in this respect.

Finally we found that there is no effective policy mechanism for co-ordination of production and employment levels in the different parts of the European Union. Neither co-ordinated policies, nor euro convergence criteria or the Stability and Growth Pact for the co-ordination of national fiscal policies in the European Union have fulfilled this role.

Task 4: The relation between the institutional setting and different dimensions of European cohesion.

In the workshop (dissemination stakeholder event) we took a look at Cohesion Policy and its different dimensions as a process of mixed success in the European Union in the last decades. The aim of harmonisation in terms of the institutional setting was to make the EU one of the most competitive and dynamic economies in the world that is capable of sustainable economic growth and promotes territorial and social cohesion. At first glance, the historic enlargement that brought 10 new member states to the European Union in 2004, has worked well. GDP growth was significantly higher in many CEE countries than in 'core EU' in mid-2000s. Real GDP growth was 3.6% in Germany and 2.5% in France, while Latvian and Estonian economies grew 11.0% and 10.1% respectively. The real economic growth was greater than 5% in majority of the then new EU member states (Eurostat 2014). These data seems to indicate that a very rapid catching up has been taking place in Central and Eastern Europe after the EU enlargement in 2004. Some of the CEE countries - Slovakia, Czech Republic, Lithuania, Estonia and Slovenia - have reached the 75% level of EU GDP per inhabitant in PPS terms by 2014, despite the crisis. Some others expect to reach it by 2020 (Eurostat 2014). It appears, however, that some regions and countries continue to lag behind even two decades or more after their EU accession. Also unemployment rate is now higher in majority of EU member states than in 2000 with the exception of Germany, Poland, Baltic States, Finland, Bulgaria and Romania. High youth unemployment and emigration of working class in the new EU member states is especially problematic. This is to say economic, social and territorial cohesion within the European Union is, empirically speaking, anything but guaranteed and automatic. We conclude that an excessive focus on equality and encouragement of total institutional convergence might be detrimental to growth and social issues in some regions.

Task 5: Political stability and institutional change.

In this task we had a research focus on political change as an extremely important dimension of the transformation process. The political coalitions in the CEECs since 1990 have changed very frequently and often followed a pendulum pattern – switching from left to right, from liberal to populist ideologies, and from conservative to progressive values. These changes had a strong bearing on the process of institutional and economic reform. This task examined the evolution of the political scenarios of the CEECs and is aimed to assess the possible relationship between characteristics of governments (stability of governments, their ideological profile, their support at micro – individual - level) and economic performances (GDP per capita, unemployment etc.) of the new EU member states.

The results allow us to submit, at the most general level, a weak support for the hypothesis that 'rightist' or 'right-leaning' governments in the longer run contribute to GDP growth and that they tend to neglect the unemployment issue. On the other hand, 'leftist' or 'left-leaning' governments contribute, though weakly, to a GDP decline and their activities have no effect on unemployment rate. The problem with these results is that of 'too small N' and – more importantly the ontology of the 'time span' needed to correctly trace the relationship between ideological leaning of particular governments and their economic accomplishments. Finally, the additional problem derives from, what we call, 'political-business cycles' – in CEE countries particularly short, only accidentally incumbents were re-elected.

More detailed analyses show however that countries of the region differ and they differ significantly. Czech Republic is a case on its own manifesting strong relationships between Left, Center and Right and citizens' policy stances. „National accommodative" socialism countries (PL, HU, SI even HR) unveil much more complicated and vague relationship as far as Left-Right issue content is concerned. The ideological `camp' strength fluctuates and differs by country, but if anything systematic comes through, it is that the RIGHT camp manifests stronger party-electoral institutionalization (definitely so in Estonia, Latvia, Slovakia and to a lesser degree – Slovenia, Hungary and Poland). Again – countries differ: in the Czech Republic either centre of right camp unveils stability, whereas in Hungary and Poland we unveil weak or no significant relationships between the analysed indicators of political stability.

All of the above leads to the following conclusion: ideological self-identities of voters matter and are effective heuristic device for mass-elite communication. Moreover, individual level analyses are in line with the macro level ones, in that it is the 'Right' camp seems to unveil clearer stability of the mass-elite relationship.

Objectives and methodology

WP7 went beyond the existing state of the art through two research strands. One line of research was linked to the joint impact of institutional convergence (or divergence) on economic, social and territorial cohesion (particularly growth, social inequality and regional disparities), and social and territorial cohesion. Novel approaches applied here include clustering institutional variables and relating them to growth and other relevant variables of cohesion (using multivariate methods). Furthermore, as institutional convergence cannot be taken for granted, the role national specificities play in cohesion were also a subject of research. This focused on the issue of corporate governance, which is particularly relevant given its importance in attracting external investment (Berglöf and Pajuste, 2005). Here, the innovative 'Varieties of Capitalism' category of 'dependent market economies' was applied to CEEC. A comparative political economy approach is applied to reveal similarities and important differences in regards to country-level CG characteristics in Czech Republic, Hungary and Poland (Noelke and Vliegenthart, 2009). The IWH Micro Database 2013 is used for a regression model to explain the occurrence of financial constrains at the subsidiary level due to the national peculiarities of corporate governance structures in Hungary, Poland, the Czech Republic, Slovakia, Romania and East Germany.

The second broad line of research focused on the role of compliance, from an institutional perspective, with the different targets of policies directed towards economic, social and territorial cohesion. Coordinated EU-wide policies focusing on economic and social cohesion can be seen as a further step towards institutional convergence in the EU. However, structural reforms under the umbrella of the Lisbon Strategy and the Europe 2020 strategy to a certain extent contained inherent tensions and trade-offs (Tabellini and Wyplosz, 2006, Pisani-Ferry and Sapir, 2006). Resolution of these dilemmas is, as a rule, left to national policy-makers. The research assessed how and what solutions were found, which priorities were favoured and how effective the coordinated and cohesion policies are. Progress beyond the state of the art also involved identifying and quantifying possible trade-offs between institutions, policies, political stability and the ideological profiles of governments in CEEC related to economic, social and territorial cohesion, for which qualitative and quantitative research methods were applied.

The objectives of this work package were split in five tasks, and specifically are:

- To analyse the impact of the European institutional convergence process on growth.
- To identify the institutional diversity in the new member states of the European Union and its impact on the process of Europeanization.
- To identify the effectiveness and the further development of the EU-wide institutional framework (the Lisbon Strategy and the 'Europe 2020' strategy).
- To analyse the effects of policies and institutions related to economic, territorial and social cohesion researched in depth in other WPs.
- To analyse the impact of ideology and political attitudes on economic development.

Evidence of analysis – synthesis (task by task)

Task 1: The impact of European institutional convergence on growth and cohesion.

