DETERMINING FACTORS OF BUSINESS ENVIRONMENT REFORMS: DO THEY DIFFER BETWEEN OLD AND NEW EU MEMBER STATES?

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Summary

The paper brings an empirical research of various elements as explanatory factors of business environment reforms. Using the panel data model, the paper investigates the effects of macroeconomic conditions, political institutions and international factors on business environment reforms. The econometric analysis is performed on a panel dataset of European Union member states for the period between 1995 and 2017. Additionally, by clustering countries into new and old EU member states, analysis was also conducted for these two sub-panels. The obtained results confirm that business environment reforms depend on a number of factors, and that these differ between old and new EU member states.

Keywords: business environment; product market reforms; European Union; NMS, EU15.

1. INTRODUCTION

In order to increase productivity, employment and competitiveness in European Union (EU), some critical measures will have to be implemented. The 2008 economic crisis, migration crisis and the most recent COVID-19 crisis have more than ever aggravated structural problems in EU member states. Even though many reforms in product markets have been implemented so far, the level of product market restrictiveness still varies considerably across the countries. While existing studies have shown that the long-run effects of structural reforms on economic performance are positive, the evidence on the short-run effects of structural reforms are relatively mixed and partial (Bordon,
which can be attributed to the fact that any reform process is under the influence of various economic, institutional and social factors which are country-specific.

The main goal of this paper is to explore which factors had effect on business environment reforms as one part of product reforms in the old (EU15) and new EU member countries (NMS). We highlight the significance of the business environment as one of the aspect of firm-level competitiveness which is then reflected in the competitiveness on national level (as in Kiseľáková et al, 2019). This is in line with previous research within which the importance of product market and business environment quality and the reforms of it have been intensely empirically tested, and the results of which point out to their positive effects on economic development, competitiveness and entrepreneurial activity (for a detailed overview of literature see e.g. Vučković, Basarac Sertić and Šimić Banović (2016), Anderton, Di Lupidio and Jarmulska (2019)).

The analysis performed in this paper is based on the Economic Freedom of the World of The Fraser Institute database, as well as on OECD PMR indicators. With these indicators we focus on measuring the existing distortions in the domain of economic policies whereby reforms are measured as the change in the level of such indicators. Precisely, a higher value of OECD PMR index indicates more restrictive regulation and the introduction of a reform would be represented by a fall of the index, while on the other side, an increase in the Fraser Economic Freedom of the World index would imply reform implementation.

The paper is structured as follows. In Section 2 we offer descriptive analysis of business environment quality in EU member states. Section 3 brings the empirical analysis of determinants of business environment reforms in EU countries, with special emphasis on investigating whether there are some differences between the old and new EU member states. Finally, in Section 4 we conclude.

2. BUSINESS ENVIRONMENT IN EU MEMBER STATES

In this paper we analyse business environment reforms as part of product market reforms. Precisely, the focus is on the regulatory and administrative aspects of the business environment, i.e. the extent to which government policies and regulations define the rules of the game for businesses and thus exhibit positive or negative effects on businesses through imposing direct and/or indirect costs (see e.g. World Bank, 2013; White and Fortune, 2004). In achieving this goal, we employ data from two databases often used for analysis of product market regulation and quality of business environment.

First, we analyse the OECD Product Market Regulation (PMR) indicators which combine restrictiveness measures in total of 16 domains of regulation (scaling from 0 – 6, from least to most restrictive), and which are aggregated into three categories (i.e. state control, barriers to entrepreneurship and barriers to trade and investment). The advantage of these indicators is that they are objective, transparent and quantifiable (Pelkmans, 2010). Figure 1 shows data for the overall PMR indicator in 2013 and 2018. The data
show that product market regulation is still high across many EU countries. This puts strong pressure on product market reforms which continue to be a priority for catching up with best performers and for pushing forward the convergence process (Anderton, Di Lupidio, & Jarmulska, 2019).

**Figure 1.** Product Market Regulation (PMR) indicators (2013 and 2018)

Source: OECD PMR indicators

**Figure 2.** Distortions induced by state involvement vs. the barriers to the foreign and domestic entry

Source: OECD PMR indicators
Also, on Figure 2 we can see that the distortions and obstacles that are induced with the state involvement are much larger than the barriers to the foreign and domestic entry (data for 2018).

