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*Oleksandra Struk*<sup>1</sup>

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## THE ROLE OF INSTITUTIONS IN SHAPING STATE COMPETITIVENESS: THE EVIDENCE FROM THE EUROPEAN COUNTRIES

**Keywords:** competitiveness, cross-country analysis, Europe, governance, institutions

**ABSTRACT:** The article aims to define the role of institutions in shaping competitiveness in certain European states. The research problem to be addressed through this study is to what extent does the level of competitiveness in world economy depends on Worldwide Governance Indicators (WGI) in particular countries. The study was conducted using a combination of quantitative and qualitative research methods of data analysis. A cross-country comparative analysis, based on data from 32 European states in 2021, revealed that the level of competitiveness is determined by institutional environment. The higher the WGI percentile ranks, the better place in the World Competitiveness Ranking. The results of the study enabled to fully confirm the 1<sup>st</sup> hypothesis, i.e. the institutional governance quality and control of corruption have a noticeably positive impact on competitiveness. It was revealed that the 2<sup>nd</sup> hypothesis could not be confirmed because of statistical insignificance, i.e. countries with political stability, absence of violence/terrorism and quality of law are typically more competitive among world economies. Meanwhile, the 3<sup>rd</sup> one was partially confirmed, i.e. the quality of regulations leads to higher competitiveness of economies, while freedom of expression, free media and ability to participate in national elections have not a significant impact on competitiveness.

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<sup>1</sup> Assistant Professor, Department of Political and Security Sciences, Institute of Political Sciences, Faculty of Social Science, University of Warmia and Mazury in Olsztyn; ORCID: <https://orcid.org/0000-0002-5316-9630>; [oleksandra.struk@uwm.edu.pl](mailto:oleksandra.struk@uwm.edu.pl).

## INTRODUCTION

In today's world of globalization, open markets, and the development of information and communication technologies, national economic policy has made international competitiveness a priority, as it contributes to the expedited movement of financial and information flows, as well as economic, societal, and political transformations. As a result, we can observe the process of heightened international rivalry between states and the dynamism of changes in rankings. It determines the extent of involvement in the international division of labor, to become an assurance of political and economic stability, prompted by both external and internal influences. The competitiveness of the economy, the means of measurement used to assess it, and its effect on the fluctuations in different economic cycles, are of great interest to economists and leaders alike, since the accuracy of the assessments and their correspondence to the underlying economic conditions are key to making effective strategic decisions on both the macro and micro levels.

Within the field of institutional economics (see: Rutherford, 2001), notably represented by T. Veblen and J. K. Galbraith, the economy is treated as a system of (formal and informal) social institutions related to the production, distribution and consumption of goods, or, other words, for the provision of the means of socio-economic life and its maintenance. The majority of institutional economists agree that the government has a substantial role to play in the economy, as it should remove or soften the effects of competition and to implement a policy that neutralizes inequalities.

Recent years have seen institutional conditions gained renewed attention as a result of Global Competitiveness Report (World Economic Forum, 2018), which inquires, "Are institutions still important?" (p. 12), emphasizing the critical importance of a proper institutional framework for international competition. Countries with comprehensive institutions are likely to guarantee effective resource assignment, stimulate investment operations to heighten productivity, minimize unpredictability, advance equitable allotment of private and public benefits and support economic actor interaction. On the contrary, countries with weak institutions often experience a variety of fiscal complications, such as low investment flows,

slow economic growth and low per capita income (see: Acemoglu et al., 2001; Hall, Jones, 1999; Knack, Keefer, 1995; Mauro, 1995; Rodrik et al., 2004).

Bearing the aforementioned in mind, *the purpose of the article* is to define the role of institutions in shaping competitiveness in certain European states. The *research problem* to be addressed through this study is to what extent does the level of competitiveness in world economy depends on Worldwide Governance Indicators in particular countries.

In order to make a comprehensive analysis of the research problem, the following hypotheses were formulated:

- H1:* The institutional governance quality and control of corruption have a noticeably beneficial impact on competitiveness.
- H2:* Countries with political stability, absence of violence/terrorism and quality of law are typically more competitive among world economies.
- H3:* Regulatory quality, freedom of expression, free media and ability to participate in national elections lead to higher competitiveness of economies.