Research of the first task was aimed to provide a unified approach to institutional convergence in Central- and Eastern European countries towards EU norms (related to the acquis communautaire) and to answer the question whether EU accession contributed to GDP growth in these countries. In order to make institutional convergence measurable, we applied multivariate and cluster analysis (Husson et al, 2010, Mair & de Leeuw, 2010) to transition indicators published by the European Bank for Reconstruction and Development. The EBRD transition indicators are numerically-coded judgements of experts which should be understood in a qualitative way or – in other words – they have an ordinal scaling level (a value of "1" stands for "no steps" or almost no steps towards EU norms, "2" for "some" steps in this direction, "3" for "significant progress" and "4.3" for "full EU norms adjustment". In this way we first tested the hypothesis that there is one best (praxis proven) coherent combination of effective institutions for all Central- and Eastern European countries that ensure macroeconomic stability and enhance economic growth and that the new EU member state will converge to this institutional framework through ex ante harmonisation. The results of empirical tests do not support this hypothesis.

We found that overall institutional convergence of the CEE countries has proceeded till 2003. Since then the convergence process slowed down and in all countries there is a trend of stagnation in relative terms of institutional convergence. Furthermore, the countries are trapped in the regional clubs (clusters) and there are few signs of changes between clusters (Table 1).

Table 1: Development of institutional indicators (EBRD transition indicators) as average per period and per cluster.

2007-2010	Large scale privatisation	Small scale privatisation	Enterprise restructuring	Price liberalisation	Trade & Forex system	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Competition Policy
all countries	3.5	4.0	2.7	4.2	4.2	3.3	2.7	2.7
Cluster 1 (EE,LV,LT,HU, PL,SK)	3.8	4.3	3.4	4.3	4.3	3.8	3.4	3.4
Cluster 2 (BG,HR,RO,SI)	3.5	4.1	2.8	4.2	4.3	3.6	2.9	2.8
Cluster 3	3.6	4.0	2.4	4.3	4.3	2.8	2.0	2.2
Cluster 4	3.0	3.7	2.1	4.0	4.0	3.0	2.0	2.1

2004-2006	Large scale privatisation	Small scale privatisation	Enterprise restructuring	Price liberalisation	Trade & Forex system	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Competition Policy
All countries	3.4	4.0	2.7	4.2	4.2	3.2	2.5	2.4
Cluster 1 (PL,HU,CZ,EE, LT,LV,SK)	3.8	4.3	3.4	4.3	4.3	3.8	3.3	3.2
Cluster 2 (BG,HR,RO,SI)	3.5	4.0	2.8	4.2	4.3	3.5	2.6	2.5
Cluster 3	3.2	3.9	2.2	4.2	4.2	2.7	2.0	2.1
Cluster 4	2.6	3.2	2.1	4.0	3.4	2.6	1.8	1.2

1999-2003	Large scale privatisation	Small scale privatisation	Enterprise restructuring	Price liberalisation	Trade & Forex system	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Competition Policy
All countries	3.1	3.8	2.4	4.1	4.0	2.8	2.3	2.2
Cluster 1 (BG,HR,CZ,EE, LV,LT,HU,PL,SK,SI)	3.5	4.3	3.0	4.2	4.3	3.4	2.9	2.7
Cluster 2 (RO)	3.0	3.8	2.0	4.1	4.0	2.4	1.8	2.0
Cluster 3	2.2	2.6	1.7	4.0	3.1	2.3	1.3	1.0
Cluster 4	1.5	3.0	1.4	3.3	2.1	1.5	1.3	1.0

1995-1998	Large scale privatisation	Small scale privatisation	Enterprise restructuring	Price liberalisation	Trade & Forex system	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Competition Policy
All countries	2.7	3.6	2.2	3.8	3.5	2.4	2.0	1.9
Cluster 1 (HR,CZ,EE,LV,LT,HU,PL,SK,SI)	3.4	4.2	2.8	4.1	4.1	3.0	2.6	2.4
Cluster 2 (BG,RO)	2.6	3.4	2.0	3.8	3.7	2.3	1.6	1.7
Cluster 3	1.1	2.5	1.1	2.7	1.5	1.2	1.0	1.0

1991-1994	Large scale privatisation	Small scale privatisation	Enterprise restructuring	Price liberalisation	Trade & Forex system	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Competition Policy
all countries	1.6	2.6	1.6	3.4	2.7	1.7	1.3	1.5
Cluster 1 (SK,PL,HU,CZ)	2.4	3.4	2.6	4.1	3.8	2.6	1.8	2.3
Cluster 2 (SI,LT,LV,EE,BG, HR)	1.7	2.8	1.6	3.8	3.0	1.8	1.3	1.5
Cluster 3 (RO)	1.2	2.0	1.1	2.7	1.9	1.1	1.1	1.2

Source: own analysis

In a second analysis, we tested the connection between clusters and growth using a Kruskal-Wallis test (Meyer and Seaman, 2013), and correlations between a) clusters and social cohesion using GINI coefficients[2], and b) clusters and regional cohesion in the EU using calculated for Eurostat NUTS3 data on regional per capita GDP in purchasing power parities. Our results of growth tests do not reflect a strong connection between clubs of institutional convergence and growth apart from a very initial period of transition (until 1995). It seems that the progress of institutional convergence does not affect growth significantly. Our results of social and regional cohesion tests do not reflect any connection at all. This outcome, however, might be caused by the problems regarding the validity of the EBRD transition indicators. As they reflect the progress towards an economic system defined by private ownership and free markets and not towards an economic system that bring growth and prosperity. Hence, the EBRD transitions indicators might be a wrong tool to study the connection between institutional convergence and growth. But they are still valid to reflect the dynamics of institutional convergence and illustrate that countries have been trapped in regional clubs. Taking into account national peculiarities (path dependence), these different clubs might need different institutional solutions to progress along the road to growth and prosperity.

To summarize, there are two major and novel results. First, while the CEE countries showed some degree of institutional convergence towards EU norms in the 1990s this process stagnated in the 2000s. Second, we found that apart from the first years of transition, when growth in the region was still sluggish as a consequence of the deep transition recession, there is a little evidence that institutional convergence towards EU norms was a driving force of growth and cohesion in the CEECs.

Task 2: The persistence of institutional diversity in the new Member States of the EU.

In this task we aimed to provide analysis of persistence on institutional diversity despite institutional ex ante harmonization focusing on the CEECs' corporate governance (CG) issues. From a theoretical perspective we used the model of extended varieties of capitalism (Noelke and Vliegenhart, 2009) going back to the original theory of Varieties of Capitalism (Hall and Soskice, 2001). The model suggests that financial system and corporate governance structure have a highly explanatory power when explaining the differences in market economies and that the two aspects are tightly interlinked. Noelke and Vliegenhart (2009) introduced the concept of „dependent market economies" (VoC-DME) and pointed at the far-reaching consequences heavy FDI dependence has on the other institutional building blocks and competitive advantage in these countries.