Since it is reasonable to expect that the differences in the pace of implemented reforms result in an \textit{ex-post} differences in terms of the overall quality of the business environment, we also analyse the index from the Fraser Institute, i.e. \textit{Economic Freedom of the World}. This index measures the degree to which the policies and institutions of countries are supportive of economic freedom (Gwartney et al., 2020). The main limitation of this index lies in the lack of reliability and transparency of the underlying source mainly referring to the opinions of business leaders in many countries, taken from the World Competitiveness Report of the WEF (Pelkmans, 2010). Based on the data presented in Figure 3, i.e. summary index values for both NMS and EU15, we can conclude that the quality of the business environment in terms of economic freedom in the new Member States increased during the observed period, especially in the years preceding the EU enlargement (2004 and 2007). Although the NMS increased both the scope and dynamics of the business environment reforms which contributed to their increased business environment quality, there is still a gap in the quality of the business environment between the EU15 and NMS when looking the trends in individual sub-indices contained in the \textit{Economic Freedom of the World}, i.e. \textit{Size of Government, Legal System and Property Rights, Sound Money, Freedom to Trade Internationally} and \textit{Regulation} (Appendix A.1).

\textbf{Figure 3.} Economic Freedom Summary Index, 1995 - 2018

![Economic Freedom Summary Index, 1995 - 2018](image)

\textit{Source: Author’s calculation from the Fraser Institute data.}

The NMS are lagging behind the EU28 average and especially behind the EU15 in almost all categories. Looking in more detail within the specific dimensions of sub-indices, particularly the \textit{Business regulation}, the gap is considerable (Figure 4). This dimension is the most closely related to the business environment in the narrow terms since it identifies the extent to which regulations and bureaucratic procedures restrain entry and reduce competition, including the administrative requirements, bureaucracy
costs, starting a business, extra payments, bribes or favouritism, licensing restrictions and costs of tax compliance (The Fraser Institute, 2020).

**Figure 4. Business Regulation sub-pillar (EU28=100)**

![Business Regulation sub-pillar (EU28=100)](image)

*Source: Author’s calculation from the Fraser Institute data.*

The debates on the causes behind the divergent paths between two groups of countries are on-going. Yet the North (1994: 366) has long highlighted that the countries that apply formal rules of another country exhibit different performance than these countries due to a variety of informal institutions. In this sense, the nominal transfer of formal political and economic rules of successful Western economies into Eastern European countries (for example, due to meeting the criteria for EU membership) is not a sufficient condition for achieving favourable economic performance that would result in reducing the previously described gap. Moreover, Liddle (2011) argued that on the one hand the Single Market programme facilitated the integration of markets for goods and services, which has driven innovation, productivity and economic growth by stimulating competition and new possibilities for economies of scale. However, on the other hand, according to the author, it also strengthened the set of neoliberal policies without simultaneously reforming the extensive socio-economic framework that would enable politically acceptable market adjustment and economic change.

This paper contributes to previous research by conducting the specific econometric analysis of factors that determine reform implementation in EU28 countries, as well as by examining if there are some differences in such factors between NMS (EU13) and EU15 countries. The obtained results could therefore also explain why such differences in both the quality of business environment and economic performance arise between countries.
3. EMPIRICAL ANALYSIS OF DETERMINANTS OF BUSINESS ENVIRONMENT REFORMS IN EU

In general, any reform process is a result of political compromise among the key actors, but it is being implemented by the government. As a result of this complexity, the theoretical and empirical research on the political economy of reforms so far emphasizes six broad categories of potential drivers of reforms. These are (1) the business conditions; (2) macroeconomic (monetary and fiscal) policies; (3) structural features of the domestic economy (e.g. size, trade openness, demographics, income inequality…); (4) external (international) factors; (5) political factors (e.g. ideology, government fragmentation, political cycles and crises) and (6) the reform strategies with a goal of overcoming the resistance to reform (Duval, Furceri and Miethe, 2018:8). These factors have been previously outlined in work of Rodrik (1996), Krueger (1995), Tommasi and Velasco (1996), Lora (2000), Drazen (2000), Drazen and Easterly (2001), Olofsgård (2003), World Bank (2008), Agnello et al. (2015) ... The results of the most recent analysis on the sample of EU advanced countries that was conducted by Duval, Furceri and Miethe (2018) confirm that reforms tend to occur during period of high unemployment, low growth or recessions/crises, supporting the crises induced reforms assumption. Also, the authors point out that political factors have an effect on reform implementation, even though much smaller than economic factors. Further, Dias Da Silva, Givone and Sondermann (2017) analysed which factors had effect on structural reforms in 40 OECD and EU countries in a 1975-2013 period. Their results also confirmed crises induced reforms hypothesis, in addition with some further factors that proved to be significant drivers of reforms, i.e. external pressure, reforms sequencing, government fragmentation and initial structural conditions. Agnello et al. (2015), on a sample of 60 developed and developing countries in 1980-2005 period, explored the effects of various crises on the probability of the implementation of structural reforms, showing that product market reforms are accelerated by political fractionalisation (in the group of OECD countries), and by the increased income inequality (in a group of non-OECD countries).