The study was conducted using a combination of quantitative and qualitative research methods of data analysis, synthesis and interpretation, as well as structural-functional approach, and comparative analysis. It contains a comprehensive analysis of scientific studies, statistical data, international reports and web sources.

The initial stage of research involves an overview of the theoretical foundations and established methodology for measuring global competitiveness (i.e. IMD World Competitiveness Ranking and The Global Competitiveness Index) and evaluation of institutional environment (based on Worldwide Governance Indicators). A cross-country comparative analysis was then conducted to demonstrate the extent to which competitiveness is linked to the institutional environment in certain European countries. Moreover, the descriptive analysis was implemented to summarize statistical data and identify trends concerning the relation between competitiveness and institutional environment. A multiple regression model was also employed to display the magnitude of the influence of governance indicators on competitiveness as a dependent variable.

## THEORETICAL AND METHODOLOGICAL FOUNDATIONS OF THE RESEARCH PROBLEM

The World Economic Forum (2016) defines Global competitiveness as “the set of institutions, policies and factors that determine the level of productivity of a country”. Since the beginning of the 1980s, numerous studies on competitiveness have been published. Along with the expansive scholarly material, two major world rankings have been developed and are commonly used to measure competitiveness. The Global Competitiveness Index was released by World Economic Forum (WEF) in the year 2004 to measure the national competitiveness of over 130 countries based on 12 pillars, which consider both microeconomic and macroeconomic foundations. These pillars include: enabling environment (i.e. institutions, infrastructure, ICT adoption, macroeconomic stability), human capital (i.e. health and skills), markets (i.e. product market, labor market, financial system, market size), innovation ecosystem (i.e. business dynamics and innovation capability). The last edition covering Global Competitiveness Index was published in 2019 (Schwab, 2019), while the special edition of WEF – in 2020 (Schwab, Zahidi, 2020).

The second one, the IMD (2023) World Competitiveness Yearbook has been published annually since 1989 and is a comprehensive global report that assesses the competitiveness of various countries. The Yearbook extensively covers 64 economies, selected due to the abundance of international statistics. It offers detailed benchmarking, trends, survey outcomes and statistical data, based on thorough research. It examines and ranks countries in terms of their capacity to foster long-term benefit through their competencies. A country’s competitiveness cannot be solely based on GDP and productivity, since companies must also contend with political, social, and cultural factors. It is thus necessary for governments to provide an environment with well-functioning infrastructures, institutions, and policies that support sustainable value creation among enterprises.

The World Competitiveness Ranking is compiled from 336 factors of competitiveness (IMD, 2022) which have been carefully chosen through extensive research, drawing on data from a range of economic sources, as

well as feedback from the business world, governmental bodies, and academics. These data include: economic performance (i.e. domestic economy, international trade, international investment, employment, prices), government efficiency (i.e. public finance, tax policy, institutional framework, business legislation, societal framework), business efficiency (i.e. productivity & efficiency, labor market, finance, management practices, attitudes & values), infrastructure (i.e. basic infrastructure, technological infrastructure, scientific infrastructure, health & environment, education). The criteria are constantly modified and adapted in response to new theories, researches, and data, and as the world economy develops.

The scientists are unified in the belief that the quality of the institutions is a foundation for competitiveness (see: Bontempo, 2022; Ervits, Zmuda, 2018; Guerrieri, Meliciani, 2004; Hollingsworth, 2000; Ingram, Silverman, 2000; Jaffe et al., 1993; Moon et al., 1998; Peng et al., 2008; Porter, 1990; Porter, Linde, 1995; Rodriguez et al., 2005; Soete, 1987; Tobey, 1990; Wan, Hoskisson, 2003). Acemoglu and Johnson (2005) stated that “property rights institutions have a first-order effect on long-run economic growth, investment, and financial development”.