Our first paper "Corporate governance in Central Eastern Europe – a comparative political economy approach" (Ozsvald, 2014) dealt with several aspects of corporate governance in three Central Eastern European countries the Czech Republic, Hungary and Poland (CEE-3). We followed that strand of literature that focuses on the CG of public companies. This prompted us to give equal attention to the evolution of capital markets in CEE-3. The equity market-CG relationship is bi-directional. On one hand, the rules and instructions from the stock exchanges improve many corporate governance characteristics, while on the other a high CG reputation certainly contributes to the development of local bourses.

In the VoC-DME approach of Noelke and Vliegenhart (2009) the CEE-3 (plus Slovakia) are treated as a homogenous group and this is supported by the data from a decade ago. We contend, however, that

[2] The Gini coefficients were taken from the Transmonee 2008 data base and the UNU-WIDER data base for the time span 1991-1998 and from the EU Commission for the time span 1999-2010.

viewed from a later and another perspective, based on the development of stock exchanges and the concomitant pressure for the improvement of CG mechanisms, the lumping together of CEE-4 conceals an important institutional divergence.

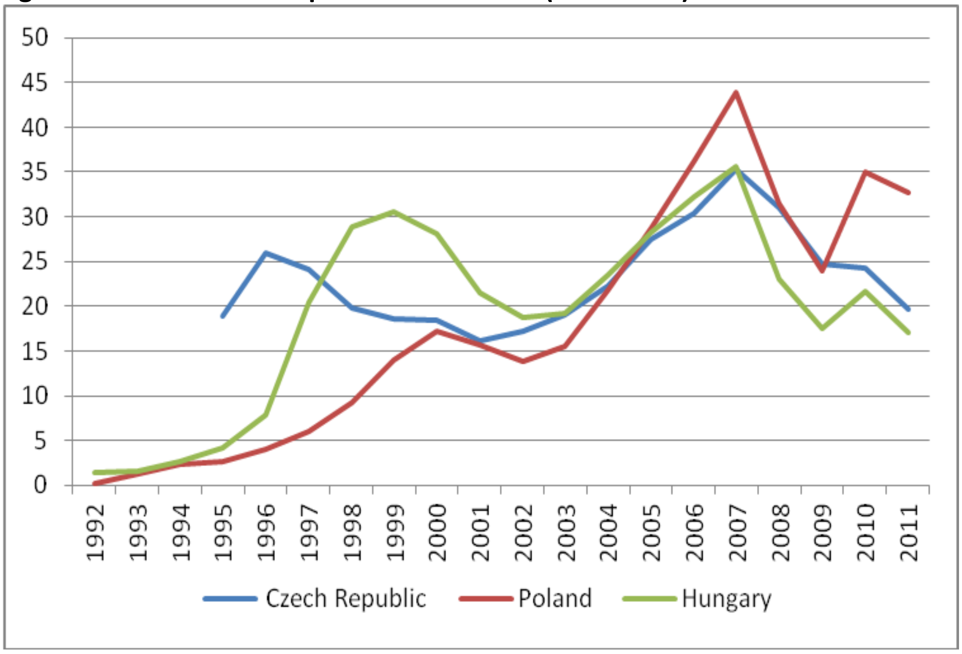
All companies can have governance problems but the term corporate governance in the main relates to corporations whose shares are freely transferable and are quoted on stock exchanges. Thus, the characteristics of national capital markets and many CG features are tightly interwoven. Because of this, we started our research by overviewing the development of capital markets in the Czech Republic, Hungary and Poland. During the first half of the 2000s these markets were described as being thin, illiquid and indeed, the trading there has been concentrated on the stocks of a small number of large corporations. The global financial crisis dealt a further blow to these markets. What is remarkable, however, is the emergence of within-group diversity in recent years.

Looking at the impact of the EU regulation in terms of institutional convergence we found that the legislation in the CEE-3 duly followed the European initiatives. In all the three countries Company Laws were updated. These new laws unlike their predecessors have explicit reference to the rules of corporate governance and make sharper distinction between private and public companies. In addition, the soft law regulation of public companies, in the form of „codes of good governance" has also been introduced in CEE-3 from 2004 onwards. The regulation by codes allows more flexibility by using the „comply ore explain" principle. The chapters of the CG Codes are very similar in CEE-3; they cover shareholder's rights and treatment of shareholders, responsibilities of the management and the boards, the establishment and the duties committees, and the procedures of disclosure.

We found also that laws on the book, however, are just one part of the story. On the one hand, there is an agreement among experts that the provisions the new EU-inspired Company Laws and other CG regulations throughout the CEE-3 are up to the levels of internationally recognized standards. On the other hand, research (Pistor, Raiser & Gelfer, 2000) has drawn attention to the fact that it is the effectiveness of the implementation of regulations, legal enforcement and the perception of legality where the real problems in the creation of efficient business environment and developed capital markets in CEEs start. The gap between regulations on the book on the one hand and the respect and enforcement of law on the other is still a recurring theme when the idiosyncrasies of CG regulation in CEEs are discussed.

Overall our assessment of corporate governance in CEE-3 revealed the impact of national peculiarities of CG that lead to differences in institutional development. We found that despite initial similarities within the CEE-3 group Poland took in the development of the equity markets the divergent trajectory as compared to the Czech Republic and Hungary. With the booming Warsaw Stock Exchange (WSE) and visible efforts to enhance several elements of good CG practices (such as regulations affecting transparency and minority shareholder rights) to internationally approved standards, Poland follows a more market-oriented road, in contrast to the Czech Republic and Hungary with stagnant or less dynamic bourses in Prague and Budapest with their relatively small number of companies, high concentration and low liquidity (Figure 1.)

Figure 1. Stock Market Capitalization to GDP (1992-2011)



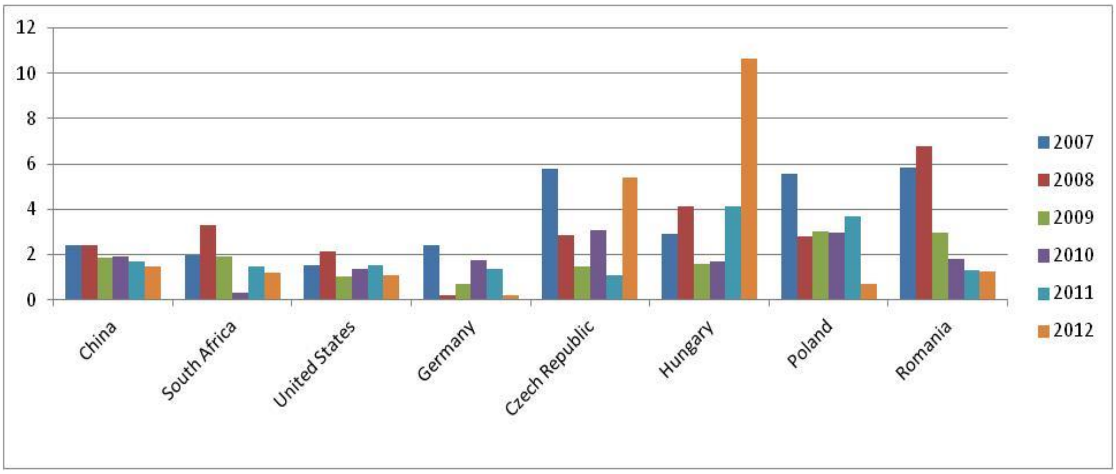
Source: http://research.stlouisfed.org/fred2/graph/?s[1][id]=DDDM01HUA156NWDB