The key question in this paper is on the drivers behind different patterns of reforms in various countries groups in EU which evidently resulted in divergent quality of business environment. Specifically, taking into consideration characteristics of countries that have undertaken reforms, and based on previous analyses, economic and political variables are tested as factors of reforms in the following lines.

3.1. Model and data

Following the approach applied in previous studies, as a dependent reform variable, we use the sub-pillar *Business Regulation* from the Fraser Institute database. This index ranges from 0 to 10, with the change towards the higher level of the index indicating more intense reform activity. In some studies reform shock can be also identified as a dummy variable which takes the value of 1 when a reform shock is observed, and 0 otherwise (see Bordon, Ebeke & Shirono, 2018).

After reviewing the literature and comparing the possible methods for the analysis as well as taking into consideration the characteristics of the used database, the
panel regression analysis was chosen. More precisely, econometric analysis is performed using the dynamic panel model based on the Arellano – Bond (1991) generalised method of moments (GMM). This estimator is widely used for the analysis of linear relationship with the dynamic dependent variable that is dependent on its own past values, as well as in a situation in which the independent variables are not strictly exogenous which is the case in our model. In addition, the estimator considers the specificity of each observed unit and allows for heteroskedasticity and autocorrelation within the unit of observation, but not across them (Roodman, 2009). The dependent reform variable is regressed on a set of independent variables, the selection of which was carried out on the basis of a detailed review of the existing scientific literature in the field of political economy of reform. The model can be written as follows:

\[ reform_{it} = \mu + \delta reform_{it-1} + \beta_{it} x_{it} + \nu_i + u_{it}, \quad i = 1, ..., N, \quad t = 1, ..., T, \]  

where \( N \) is the number of observation units, \( T \) is the number of periods, \( reform_{it} \) stands for the value of the dependent variable \( i \) in the period \( t \), the parameter \( \mu \) is the constant, \( \delta \) is the scalar, \( reform_{it-1} \) is the one-period-lagged (one year) dependent variable (for the same country), \( x_{it1}, ..., x_{itK} \) are the K of independent variables for the member state \( i \) during the period \( t \) (i.e. \( x_{it} \in \mathbb{R}^K \) and \( \beta \in \mathbb{R}^K \)), \( \nu_i \) is the fixed element or random error for the unit of observation, and \( u_{it} \) the error term. It is assumed that all variables \( x_{it} \) are strictly exogenous and uncorrelated with any \( u_{it} \). The lagged value of a dependent variable (one-period lag) is used as an instrumental variable. The model is estimated with the robust standard errors. The test for the autocorrelation in residuals is performed using the \( m_1 \) and \( m_2 \) tests. Table 1 summarizes the list of indicators used, the expected effects of the estimated coefficients as well as the data sources.

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5 The null hypothesis of the \( m_1 \) test assumes the absence of a first-order autocorrelation between differenced residuals, and the null hypothesis of the \( m_2 \) test assumes the absence of a second-order autocorrelation between differenced residuals.
Table 1. List of independent variables

| Variable            | Expected effect | Data source                                      |
|---------------------|-----------------|-------------------------------------------------|
| reforms
| lagged dependent variable | positive | Economic Freedom of the World (Fraser Institute) |
| efw                 | overall index of economic freedom | positive | Economic Freedom of the World (Fraser Institute) |
| unemp               | unemployment rate | positive or negative | Eurostat |
| left                | ideology of government (dummy variable, value 1=left, 0=all other cases) | negative | Database of Political Institutions (Scartascini, Cesi and Keefer, 2018) |
| elec                | political cycles (years before the election year) | positive or negative | Database of Political Institutions (Scartascini, Cesi and Keefer, 2018) |
| herfgov             | government fragmentation (with single-party government, herfgov index equals 1 and with coalition governments it takes a value between 0 and 1²) | positive | Database of Political Institutions (Scartascini, Cesi and Keefer, 2018) |
| mature              | government maturity (tenure in office) | positive | Database of Political Institutions (Scartascini, Cesi and Keefer, 2018) |
| net_lend            | general government net lending (proxy for fiscal policy effects) | positive or negative | Eurostat |
| global              | external (international) influence | positive | KOFI index of globalisation (Savina et al., 2019) |

Source: Author’s compilation.

