SPECIFYING QUALITY OF GOVERNANCE IN TRANSITION ECONOMIES WITH CLUSTER ANALYSIS

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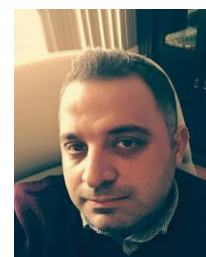
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ABSTRACT

With the collapse of Soviet Russia, transition of communist countries towards the market economy not only caused an economic transformation but also formal and informal constraints, institutional structures and legal norms in society were changed. IMF's and World Bank's reports and governance concept containing neoliberal policies that took place in World Bank's publications were important factors behind this transition. In this study, it is aimed to analyze quality of governance in transition economies by the year 2014. With this framework, Cluster analysis is performed by Ward (1963) Minimum Variance Method by using World Bank Governance and Freedom House dataset.

Contribution/ Originality: This paper contributes to the literature by determination of transition economies' position in terms of their governance scores in a multivariate framework. The results of Cluster analysis indicate that countries in the process of integration with the EU have better governance scores with respect to other transition economies.

1. INTRODUCTION

Political and economic disintegration in the Soviet Union at the end of the 1980s and the collapse of the Berlin Wall in 1989 and the economic stagnation in command economies was the signal of the major transformation in the economies. After the fall of the Soviet Bloc, it was envisaged that a market system would work in which rational individuals pursued their own interests, minimum government interventions to economy and strengthening the market dynamics expressed in many Neo liberal arguments. However, without government intervention, the state of a self-functioning market undoubtedly brings a system away from society and generates chaos. This foreseen transformation to eliminate the associated problems above gave rise to change in the rationale for government.

Changing view of government and policies caused weakening of the socialist system as well as fostering the transformation process from the centrally planned economies to market dynamics. With the transition to market

system high rate of economic growth was conjectured, *i.e.* former socialist countries catch the middle income countries as this foresight was partially verified.

It was an important fact that this transition process did not last for a small period and no single formulation valid for all countries and differentiations are required for institutional and political structure. Svenjnar (2002) groups transition economies into two, based on the criterias in which the first includes the rapid and essential policy requirements from transition to command economies to market economies such as price liberalizations, eliminating constraints on the foreign trade, privatizations, anti-monopolistic actions, removing obstacles for establishing new firms. The second type economies gave rise to commercial banking, establishing an efficient tax system, labor market regulations, forming institutions for social security networks, legal system focusing on the market and other institutional reforms. The difference between these two types of transition economies stems from tax collection, and necessary actions for minimizing corruption and rent-seeking. In the first type economies, the dominant view is the reducing the role of the government in the economy whereas the countries in the second type, the existence of a government which is reliable, away from dictatorship and the rule of law is dominant are stressed.

Changing the balance of power, transition from the centrally planned economy to the market mechanism around the world, the existence of the government during this transition, people's increasing need for public goods and services, increasing expectations for qualification and productivity caused criticisms for traditional view of government and gave rise to debate on "ideal government". This discussion and change trends highlights the role of government in the global world again and prepare the ground for hierarchical to heteratical order (Yuksel, 2000). This heterathetic order ensures the governance concept to gain importance in the literature.

In this study, the background and the scope of the governance concept will be examined first. Then, Cluster Analyses will be performed in order to group transition countries with respect to their similarities. In this part, the theoretical structure will be explained and the results of the cluster analysis will be visualized within a dendrogram by explaining the dynamic behind the multivariate structure. The last section concludes.

2. THE CONCEPT OF GOVERNANCE

The origin of the definition of governance finds it roots in *governing*. Nevertheless, despite the word of governing states hierarchical order, governance is the effort of governing, diverting, controlling and guiding of not only the governmentally owned but also social, political, administrative actors in the society in a heteratical order (Kooiman, 1993).

The changing world order and the political and institutional developments that have taken place in the past twenty-five years, the discussion of the roles, dimensions and the functions of the government bring along to gain importance of the concept of governance.