Our conclusions are that the bigger size of the Polish economy and growth potential of the domestic market has given Poland advantage in the expansion of its stock exchange. Government policies and incentives, however, also substantially contributed to what is called „equity" culture. The WSE now counts as the main financial hub in Central Eastern Europe, attracting a big number of domestic and foreign businesses. The steadily expanding capital market in Poland is expected to transform the structure of the whole financial system and contributes to the improvement of corporate governance practices of listed companies. Reverse causality also applies in the sense that better regulated, more transparent companies are more valued by investors and thus can attract more outside capital.

Looking at the high inward FDI flow in CEEC (Figure 2), our second paper "Corporate Governance and Finacial constraints in foreign owned enterprises" (Gauselmann and North, 2014) addresses the research question whether foreign ownership and in particular its impact on internal corporate governance structures affects financial restraints of firms in CEEC. In our empirical analysis we focus on the distribution of decision power over financing and investment between MNEs' headquarters and foreign subsidiaries and its' influence on the foreign affiliates' financial restrictions.

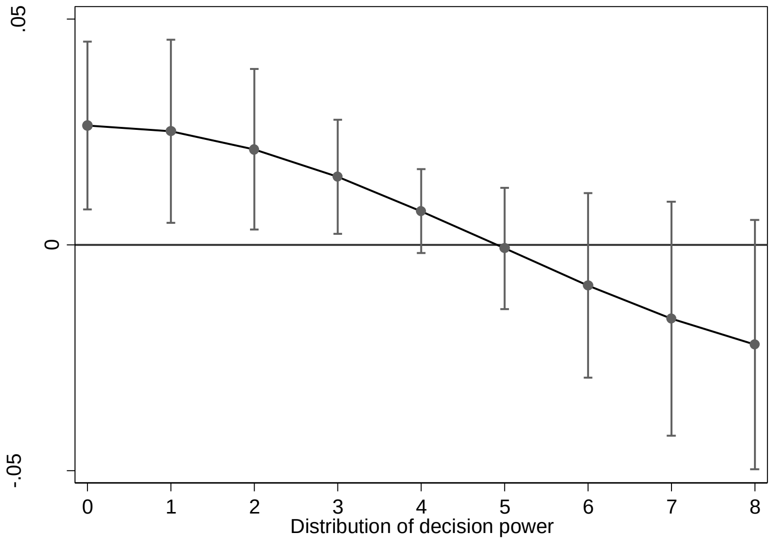
We used data from the IWH FDI Micro database that contains information on corporate governance structures and financial restrictions of 609 enterprises with foreign investor. We matched data from Bureau van Dijks AMADEUS database on financial characteristics in Hungary, Poland, the Czech Republic, Slovakia, Romania and East Germany. We found that a high concentration of decision power within the MNE's headquarter implicates high financial restrictions within the subsidiary. Square term results showed, however, that the effect of financial constraints within the subsidiary decreases and finally turns insignificant when decision power moves from headquarter to subsidiary.

Figure 2: Inward FDI flow, share of GDP per year (2207-2012)



Source: Unctad 2013.

Figure 3: Squared term results



Source: own calculations, IWH FDI Micro database 2013.

The results of our empirical analysis suggested that corporate governance structures that allow for more decision power of the local management of the subsidiary increase the likelihood of financial constraints for these firms (Figure 3). This is at odds with the literature that for example shows that foreign ownership in general decrease financial constraints (Gugler and Peev, 2010). On the other side, the results are similar to studies that find that control rights in foreign owned firms increase private benefits at the firm level and make underinvestment more likely. Also, our results might be explained by poor governance in firms with a more balanced division of decision power and are thereby similar to the study by Francis et al. (2013). This might lead to the conclusion that there are frictions that come with the allocation of decision power to the headquarter that are only healed if the corporate governance structure is changes significantly to a level where the subsidiary posses the decision power for most of the business functions. The main take away from our results therefore is, that, in order to alleviate financial frictions, one should think of allocating as much power as possible to the subsidiary. However, - according to our results - headquarters of multinational enterprises have not (yet) given much decision power to their foreign subsidiaries at all.

Task 3: The impact of EU-wide coordinated policies and structural reforms on cohesion.

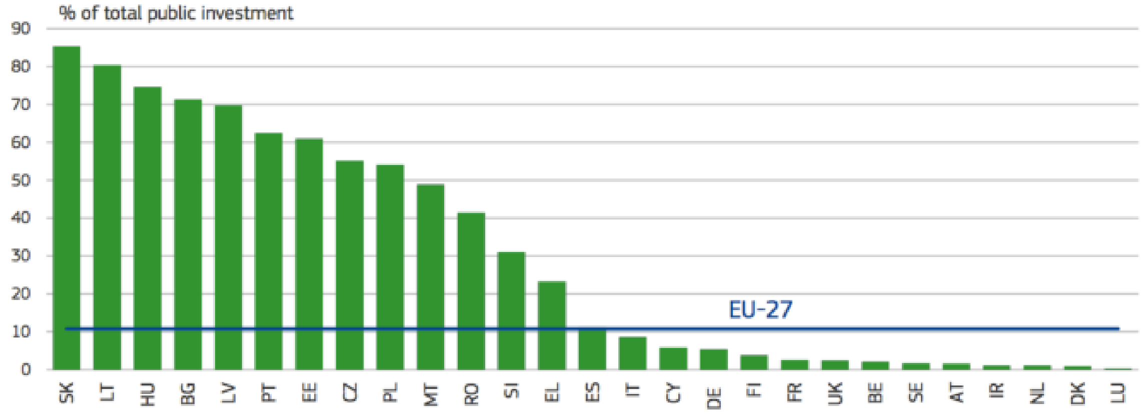
In the task 3 we focused our research (Kalman and Tiits, 2014) on the impact of EU-wide coordinated policies on cohesion. The institutionalized relation of territorial focused European Union (EU) cohesion policies and the coordinated policies (Lisbon Strategy, Europe 2020) went through many changes in the past 10-15 years. Expectations in 2005-2006 indicated that the "*Lisbonisation of Cohesion Policy*" could on one hand promote the fulfilment of comprehensive Lisbon goals, while shifting the focus of cohesion policy from traditional alleviation of regional disparities to enhancing human resources and the knowledge intensive economic activities in prospective competitive parts of the economy. This relationship however has hardly been investigated. Our paper explored the reasons behind these changes and processes, their implementation and impact on Lisbon & Europe 2020 targets and cohesion outcomes, putting special emphasis on effectiveness of governance and on institutional issues as institutional weaknesses might lead to rent-seeking and inappropriate policies (Persson et al. 1997, Grossman and Helpman 2001, Acemoglu 2006, Acemoglu and Johnson 2006).