Table 2. Descriptive statistics

| Variable | Obs | Mean  | Std. Dev. | Min  | Max  |
|----------|-----|-------|-----------|------|------|
| efw      | 532 | 7.557707 | .5249801  | 4.11 | 8.52 |
| reform   | 517 | 7.207696 | .8988794  | 4.84483 | 9.024955 |
| global   | 532 | 80.50781 | 7.069845  | 49.23808 | 90.64874 |
| unemp    | 532 | 9.0915 | 4.554659 | 0 | 27.475 |
| mature   | 531 | 3.922787 | 2.82303 | 1 | 18 |
| left     | 532 | 3.082707 | .4622136 | 0 | 1 |

⁶ As in Gregorini and Longoni (2010) and Vučković and Basarac Sertić (2013)
3.2. Results

Table 3 shows the results of the estimated impact of the selected variables on business environment reforms in the EU28 member states, as well as in the sub-groups of old (EU15) and new (NMS13) EU member states. The tests for first- and second-order autocorrelation yield the expected results, i.e. the tests do not reject the absence of second-order autocorrelation7 among differenced residuals. The model was estimated with robust standard errors. The lagged dependent variable is statistically significant and has a positive sign in all three models.

For EU28 countries, the results show that the variables unemp, elect-1, mature, net_lend, left and efw are statistically significant. Precisely, business environment reforms in analysed EU member states are influenced by initial structural conditions, economic performance in countries (proxied by unemployment), electoral cycles, government maturity, government budget balance and overall economic freedom index. Higher unemployment is positively correlated with reform activities, indicating that the reforms are implemented more during a deteriorating economic situation (as in Drazen and Easterly, 2001). Furthermore, more mature governments are those implementing reforms - mature governments implement more reforms due to the fact that there is a certain period of time in which the political and administrative obstacles have to be overcome (as in Høj et al. (2006)). Next, an increase in the overall economic freedom is in positive and an increase in government deficit is in negative relation with reforms. The effect of fiscal policy was tested using the data on budget deficit because poor public finances can limit governments in implementing reforms as measures to compensate potential losers need to be financed from the state budget, and they often decide to direct resources on fiscal consolidation rather than on structural reforms (Tompson and Dang, 2010). Finally, the analysis shows that political cycles also have a statistically significant impact on the implementation of reforms in EU28 countries, where a result that reforms are implemented in a year prior to elections could be an indicator of opportunistic behaviour of politicians and fulfilling their own short-term interests since, with the approaching date of the election, they could implement rather popular reforms. The result that shows that left-oriented governments implement business environment reforms is in line with reasoning that as they attach greater weight to equity, the negative coefficient would be rather expected with the reform of the labour market than for the product market reforms which are analysed here (see Castanheira et al., 2006). However, the variable capturing the government fragmentation did not turn out significant in neither of models.

7 Despite the existence of the first order autocorrelation but with no second-order autocorrelation, GMM estimates are consistent (Arellano and Bond, 1991).
### Table 3. Results of dynamic panel model

|          | (1) | (1)       | (2)   |
|----------|-----|-----------|-------|
|          | EU28| EU13 (NMS)| EU15  |
| reformt-1| 0.704*** | 0.644*** | 0.683*** |
|          | (0.0586) | (0.080)  | (0.058)  |
| unemp    | 0.004*** | 0.004*** | 0.003**  |
|          | (0.001)  | (0.001)  | (0.001)  |
| mature   | 0.003*** | 0.004*** | 0.002*   |
|          | (0.001)  | (0.002)  | (0.001)  |
| left     | 0.015*  | 0.024*    | 0.015   |
|          | (0.008)  | (0.014)  | (0.0119) |
| net lend | -0.004*** | -0.001   | -0.005*** |
|          | (0.001)  | (0.001)  | (0.001)  |
| elec     |       |           |       |
| t-1      | 0.011*  | 0.021***  | 0.001  |
|          | (0.007)  | (0.008)  | (0.007)  |
| t-2      | 0.011   | 0.019**   | 0.001  |
|          | (0.007)  | (0.009)  | (0.009)  |
| t-3      | 0.006   | 0.013     | 0.001  |
|          | (0.008)  | (0.009)  | (0.011)  |
| t-4      | 0.002   | 0.011     | -0.006 |
|          | (0.007)  | (0.008)  | (0.009)  |
| herfgov  | -0.006  | 0.014     | -0.020 |
|          | (0.010)  | (0.015)  | (0.027)  |
| efw      | 0.770*** | 0.839***  | 0.902*** |
|          | (0.233)  | (0.188)  | (0.300)  |
| global   | 0.191   | 0.089     | 0.644** |
|          | (0.130)  | (0.164)  | (0.268)  |
| Observations | 360  | 165       | 195    |
| Number of countries | 28   | 13        | 15     |
| Arellano Bond test for AR(1) (p-values) | 0.000 | 0.006 | 0.001 |
| Arellano Bond test for AR(2) (p-values) | 0.453 | 0.735 | 0.169 |