Rothstein and Teorell (2008) define quality of governance as “the impartiality of institutions that exercise government authority”. The concept of institutional quality has also been discussed in the literature as the basis of economic transformation (Acemoglu et al., 2001, 2002; Acemoglu, 2003; Acemoglu et al., 2005; Acemoglu, Johnson, 2005; Lane, 2014).

The institutional quality was also defined by Graham and Naim (1998) within a range of conditions: (1) resource conditions: the extent, quality, and allocation of available resources; (2) political conditions: co-optation, corruption and politicization of resource allocation; (3) systemic conditions: pertaining to the clearness of long-term objectives, dominance of economic entities, and external government interference.

The other scholars and institutions have paid close attention to the concept of good governance. According to the United Nations Development Programme (1997):

Good governance is, among other things, participatory, transparent and accountable. It is also effective, equitable, and it promotes the rule of law.

Good governance ensures that political, social, and economic priorities are based on broad consensus in society and that the voices of the poorest and the most vulnerable are heard in decision-making over the allocation of development resources.

According to the World Bank, the concept of governance encompasses the way of electing, controlling and replacing governments; the capability of forming and implementing prudent regulations and policies; and the recognition of citizens and the state for the mechanisms that direct economic and social interactions between them. Thus, in terms of these 3 priorities, the Worldwide Governance Indicators (Hereafter: WGI) project has accumulated and evaluated governance indices for 200 countries and regions from 1996-2021, based upon six dimensions of governance (see: Table 1).

**Table 1.** The World Bank's World Governance Indicators

Variable	Description
Control of Corruption	Perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.
Government Effectiveness	Perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
Political Stability and Absence of Violence/Terrorism	Perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism.
Rule of Law	Perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.
Regulatory Quality	Perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
Voice and accountability	Perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

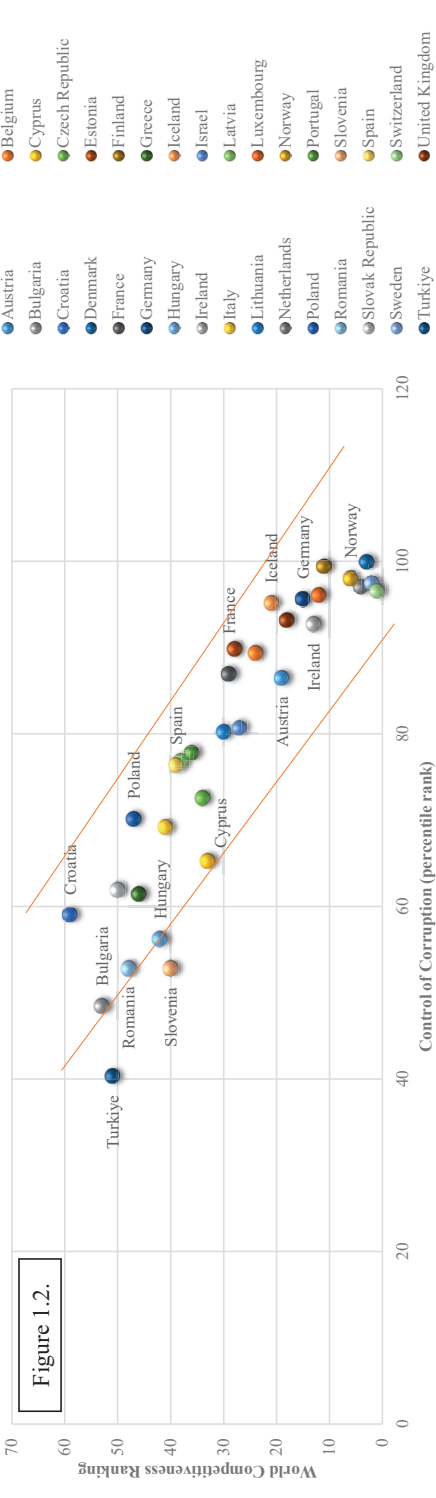
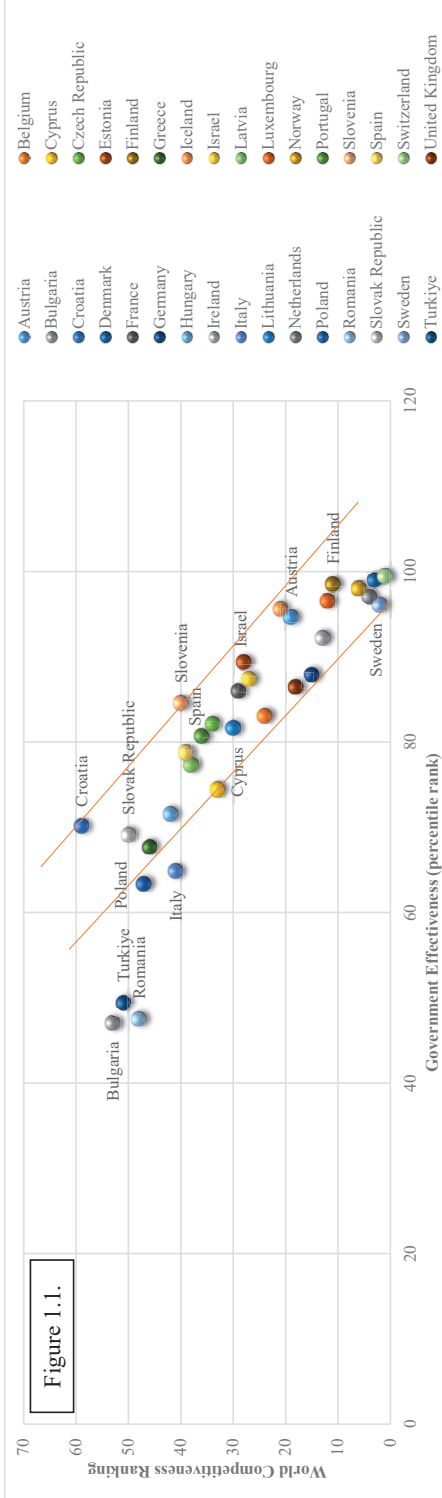
Source: Kaufmann, Kraay, & Mastruzzi, 2010.