Despite the common believe that economic and institutional integration leads to convergence of income levels and hence wealth level (Krugman, 1985, Ben-David, 1996) we found that while we witness an 'asymmetric integration' in Europe today, the various macroeconomic conditions, including global financial flows (incl. portfolio investments and loan financing) have been much more powerful in fuelling the unsustainable domestic consumption led growth, than what the combined efforts of co-ordinated policies (Lisbon and Europe 2020 strategies) and cohesion policies have achieved in improving competitiveness of the cohesion regions in the 2000s. In connection we have identified, a number of blind spots in the EU economic policy mix, which have allowed this to happen.

We found that some elements of the EU economic policy framework, such as foreign trade policy, monetary policy or even R&D and innovation policy, continue to face major challenges in meeting the realities and needs of the 28 member states with very diverse levels of competitiveness. Some countries, such as Germany, would like to continue to benefit from strong euro, but less competitive cohesion economies would clearly benefit from weaker currency. European R&D policy concentrates on innovation and knowledge-intensive services supported by endogenous growth theory model (Romer, 1986, Grossman and Helpman, 1991, Aghion et al, 2005). It puts scientific excellence first and, thus, tends to benefit the largest and strongest labs in Europe foremost, leaving the weaker research labs and companies to lag behind. This leaves both structural and cyclical imbalances, which do not get sufficient attention from other policy domains, for the EU cohesion policy to be resolved, and leads the euro area in particular to the situation where more competitive economies export their manufactured goods and less competitive economies export their unemployed.

Why is this so? We witness asymmetric integration in the European Union, which has brought together 28 member states with very different levels of competitiveness of their exporting industry. We found that both the labour productivity gap in the exporting industry and structural challenges in industrial specialisation are larger than often anticipated in the European public policy. More competitive member states in core Europe specialise in increasing returns high-income activities, such knowledge intensive services, medium and high technology manufacturing. Cohesion economies, which are mostly located on the EU periphery, specialise, however, in low-income non-knowledge intensive services, low and medium technology manufacturing. This is the fundamental reason why the productivity and cohesion gap persists in the European Union. So far, combined national efforts, EU policy co-ordination and cohesion funds have been ineffective in fostering the emergence of a 'flying geese' development pattern that would be similar to the ones witnessed after the British Industrial Revolution in 18-19th centuries in Western Europe and in 20th century East Asia. Hence, the cohesion gap persists.

Figure 4. EU has become major source of public investment after crisis in CEE.



Source: Eurostat, DG REGIO

Looking at the time span after the last crisis which imposed additional challenges on EU-wide coordinated policies the recovery is not very promising either. Since after the 2008 crisis, EU Cohesion Policy became a major source of public investment in cohesion countries, especially in the CEEs (providing a good counter-cyclical tool for these countries). Hence the relevance of 'Lisbonisation' of EU Cohesion policy has gained special relevance (Figure 4). The economic growth has remained, however, uneven across sectors and countries even six years after the outbreak of the last crisis in the European Union. There are pockets of stronger growth, such as Germany, while the growth economic output is negligible or even declining elsewhere in European Union.

Some degree of regional disparities seem necessary according to development economics and economic geography, an excessive focus on equality and encouragement of total convergence (the original goal of Cohesion Policy) might in fact be detrimental to growth, as it limits productivity and innovation effects of agglomeration, the concentration of economic activities in more prosperous regions (Farole et al, 2011). Regional disparities are higher in the EU, than in the US and there is more solidarity and care for inclusion – hence the existence and main part of Cohesion Policy in the EU Treaty. Yet if the EU wants to remain competitive in the global economy agglomeration of economic activities might be one key element.

Lisbon Strategy of the European Union expected the increase the R&D intensity of the economy to 3% of GDP, and a healthy 70% employment level, which were to indicate a competitive and inclusive economy. Unfortunately, Lisbon Strategy proved largely a failure, as its objectives were unlikely to have been met even without global financial and economic crisis[3]. Sadly, the Europe 2020 strategy shares a number of the weaknesses of the earlier Lisbon Strategy. The headline objectives of the Europe 2020 strategy, such as the intended R&D intensity or employment level, reiterate some of the headline objectives of earlier Lisbon strategy. These targets are, however, of a very high level of abstraction, and the strategy itself does not clear enough on what it actually takes to achieve these

[3] First publicly admitted by Swedish Prime Minister Fredrik Reinfeldt on 02 June 2009. http://www.euractiv.com/priorities/sweden-admits-lisbon-agenda-fail-news-221962

targets. For example, 3% R&D intensity target calls implicitly for major structural change in the European economy; 75% employment level is an indication of well performing economy, but these targets alone do not indicate how Europe actually seeks to become successful. Proper operationalisation of the headline targets or the Europe 2020 strategy into meaningful policies remains, however, a major challenge for the member states.

Apart from efforts on coordinating strategic planning and monitoring in the EU Semester, the primary tool for 'promoting Lisbon through Cohesion' was the thematic allocation of Cohesion funding to Lisbon priorities via earmarking. Although original percentage goals got over-fulfilled, still there was no strong enforcement and performance was left to Member States own initiative, with wide differences (exemption for CEEs, HU: 46.8% and EE: 54.1% among least Lisbon-earmarked Cohesion spending) and not much enforcement. The earmarking instrument itself has been criticized for being too top-down, administratively demanding and contributing to the emphasis on spending instead of outcomes. Yet it was a precedent for top-down governance, when EU could set parameters in allocation decisions of Member States – a tendency strengthened for the new 2014-2020 period with more specific spending categories for both ERDF and ESF.

From a governance perspective, the single market, Cohesion Policy and the Lisbon and Europe 2020 strategies represent not only three distinctive pillars of European public policy, but also rely on three different modes of governance: the first mostly regulatory, the second relying on public spending and the third being about coordination of national policies in the common interest (Mendez, 2011, Bachtler et al, 2013). While Cohesion Policy is rather linked to a model of multi-level governance (MLG) (Marks, 1993, Hooghe, 1996), the principal governance mechanism for the Lisbon Agenda was the non-hierarchical and voluntary Open Method of Coordination (OMC), which eventually proved to be beneficial as a soft mechanism of policy learning and diffusion across EU countries, due mostly to formal requirements for allocating EU funds.