*Source: Author’s calculation*

*Note: *, **, *** indicate statistical significance at levels of 10%, 5% and 1%; p-values are in brackets; Std. Err. adjusted for clustering on countries in brackets*
In the second model analysing the determinants of reforms in new member states (NMS11), the results show that, besides lagged dependent variable, *unemp*, *mature*, *left elec t-1*, *elec t-2* and *efw* are statistically significant. The results show that reforms are implemented in times of unemployment growth, two years’ prior elections, with an increase in maturity, in countries with more economic freedom in general and by the left-wing governments. Finally, in the cluster of old (EU15) countries, the results show that the reform*, t-,* *unemp*, *mature*, *net_lend*, *global* and *efw* are statistically significant. Beside the variables that were significant in the first model and minus the ideology of government, here is also significant indicator for globalisation capturing the external influence.

4. CONCLUDING REMARKS

Results of the empirical analysis performed for the EU countries in the period from 1995 to 2017 confirm that business environment reforms are a complex process which depends on a number of economic and institutional factors. We contribute to the existing research through the analysis of explanatory factors of reforms in EU countries with special emphasis on the difference between old and new EU member states which has implications for future avenues of research within this research area. The obtained results are in line with previous research, i.e. Duval, Furceri and Miethe (2018) as well as with Dias da Silva, Givone and Sondermann (2017) who both showed that in EU and OECD countries reforms tend to occur during period of high unemployment, supporting the crisis induced reform hypothesis. Also, Duval, Furceri and Miethe (2018) point out that political factors have much smaller effect than economic factors. A difference in our analysis is that for the group of NMS the opposite is true, i.e. that political factors have larger effect than economic factors. In addition to crises variable, Dias da Silva, Givone and Sondermann (2017) also showed that external pressure, reforms sequencing, government fragmentation and initial structural conditions have a significant effect on reforms in various areas, including the business environment.

One of the directions for future research is seen in the analysis of some more of unpopular reforms such as the reforms in labour market or in health sector. Also, it would be advisable to test the obtained results on some other available indicators and using alternative methods. In addition, this type of research is also of great importance for future research on the impact of reforms on various economic outcomes, since it has been shown that the specific characteristics of countries should be considered in the process of designing various reform programmes, and no “one size fits all” approach could be followed.

However, the obtained results should be interpreted with caution considering all of the limitations of the research such as endogeneity, the sample size and time period. The main objective is to encourage further discussions in this research area and additionally highlight what Bergsten and Williamson (1994:4) already stressed: that although there is no set of rules that could provide some kind of the manual for all countries in all circumstances, any guidelines that result from detailed examination of
specific processes in individual countries could be helpful to policy-makers and economists. Thus, the research conducted in this paper could serve as one of among many guidelines for policy-makers in the process of reform implementation.

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APPENDIX A1. Individual sub-indices contained in the *Economic Freedom of the World (EU28=100)*

![Graphs showing the Economic Freedom of the World sub-indices](image)
ODREDNICE REFORMI POSLOVNOG OKRUŽENJA: POSTOJI LI RAZLIKA IZMEĐU STARIH I NOVIH DRŽAVA ČLANICA EU?

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Sažetak

U radu je provedena empirijska analiza čimbenika reformi poslovnog okruženja. Preciznije, primjenom analize panel podataka, u radu se istražuju učinci makroekonomskih uvjeta, političkih institucija i međunarodnih čimbenika na reforme poslovnog okruženja. Ekonometrijska analiza provedena je na uzorku 28 država članica Europske unije za razdoblje od 1995. do 2017. godine. Osim toga, grupiranjem zemalja na nove i stare države članice EU provedena je posebna analiza za ta dva uzorka. Dobiveni rezultati pokazuju da su reforme poslovnog okruženja pod utjecajem niza čimbenika, ali i da se značajnost čimbenika razlikuje među starim i novim državama članicama EU.

Ključne riječi: poslovno okruženje; reforme tržišta proizvoda; EU; NMS, EU15.