The WGI are a research dataset initiated by D. Kaufmann (President Emeritus, Natural Resource Governance Institute and Brookings Institution) and A. Kraay (World Bank, Development Economics) in 1999. The six composite WGI measures, compiled from 30+ data sources from survey institutes, think tanks, NGOs, international orgs, and private firms, prove to be a proper tool for making general cross-country comparisons as well as for identifying broad trends in the long run. Additionally, these inclusive indicators combine the perspectives of a considerable amount of business, public and specialist survey respondents from different countries.

### **THE IMPORTANCE OF INSTITUTIONS TO STATE COMPETITIVENESS: CROSS-COUNTRY ANALYSIS**

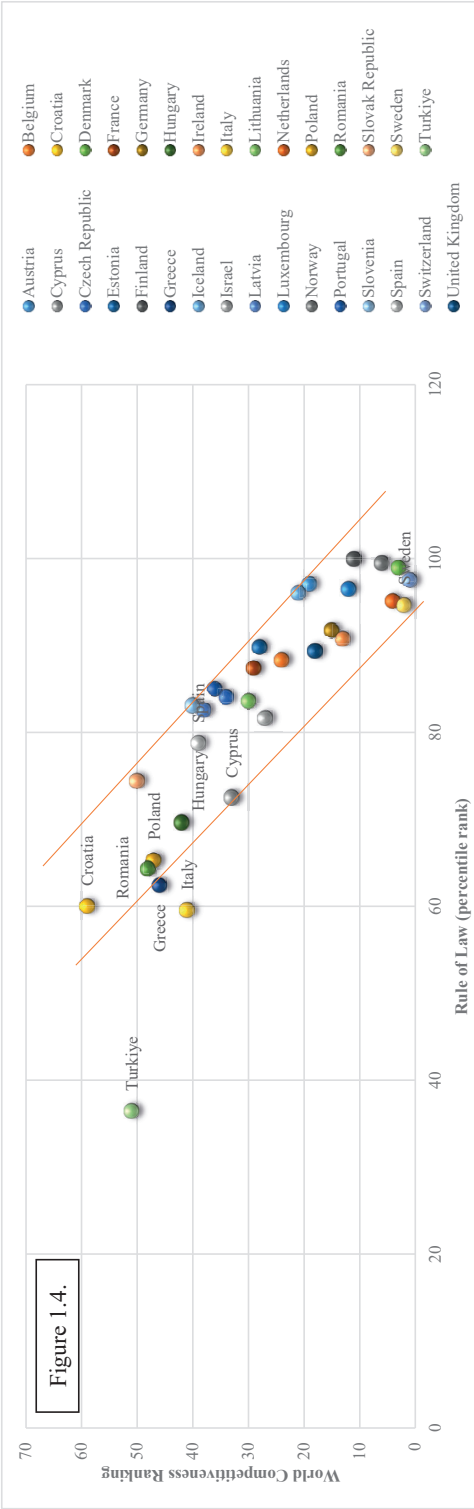
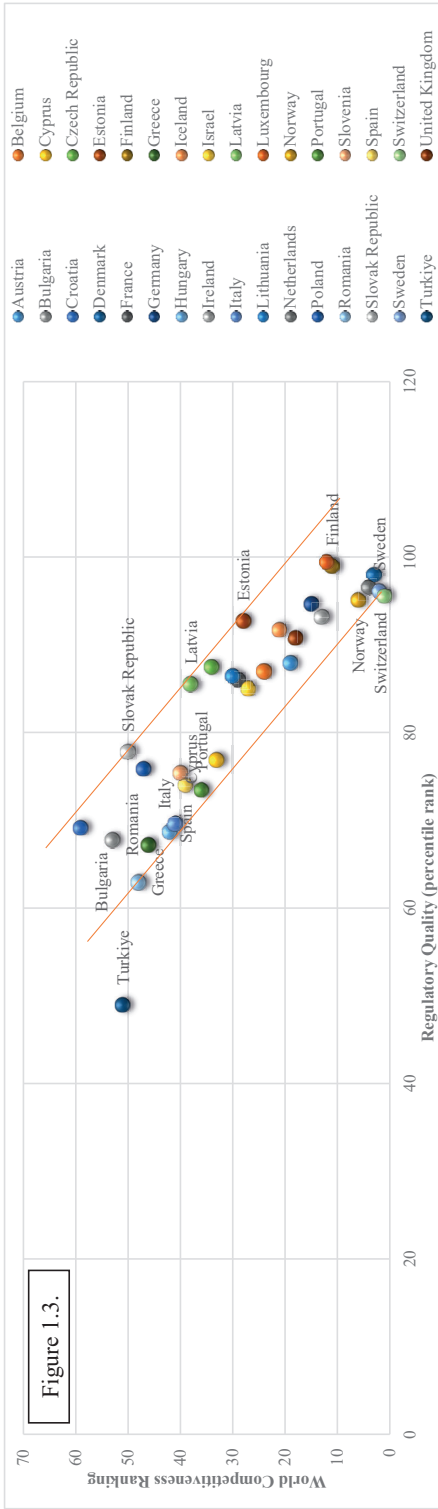
For the purpose of conducting a comparative analysis, 32 states with different level of economic development from across Europe were selected, and Turkey, as a state in a Customs Union with the EU. In view of the available statistical data, the research was conducted based on 2021-2022 data. To measure the quality of governance we use the WGI, while the competitiveness is presented based on the World Competitiveness Ranking. The results of the study are presented in figure 1 with indicators of 32 states in 2021. Thus, it is clearly evident that states form trend channels with varying degrees of dispersion, proving that the competitiveness of particular states is determined by the institutional environment. The higher the WGI percentile rank, the better place in competitiveness ranking.