Multi-level governance (MLG) is accounted by theory and many reports (e.g. OECD 2009 & 2011 and Barca 2009) to be the best and most effective approach for carrying out national or regional development policies, due to its reliance on subsidiarity, mix of central priorities with local needs and potentials, thereby allowing a more effective, legitimate and more transparent development policymaking and better commitment (similar arguments used in the fiscal federalism literature for the benefits of decentralization – see, e.g., Oates 2003). However, robust, credible, quantitative empirical evidences about the effectiveness of MLG approach in terms of economic or development outcomes reached in EU are still missing, plus its inefficiency, heavy administrative and bureaucracy burden is one of the most frequent criticisms of national stakeholders (LSE 2011, METIS-EPRC 2014).

The OMC has also failed as a mechanism of governance for achieving an overall EU-wide policy focus on competitiveness and employment levels. This was in part due to the overly complex and large pool of Lisbon goals and unclear policy and development paths, initial lack of horizontal coordination between e.g. employment versus social protection OMCs, or the lack of clarity of the linked Cohesion Goals per se, as well as due to the lack of political commitment to assessment indicators and performance reporting.

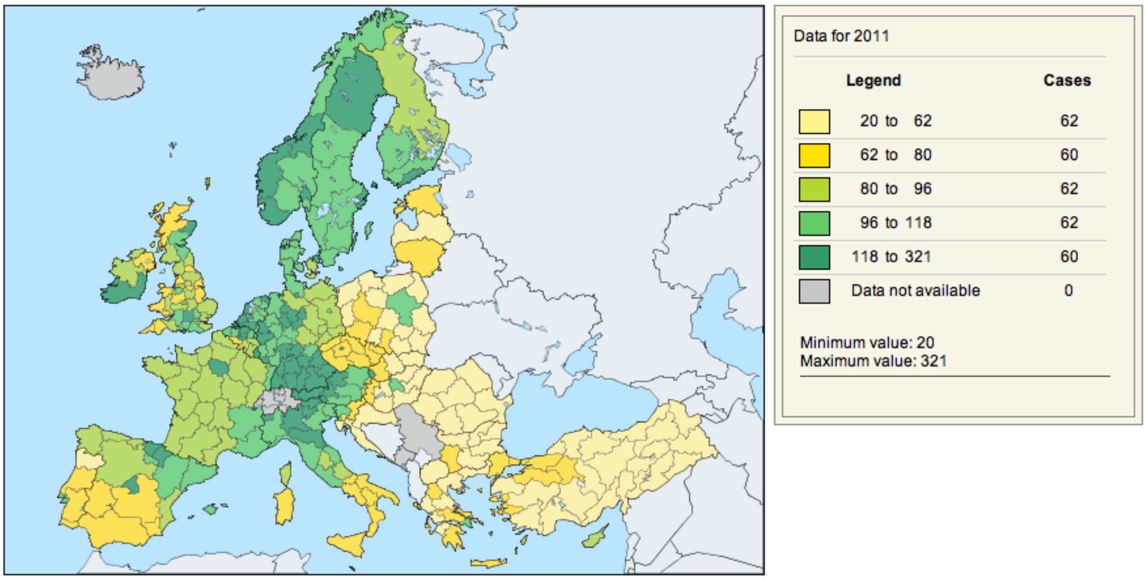
Concluding we found that regarding cohesion policy several research results highlight that its effectiveness and contribution to growth and convergence largely depends on the general quality of the institutional environment, in which it operates (Cappelen et al 2003, Ederveen et al 2006, Farole et al 2011, Bachtler et al 2009), i.e. not only the institutional and administrative structure of its execution within the member state, the governance mechanisms and culture within its public sector, but also the ease of doing business (as reflected by complex indices e.g. in World Economic Forum reports) and the general macroeconomic environment, such as openness to trade and investment opportunities. At the same time this is an endogenous condition for policy effectiveness, as Cohesion Policy also tries to improve the business environment, attractiveness and socio-economic fabric of places in cohesion countries. The institutional environment and the way it affects effective absorption of EU funds is especially important in CEEs given their transition experience, however they started to show marked differences since EU accession in this respect. Regarding the general macroeconomic environment we found that there is no effective policy mechanism for co-ordination of production and employment levels in the different parts of the European Union. Neither co-ordinated policies, nor euro convergence criteria or the Stability and Growth Pact for the co-ordination of national fiscal policies in the European Union have fulfilled this role.

Task 4: The relation between the institutional setting and different dimensions of European cohesion.

In the workshop (dissemination: stakeholder event) we took a look at Cohesion Policy as a process of mixed success in the European Union in the last decades. Some cohesion countries, often the poorest, have been catching up fast in GDP per capita terms, but their average wage growth was often even faster than productivity growth in exporting industry in 2000s. Rapid increase of unit labour cost along with consumption rather than export led growth led to the erosion of competitiveness in such economies. While this has been the case, a number of other countries have not experienced meaningful growth for a decade or even longer in the new EU member states. Social situation, which improved prior to the global financial and economic crisis, has worsened significantly thereafter.

The aim of harmonisation in terms of the institutional setting was to make the EU one of the most competitive and dynamic economies in the world that is capable of sustainable economic growth and promotes territorial and social cohesion. At first glance, the historic enlargement that brought 10 new member states to the European Union in 2004, has worked well. GDP growth was significantly higher in many CEE countries than in 'core EU' in mid-2000s. Real GDP growth was 3.6% in Germany and 2.5% in France, while Latvian and Estonian economies grew 11.0% and 10.1% respectively. The real economic growth was greater than 5% in majority of the then new EU member states. (Eurostat 2014) This seems to indicate that a very rapid catching up has been taking place in Central and Eastern Europe after the EU enlargement in 2004. Some of the CEE countries - Slovakia, Czech Republic, Lithuania, Estonia and Slovenia - have reached the 75% level of EU GDP per inhabitant in PPS terms by 2014, despite the crisis. Some others expect to reach it by 2020 (Eurostat 2014). It appears, however, that some regions and countries continue to lag behind even two decades or more after their EU accession (Kalman and Tiits, 2014, p.15-16). Also unemployment rate is now higher in majority of EU member states than in 2000 with the exception of Germany, Poland, Baltic States, Finland, Bulgaria and Romania. High youth unemployment and emigration of working class in the new EU member states is especially problematic (Eurostat 2014). This is to say economic, social and territorial cohesion within the European Union is, empirically speaking, anything but guaranteed and automatic (Figure 5).