The demolition of the Berlin Wall and detoriation in the political and economic alliance of the Eastern Bloc engendered the collapse of the Soviet Union (Maldona, 2010). Changing balance of power with this decadence, globalization process around the world, changing structure of people's perception of public goods and services interrogated and criticized the traditional view of government. Towards the end of the 1980s this concept served as a solution to developing countries by the international organizations. In the reports published by these institutions, the main questions were related with the reasons why the rich countries and poor countries stayed at the same prosperity level around time and the remedies other than the active economic policies. The answer lies beneath this question gives rise to the concept of governance.

The reports issued by World Bank, International Monetary Fund, United Nations the framework include institutional reforms and minimal government structure. But, over time this concept began to include a governing style in which market orientation and regulation are the aims of government beyond a liberal approach.

The report by The World Bank in 1989 is called "*Sub Saharan Africa: From Crisis to Sustainable Growth*". In this report, governance is defined as "the use of political power to solve the problems of a nation" and the problems

devoted to economic development in Africa were associated with governance crisis (World Bank, 1992). In 1989, Conable, Former President of the World Bank, defines governance as "effective public service, reliable judicial service and public accountability", implicitly pointing out good governance. Moreover, The World Bank the concept was transformed to good governance (World Bank, 1989). In a report by World Bank called "*Governance and Development*", governance was defined as "the manner in which power is exercised in the management of a country's economic and social resources for development" (World Bank, 1992). These definitions construct the first step by linking governance and economic development. The common feature of these definitions is the aim of minimizing government intervention in this period.

In the same report, correcting market failures and ensuring efficient working of the market were the tasks of the government. To fulfill these functions governments need revenue that can be collected from households and firms. This obligation requires accountability in public expenditures and resource management, provision of sufficient and adequate information and efficiency (World Bank, 1992). In other words, the scope of government was constrained and exhibited minimum level of activities.

In other report titled "*Governance and World Bank Experiences*", it was mentioned that World Bank used non-governmental organizations for service provision and in many countries governments supported the governance structure for maintaining and ensuring employment, efficient working and administration (World Bank, 1994). While governing determines the frontiers of authority and responsibility between public and private sectors, governance includes all stakeholders (Kooiman, 1993). This report distinguishes from the report in 1992 as it includes more social and market oriented policies with respect to the report in 1992.

World Bank's other report in 1997 constructs governance over five different pillars: An appropriate political environment including macroeconomic stability, investment in the public and infrastructure, protection of the vulnerable and protection of the natural environment (World Bank, 1997). With this report, the role of government gained importance again and the state's key role in changing and developing world was highlighted. By defining efficient government, World Bank's "market against government" argument was considered to be incomplete. Instead, the need for an ideal government supporting and regulating the market was stressed

World Bank report in 2001, called "*Issue Note: E-Government and The World Bank*" points out a road map to e-government (World Bank, 2001). In this manner, e-government is called government that ensures strengthening citizens, improving service delivery, strengthening accountability, increasing transparency, increasing government efficiency and possessing communication technologies and information systems.

As stated above, no single definition of governance can be encountered and it varies with the changing world and associated ideological differences among time. Considering prescriptions of World Bank and other international organizations for economic development, no general formulation can be found valid for all countries. As Rodrik (2007) stresses, attaining stable economic growth in the long run, countries have to evaluate their domestic conditions in the direction of different institutional structures.

3. METHOD, DATA AND RESULTS

In this study, to explore the multivariate structure regarding the governance in transition economies, hierarchical cluster analysis were performed (Unlukaplan and Canıkalp, 2015).

Hierarchical cluster analysis is suited for defining groups or units with maximum homogeneity within the groups while maximum heterogeneity between the groups. It determines the most similar and different groups. Scaling describes the process of producing a small number of variables that can be used to describe the relationship between a group of objects, starting either from a matrix of distances or similarities between the objects, or from the values of some variables measured on each object (Manly, 2005; Unlukaplan, 2011).

Methods in the hierarchical cluster analysis can be counted as single-linkage clustering, complete-linkage clustering, average-linkage clustering, weighted average-linkage clustering, Centroid linkage clustering, median

linkage clustering and Wards' method where the decrease in variance for the cluster being merged (Hair *et al.,* 2009).

Within this framework, data used in the study gathered from World Bank Governance Indicators and Freedom House dataset for 2014. The data covers 29 countries. For the hierarchical cluster analysis "Ward (1963) Minimum Variance Method" and Squared Euclidean distance measure were employed.