The top 10 countries among those covered by the research as to the World Competitiveness Ranking are: Switzerland (1 place in 2021 and 2 – in 2022), Sweden (2 place – in 2021 and 4 – in 2022), Denmark (3 and 1 places respectively), Netherlands (4 and 6 places), Norway (6 and 9 places), Finland (11 and 8 places), Luxembourg (12 and 13 places), Ireland (13 and 11 places), Germany (15 place in both years), United Kingdom (18 and 23). Table 2 and Table 3 include WGI percentile ranks of the states with the highest / lowest competitiveness. All these states, from table 2,

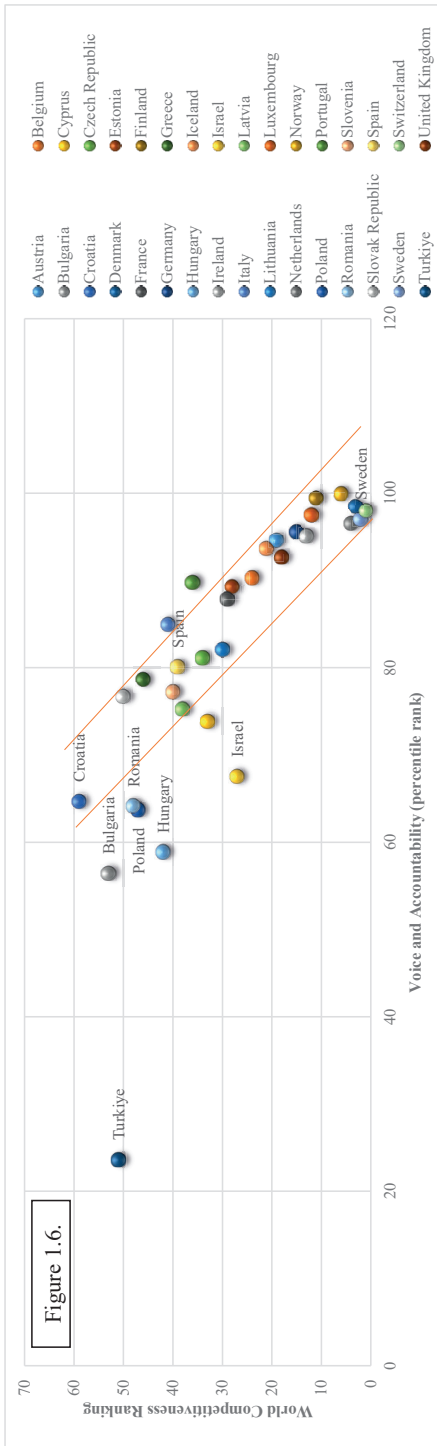
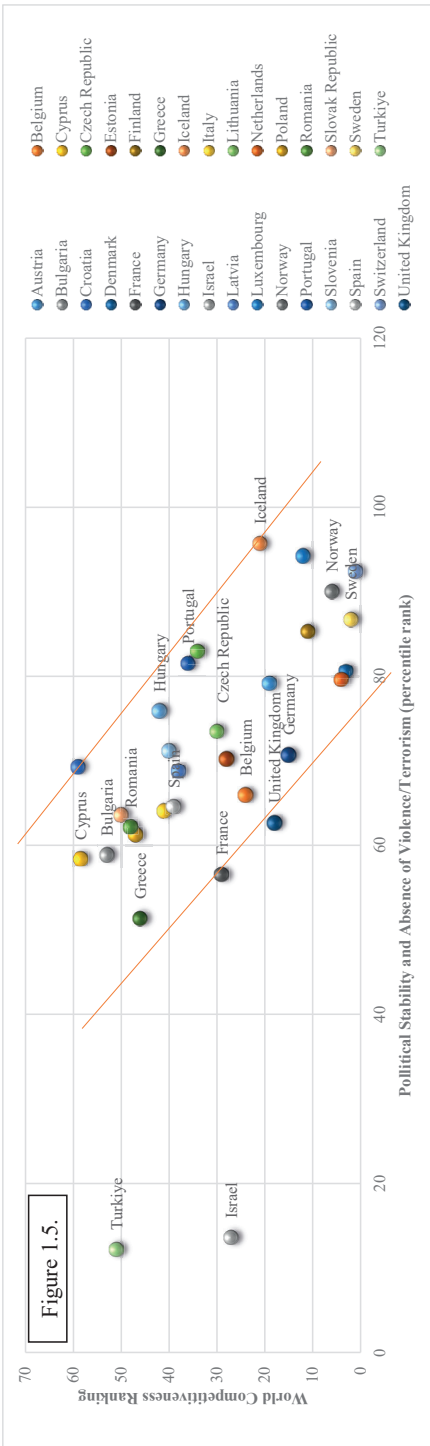