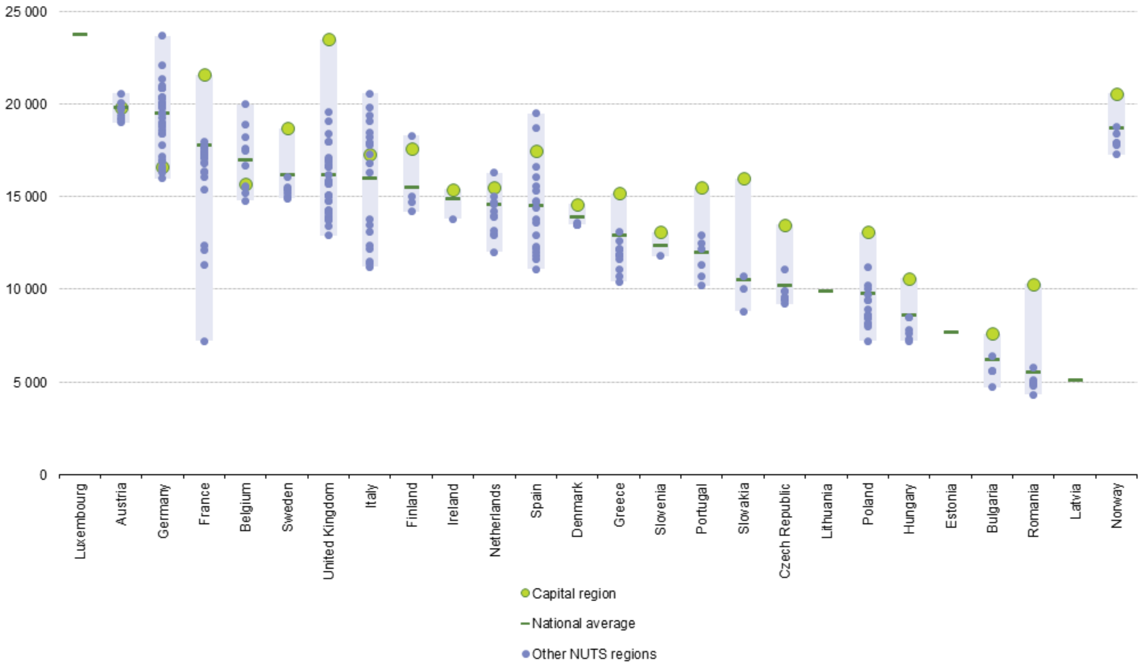
Figure 5. Cohesion gap remains there even decades after EU accession (NUTS2, GDP per inhabitant, PPS, % of EU28, 2011)



Source: Eurostat 2014.

The cohesion gap between the strongest and weakest EU regions is at least four-/five-fold when the disposable income in PPS terms is considered. While this is the case, capital regions offer much greater living standards than other regions in most of the member states (Figure 6).

Figure 6. Cohesion gap in disposable income terms (NUTS2, PPS, 2011)



(¹) The light purple shaded bar shows the range of the highest to lowest region for each country. The dark green bar shows the national average. The green circle shows the capital city region. The dark purple circles show the other regions. Guadeloupe (FR91), Martinique (FR92), Guyane (FR93) and Réunion (FR94): 2009. Italy and Norway: forecasts. Croatia, Cyprus and Malta: not available.
Source: Eurostat (online data code: nama_r_ehh2inc)

Source: Eurostat 2014.

Looking at the new EU member states and their implementation of institutional setting of the EU our research revealed that some of them – for example Poland, the Czech Republic, Estonia – show a very impressive outcome in terms of economic, territorial and social cohesion while others seem to be captured in a kind of development trap (e.g. Romania, Bulgaria). Taking into account national peculiarities (path dependence) we conclude that different countries might need different institutional solutions or at least a different pace of institutional harmonisation. Further, an excessive focus on equality and encouragement of total convergence might be detrimental to growth in some regions. Beyond the appropriate institutional setting also political factors are playing an important role in the process of decision-making, promoting and enforcement of institutions.

Task 5: Political stability and institutional change.

This task had a focus on political change as an extremely important dimension of the transformation process. The political coalitions in the CEECs since 1990 have changed very frequently and often followed a pendulum pattern – switching from left to right, from liberal to populist ideologies, and from conservative to progressive values. These changes had a strong bearing on the process of institutional and economic reform. This task examined the evolution of the political scenarios of the CEECs and is aimed to assess the possible relationship between characteristics of governments (stability of governments, their ideological profile, their support at micro – individual - level) and economic performances of the new EU member states.

Our research has a focus on two key questions: first, whether one can trace clear effects of the ideological profile of governments in Central and Eastern Europe on the economic fortunes of their respective countries, and whether different indicators (GDP growth, unemployment, inflation) of the economic development 'perform' differently in this respect. Second fundamental question is whether this macro-level relationship between type of governments and their economic accomplishments, can be unveiled at the micro-level, among citizens of CEE polities.

The results allow us to submit, at the most general level, a weak support for the hypothesis that 'rightist' or 'right-leaning' governments in the longer run contribute to GDP growth and that they tend to neglect the unemployment issue. On the other hand, 'leftist' or 'left-leaning' governments contribute, though weakly, to a GDP decline and their activities have no effect on unemployment rate. The problem with these results is that of 'too small N' and – more importantly the ontology of the 'time span' needed to correctly trace the relationship between ideological leaning of particular governments and their economic accomplishments. Finally, the additional problem derives from, what we call, 'political-business cycles' – in CEE countries particularly short, only accidentally incumbents were re-elected.

The individual level analyses were run under the assumption that policies are implemented only if politics allows and the latter – in democracies – depends on voters preferences and support. The most general individual level analyses' results indicates that in most instances ideological leaning (Left or Right) of citizens is logically related to their detailed policy/issue preferences.

Furthermore, we found that the two measures of political system stability (important in our design that assumes only stable governments can effectively implement any policy) are positively related: quality of representation, party-electorate homogeneity is associated with clear party preferences (measured by a fairly novel way as 'party differential').

More detailed analyses show however that countries of the region differ and they differ significantly. Czech Republic is a case on its own manifesting strong relationships between Left, Center and Right and citizens' policy stances. „National accommodative" socialism countries (PL, HU, SI even HR) unveil much more complicated and vague relationship as far as Left-Right issue content is concerned. The ideological `camp' strength fluctuates and differs by country, but if anything systematic comes through, it is that the RIGHT camp manifests stronger party-electoral institutionalization (definitely so in Estonia, Latvia, Slovakia and to a lesser degree – Slovenia, Hungary and Poland). Again – countries differ: in the Czech Republic either centre of right camp unveils stability, whereas in Hungary and Poland we unveil weak or no significant relationships between the analysed indicators of political stability.

All of the above leads to the following conclusion: ideological self-identities of voters matter and are effective heuristic device for mass-elite communication. Moreover, individual level analyses are in line with the macro level ones, in that it is the 'Right' camp seems to unveil clearer stability of the mass-elite relationship.

Moreover, macro-micro interactions employed allow us to say that, whenever there is a Rightist government in power the dominant public opinion mood is also rightist and that the same, though 'mirroring' relationship holds true for the other side of the ideological spectrum, i.e. that when incumbents are of Leftist pedigree the dominant public mood is also leftist. Yet, wherever we find a high inflation context, the more likely it is accompanied by a Right social mood and when higher level of unemployment is in place it is very likely that Leftist social mood dominates. The latter results point to the importance of the 'demand-supply' mechanism behind the macro level of political-economic relationship. Briefly, whenever there is a shortage (or abundance) of these two mentioned above key economic parameters, the public reaction is aimed at achieving (new) equilibrium. If true, that is if confirmed by other and/or further analyses, a pretty important and promising result.