Variables used in the analysis are:

- X1: Political Stability and Absence of Violence
- X2: Voice and accountability
- X3: Regulatory Quality
- X4: Government Effectiveness
- X5: Rule of Law
- X6: Control of Corruption
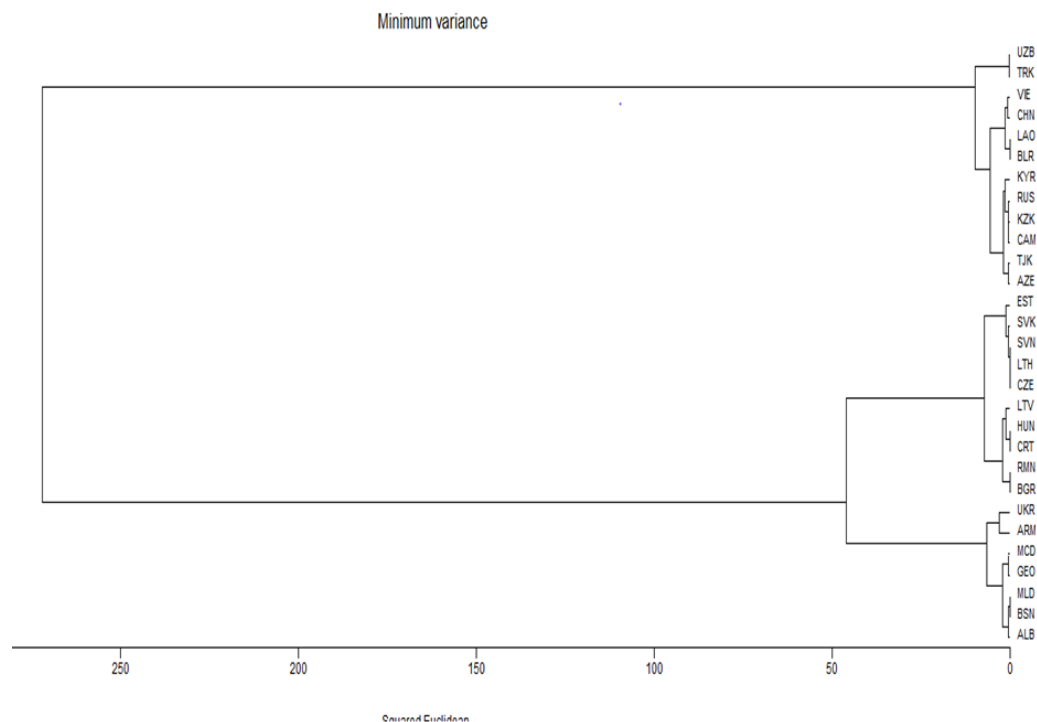- X7: Civil Liberties
- X8: Political Rights

Figure-1. Results of Cluster Analysis

Source: Authors' calculations

The cluster analysis procedure was employed using Ward's Method and Squared Euclidean distance measure to group transition economies into clusters based upon similarities according to governance indicators between them.

According to the results of the cluster analysis, a dendrogram was sketched as indicated by figure 1, where the countries are divided into two main groups: countries with good governance level and countries with poor governance level. In this framework, countries with good governance correspond the European Union members or in the negotiation process where the countries with poor governance level have a lower institutional quality level and in this countries the elite and interest mechanism work more strongly. In the context of the study, for the detailed examination of the governance quality of the countries subject to the study, the dendrogram in Figure 1 was evaluated under seven different clusters.