**Figure 1.** World Competitiveness Ranking & Worldwide Governance Indicators in 2021





**Figure 1.** continued



**Figure 1.** continued

Source: Own elaboration based on data downloaded from database: World Bank (2022), Worldwide Governance Indicators. Retrieved from: <https://databank.worldbank.org/source/worldwide-governance-indicators> (last updated: 09/23/2022) and IMD (2023), World Competitiveness Ranking. Retrieved from: <https://www.imd.org/centers/wcc/world-competitiveness-center/rankings/world-competitiveness-ranking/>.

have a WGI percentile rank above 90%, indicating a high level of institutional quality. The sole exception is the ‘Political Stability and Absence of Violence/Terrorism’ indicator, which accounts for 62.74% in the United Kingdom, 70% in Germany, 75.47% in Ireland and 79.72% in the Netherlands.

**Table 2.** WGI percentile rank of the states with the highest competitiveness

Country Name	Worldwide Governance Indicators (2021)					
	CC	GE	PS	RQ	RL	VA
Denmark	100,00	99,04	80,66	98,08	99,04	98,55
Finland	99,52	98,56	85,38	99,04	100,00	99,52
Germany	95,67	87,98	70,75	94,71	91,83	95,65
Ireland	92,79	92,31	75,47	93,27	90,87	95,17
Luxembourg	96,15	96,63	94,34	99,52	96,63	97,58
Netherlands	97,12	97,12	79,72	96,63	95,19	96,62
Norway	98,08	98,08	90,09	95,19	99,52	100,00
Sweden	97,60	96,15	86,79	96,15	94,71	97,10
Switzerland	96,63	99,52	92,45	95,67	97,60	98,07
United Kingdom	93,27	86,54	62,74	90,87	89,42	92,75

*Note:* CC – Control of Corruption: Percentile Rank; GE – Government Effectiveness: Percentile Rank; PS – Political Stability and Absence of Violence/Terrorism: Percentile Rank; RQ – Regulatory Quality: Percentile Rank; RL – Rule of Law: Percentile Rank; VA – Voice and Accountability: Percentile Rank.

Source: own elaboration based on IMD data retrieved from: <https://www.imd.org/centers/wcc/world-competitiveness-center/rankings/world-competitiveness-ranking/>.

Meanwhile, Croatia, Greece, Slovak Republic, Poland, Romania, Hungary, Turkey, and Bulgaria have the lowest positions in World Competitiveness Ranking among those studied. Similarly, the low results could be found considering WGI (see: Table 3).

**Table 3.** WGI percentile rank of the states with the lowest competitiveness

Country Name	Worldwide Governance Indicators (2021)					
	CC	GE	PS	RQ	RL	VA
Bulgaria	48,56	47,12	58,96	67,79	53,37	56,52
Croatia	59,13	70,19	69,34	69,23	60,10	64,73
Greece	61,54	67,79	51,42	67,31	62,50	78,74
Hungary	56,25	71,63	75,94	68,75	69,71	58,94
Poland	70,19	63,46	61,32	75,96	65,38	63,77
Romania	52,88	47,60	62,26	62,98	64,42	64,25
Turkiye	40,38	49,52	12,26	49,04	36,54	23,67

*Note:* CC – Control of Corruption: Percentile Rank; GE – Government Effectiveness: Percentile Rank; PS – Political Stability and Absence of Violence/Terrorism: Percentile Rank; RQ – Regulatory Quality: Percentile Rank; RL – Rule of Law: Percentile Rank; VA – Voice and Accountability: Percentile Rank.