Policy implications and recommendations

The analysis of work package 7 revealed that national peculiarities in institutional terms are playing a very important role for economic integration and development of EU member states. We want to conclude with the following policy implications and recommendations:

- Ex ante harmonisation of institutions in CEE countries before the EU accession was in the 90s a unified procedure that made the accession process on the one hand predictable and on the other not well suitable institutionally for all new member states. Our conclusion is that taking into account national peculiarities (path dependence), different regional clubs might need different institutional solutions and/or different pace of institutional set-up to progress along the road to growth, prosperity and economic integration. Hence, the institutional harmonisation has to be adapted to the institutional framework of the country under consideration. Further, this assumption might also require a strong modification of the prevailing model of economic growth and development.

- Looking at the corporate governance we also underline the role of national peculiarities as they strongly influence economic performance of national enterprises. Particularly, when the adopted rules and existing praxis do not go hand in hand it might create unexpected restriction to economic development. Looking at corporate governance issues economic policy objectives should particularly take the importance of decision power over business functions within the subsidiary into consideration. Financial restriction can be attenuated when foreign owned enterprises are provided with as much decision power over internal business functions as possible. The access to finances is very important to allow further investment be it within the enterprise or the region of location. Thus, economic policy should encourage foreign investors in the case of foreign acquisition of local enterprises to leave decision power within the enterprise and in the case of Greenfield investment to provide the newly establishes subsidiaries with as much power over corporate governance structures as possible. Beyond that, it can be assumed that the extent of decision power and therewith the extent of financial restrictions also depend on the foreign owned enterprise’s position in the global value chain of the MNE. Thus, economic policy and economic development promotion should not only consider the quantity but also the structure of incoming FDI. Value-adding FDI should be connected to subsidiaries endowed with more decision power over business function and less financial restriction and thus foster not only further investments in the region of location but also positive knowledge and technology spill-overs to the investment site.

- Further, the European Union, and the euro area in particular, needs a much better co-ordination of its macro- and microeconomic policies. The co-ordination of production and employment levels should be central to it as far the stability of euro, and socio-economic cohesion are concerned. This is a hugely challenging proposal, as we were discussing an international multi-level governance system with several principals and multiple agents with vastly different resources. Soft policy co-ordination, such as the Lisbon strategy and open method of co-ordination, applied prior to the crisis have proven insufficient. It is yet to be seen whether new and more stringent methods – macro and initial conditionalities, EU Semester taken more seriously – introduced for 2014-2020 EU financial period will work or need further reinforcement.

- Beyond that, Europe 2020 strategy needs a more stringent and actionable vision. Identification and creation of European lead markets for emerging science and technology intensive industries is where the reinforcement of the EU 2020 strategy should start. A stronger vision of Europe’s technological and industrial future beyond 2020 would open both for more and less advanced economies in European a more clear vision of the direction European Union seeks to take. This, in turn, allows for better re-alignment of research, education and labour market policies, etc. ‘Green growth’, which emphasises energy efficiency and environmentally friendly development, is already part of Europe 2020, and may very well emerge as central element of next techno-economic paradigm that will last for the most of the 21st century. However, it may very well be that biotechnology, nanotechnology or some other technology will emerge over the next decade as the next paradigm leading technology. In any case, Europe needs to co-ordinate better its efforts. Therefore, development of a more specific strategy of industrial revival is crucial.

- Europe can and should, nonetheless, do more for upgrading its exporting industry, with a strong focus on European cohesion economies in particular. For one, the European Investment Bank and the European Investment Fund could play a much stronger role – as institutional setting – in fostering industrial upgrading in Europe by establishing specialised investment funds that support early stage growth in new high-tech firms, and restructuring of the existing major industries across Europe. Such investment funds should seek co-investment from major private venture capital firms and commercial banks, channelling this way also private capital into industrial revival in Europe.

- From institutional point of view setting the incentives right is crucial in such a multiple principals and agents setup if the execution of a strategy is to be a success and the EU is to avoid rent-seeking, principal-agent problems, clientelism or elite capture and eventually a waste of its resources. Lisbon Strategy was originally a strategy without any financial resources the European Union itself could potentially commit for the achievement of its strategic objectives. 'Lisbonisation' of cohesion policy that has take place from the mid-2000s has helped somewhat, but this has been too little and too late. The adoption of cohesion funds has, however, a history of focussing too much on the absorption of resources while paying too little attention to the impact achieved. Recent reform of cohesion policy, and the introduction of the element of performance contracts to the partnership agreements for the 2014-2020 period will hopefully improve the situation with this respect. For positive institutional dynamics of development consideration should be given to an incentives-system as stimuli for better compliance - e.g. best compliers access to special funds at a later stage, or other benefits. Greater conditionality seems to be a must – as well as the threat of funds suspension for successive breach of conditionalities to be truly credible.

- Reducing disparities in a growth-enhancing way: Cohesion policy should focus less on convergence, more on tackling underdevelopment in a way that promotes both local and EU growth, focused on specific spatial context. A stronger focus on areas of structural change and capacities seems as a good solution, or 'soft infrastructure' such as human capital, labour markets, education and health. Such basic public services are true problems in CEE and at the same time are proven to be main drivers of an inclusive growth and development. Even though there were absorption problems in some CEE for exactly these types of operative programmes in the 2007-2013 period, the indirect effects of such investments might be as strong or even stronger than hard infrastructure from both growth, competitiveness and cohesion aspects.

- Stronger focus is still needed on building regulatory, administrative and institutional capacities as well as emphasis on greater involvement of regional agencies for planning (setting context-specific local goals for an inclusive growth strategy) – and implementation. These are proven conditions for success of Cohesion policy intervention and development in the long run – and though to varying degrees, cohesion beneficiaries all show some shortages and misfit.

- As functional institutional framework the alignment of Cohesion Policy with the Europe 2020 need to take close care for the potential trade-offs involved in pursuing goals of growth and competitiveness (thus allowing economic concentration) versus convergence and equity. If convergence oriented cohesion policy tries to spread economic activity (e.g. via linkages between poorer and richer regions, active labour market policies etc.) – a much more careful and rigorous estimation of possible overall benefits and (opportunity) costs needs to be carried out, in order to determine the right policy and target mix for these two policy phenomena in interaction.

We assumed that these policy recommendations – put into praxis – will generate positive dynamics of institutional convergence in the EU member states and boost economic, social and territorial cohesion within the EU.

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Products of WP7

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Institutional Convergence of CEECs and its Connection to Growth and Cohesion

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