1. Cluster: Uzbekistan, Turkmenistan

2.   Cluster: Vietnam, China, People's Republic of Laos, Belarus

3.   Cluster: Kyrgyzstan, Russia, Kazakhstan, Cambodia, Tajikistan, Azerbaijan

4.   Cluster: Estonia, Slovak Republic, Slovenia, Czech Republic, Lithuania

5.   Cluster: Latvia, Hungary, Croatia, Romania, Bulgaria

6.   Cluster: Ukraine, Armenia

7.   Cluster: Macedonia, Georgia, Moldova, Bosnia and Herzegovina, Albania

1. Cluster consists of Uzbekistan and Turkmenistan, among the former Soviet republics and steeped in the self-seeking institutions. Acemoğlu and Robinson (2012) examine cotton production to gauge the power of the self-seeking institutions in Uzbekistan. They put forward many arguments related to cotton production to validate the power of these institutions. Moreover, elections in this country constitute another dimension of this power. If one looks into political pressure in these countries, claimed to have a high literacy rate, books are banned, the internet is censored, arrests and tortures in the country are observed. After the collapse of the central planning system, these exploiting institutions inherited to Uzbekistan can be considered as obstacles to market economy and the development of democracy. By the existence of these exploitative economic and political institutions, Uzbekistan and Turkmenistan meet at many common points (Acemoğlu and Robinson, 2012).

In the 2. Cluster, Vietnam and People's Republic of Laos's the most important common feature is that they are among the poorest countries in Southeast Asia. Their similarity in terms of governance quality stems from the colonization structure and historical process. The reason why these countries are among the poorest countries of Asia was explained by Gainsborough (2012). He claims that they are located in the in Mekong Sub-region and their history of membership of the Association of Southeast Asian Nations is not very old. however, results of the cluster analysis in this study indicate that Cambodia is not in this cluster even though it is an Indochina country as Vietnam and People's Republic of Laos. The reason is that reforms for democratic transition in Cambodia after the Cold War were not available in People's Republic of Laos and Vietnam as there is not a democratic transition in these countries.

Belarus is known as the Europe's latest autocracy state. It has been a strategic partner with China since 2007. By attracting foreign investments to the country, establishing industrial parks with partnerships, conducting reforms in tax codes, Belarus promote foreign investments. Various big investments and mergers were observed with Belarus and China (Andrijauskas, 2013). This strategic partnership brings about the closeness of these two countries in terms of governance quality.

Aside from Cambodia and Azerbaijan, 3. cluster includes countries in Eurasian Economic Community. This economic integration that has been lasting more than 20 years, has economic, geographical and political bases. With these dimensions, it can be considered to be a similar formation to the European Union. The aim of this community is to establish a common market by setting a common foreign policy, determining tariffs and prices in the region (Eurasıan, 2016). Russia and Kazakhstan who are the members of the group, are economically stronger countries than Tajikistan and Kyrgyzstan as Germany and France, a locomotive twin and trying to keep power in the European Union (Yesdauletova and Yesdauletov, 2014). Mikheev (2006) claims that Russian elites which have significant power in the region act as unwillingness for other economies' economic developments. Mukhamedzhanova (2007) states that this integration does not offer a real production model. The fact that the member states first struggle for their own interests and then takes common interests into account is the most important reason for the failure of the countries that are members of this union. Mikheev (2006) and Mukhamedzhanova (2007) view support Acemoğlu and Robinson (2012) hypothesis in which even though they have an idea about the formulation necessary for growth, they are the most important obstacles to change in the current system because of their own interests. This argument can explain why the countries which have been scattered after Soviet Russia and are members of the Eurasian Union are in the same cluster. Kyrgyzstan, Russia, Kazakhstan and

Tajikistan are among the member countries in the Shanghai Cooperation Organization while Azerbaijan and Cambodia are countries that have a dialogue partner with this organization.

Slovak Republic and Czech Republic in the 4. cluster were the part of Czechoslovakia Until 1989. As a result of the dissolution of the Soviet Union, they declared their independence as a two different countries with the "Velvet revolution", thereby transition to a democratic structure was began. Therefore, it is not surprising that these two countries are in the same group. Considering other members of the group, it can be easily seen that they are the member of OECD and European Union. In terms of average governance scores, these countries have relatively poor scores than EU and OECD scores but have better scores than the most of the transition economies. Becoming a member of EU, reforming many areas, monetary union and tax harmonization resulted these countries to converge. Abed (1998) claims that Slovak Republic, Slovenia, Czech Republic reforms property rights and corporate governance more intense with respect to other countries. With the policies followed in these countries, even though progress in price, trade and foreign exchange policies was recorded, no desired progress have been made for structural reforms and institutional dimensions. The justification for this deficiency have its source in political mechanism's determination of the property rights and in an environment where it is far from zero transaction cost and lack of low compensation, certain situations crop up like the inability of economic exchange to take place effectively, corruption, fraud and audit weakness (North, 1990). For these reasons, these countries have relatively lover governance quality with respect to other EU members.

Countries in the 5.cluster are EU member countries as in the 4. cluster. The explanation why these countries are in this cluster can be explained by the negotiation process. These countries' membership dates and starting dates of the reform movements are relatively late. Lithuania and Hungary in 2004, Romania and Bulgaria became members of the EU in 2007, while Croatia became a member of the union in 2013. Johnson (2002) attributes the success of Romania and Bulgaria in transition economies into three factors. First, in the process of democratization, ethnic battles within the transition countries were faced, while these two countries succeeded in preventing ethnic violence. Thus, possible political problems and violence in the country were avoided. Second, maybe the most important, various measures are taken to ensure the inclusion of the political institutions in the country after the collapse of communism. Third, examination and restriction of the political parties in the country and the authorizations given to these parties. Of course, their membership of the EU since 2007 and the various reforms followed in the process have also played an important role in this progress.

The explanation of Armenia and Ukraine's location in the 6.Cluster can be explained by geographical proximity and political progress and in recent years. After the Georgia-Russia war in August 2008, European Union attempted to form Eastern Partnership Policy initiative to increase the possibility of cooperation with the former Soviet States in May 2009. In Ukraine, in 2004, the pro-European group rebelled against allegations of corruption and voting, and the "Orange Revolution" took place in the country. Ukraine was under pressure to make a choice between Russia and the European Union because of the economy coming to a halt and President Yanukovych declared that they will not to sign the Association Agreement with the European Union (EU) 28-29 November 2013. Consequently, the protests grew steadily. The political, economic and legal reforms that Ukraine has long postponed become obligatory with the European Union process. Such reforms will encourage economic growth in the long run, and will prevent certain political parties from regaining elections. In this case, Yanukovych, who holds the political power, has not signed the Association Agreement with the European Union (Freedom House, 2014). With the Yanukovych's departure from the government, Russia occupied the Crimea, which is closely related to Russia and the European Union (Freedom House, 2015). The political instability and insecurity experienced in Armenia with the response shown against the government can explain why Ukraine and Armenia are in the same cluster.

Common feature of the countries in the 7.cluster is that ethnic conflicts are very much observed and political stability is not achieved in these countries. With the disintegration of the former Socialist Republic of Yugoslavia,

Macedonia declared its independence in 1991 and Bosnia and Herzegovina in 1992. By 2016, these countries are among the candidate countries to the European Union. In Macedonia's European Union report, problems related to press and freedom of expression, administrative and judicial reforms and fight against corruption were examined. Also, it is emphasized that progress in Bosnia Herzegovina is limited (Cihangir, 2011). Ukraine and Georgia, signed a partnership agreement signed with EU are seem to be far away from EU and good governance as a result of current unstable political situation, corruption, economic decay, ethnic structure and minority rights, democratic freedoms and complex relations with Russia (Mikhnovets, 2015). Albania is in the same cluster as a potential candidate country for EU since 2011. Domestic disorders, Kosovo War and Great Albanian thought indicate serious chapters are needed for political stability and non-violence in Albania. It is possible to say that this political thriller in this country negatively affects the governance level in the transition process.

4. CONCLUSION

By employing World Bank Governance Indicators and Freedom House dataset for 2014, hierarchical cluster analysis with Ward (1963) Minimum Variance Method" and Squared Euclidean distance measure were employed. Dataset include 29 transition economies. The results of the cluster analysis indicate that seven clusters were formed. Under this multivariate formation the institutional structure of the countries and the elite mechanism, their political and social rights, their integration process into the European Union, economic structures and geographical conditions are the substantial factors.

According to the results of the cluster analysis, countries don't accept the European Union integration process, countries where the property rights are trivial, ethnic differences are observed, have lower scores of governance quality. The quality of the institutions inherited from the former Soviet Russia is also influenced by the low quality of governance. In the countries included in the European Union or in the countries that have reached consensus for the membership, it can be said that the beginning of the reform process contributed to the increase in the quality of governance, the formation of regulatory institutions and the relatively importance of political and social rights.

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