Source: own elaboration based on IMD data retrieved from: <https://www.imd.org/centers/wcc/world-competitiveness-center/rankings/world-competitiveness-ranking/>.

## MULTIPLE REGRESSION MODELING AND FINAL RESULTS

Considering dependence between competitiveness and WGI (as presented in Figure 1), it is noteworthy to make an attempt of presenting a multiple regression model and assess its significance. A regression model provides a function that describes the relationship between one or more independent variables and a response, dependent, or target variable.

Assuming that development of the institutional environment has its influence on the competitiveness with some lag of time, the dependent variable ‘World Competitiveness Ranking’ (WC) presents a rank of states in 2022 (where 1 is the best position), while independent variables ‘Control of Corruption’, ‘Government Effectiveness’, ‘Political Stability and Absence of Violence’, ‘Regulatory Quality’, ‘Rule of Law’ and ‘Voice and Accountability’ (all as percentile rank) – the data from 2021 (from 0 to 100%, with 100% – the best result).

The first regression model is as follows:

**Table 4.** Regression Statistics of the model 1

Regression Statistics				
Multiple R	0,948889			
R Square	0,90039			
Adjusted R Square	0,876484			
Standard Error	5,79345			
<i>Significance F</i>	2,43E-11			
Observations	32			
	Coef	Std err	t-Stat	P-value
<i>Intercept</i>	115,6539	8,960704	12,90678	1,48E-12
Control of Corruption	-0,56308	0,284697	-1,97783	0,059071
Government Effectiveness	-0,51697	0,237745	-2,17447	0,03934
Political Stability and Absence of Violence	-0,08707	0,089612	-0,97163	0,340541
Regulatory Quality	-0,50502	0,282437	-1,78809	0,085889
Rule of Law	-0,333437	0,28159	-1,184122	0,247501
Voice and Accountability	-0,242491	0,186412	-1,30083	0,20518

Source: Own elaboration

According to table 4, the value of R square is 0,90, thus 90% of the dependent variables (*y-values*) are explained by the independent variables (*x-values*). The value of *Significance-F* and *Standard Error* also prove the overall significance of the model. So, we can observe the negative correlation, that is, the higher percentile rank of institutional variable, the better position in the World Competitiveness Ranking. Meanwhile, some variables present a high *p-value* (i.e. 'Political Stability and Absence of Violence' (0,34); 'Rule of Law' (0,24); 'Voice and Accountability' (0,20)), thus are statistically insignificant.

The next step is an attempt to show the multiple regression model by taking into account only significant variables (Table 5).

Model 2 is as follows:

**Table 5.** Regression Statistics of the model 2

Regression Statistics				
Multiple R	0,940169			
R Square	0,883918			
Adjusted R Square	0,871481			
Standard Error	5,909616			
<i>Significance F</i>	3,3E-13			
Observations	32			
	Coef	Std err	t-Stat	p-value
<i>Intercept</i>	116,1178	8,773402	13,23520914	1,43E-13
Control of Corruption	-0,27927	0,23932	-1,16694409	0,253076
Government Effectiveness	-0,40354	0,206254	-1,956495065	0,060448
Regulatory Quality	-0,39834	0,263656	-1,510818996	0,142039

Source: Own elaboration

As a result of eliminating statistically insignificant variables (Table 4), the overall significance of the model is still high (R Square = 0,88; Adjusted R Square = 0,87). Consequently, it can be stated that such institutional variables as ‘Control of Corruption’, ‘Government Effectiveness’ and ‘Regulatory Quality’ have a high impact on the competitiveness.

## CONCLUSIONS AND FINAL REMARKS

A cross-country comparative analysis, based on data from 32 European states in 2021, revealed that the level of competitiveness of particular states in world economy is determined by the institutional environment (i.e. by forming trend channels with varying degrees of dispersion). The higher the WGI percentile ranks, the better place in the World Competitiveness Ranking.

In order to evaluate the influence of WGI on the level of competitiveness, a multiple regression model was employed. The results show the overall significance of the model (90% – model 1 and 88% – model 2), thus, the place in Competitiveness Ranking is highly determined by some WGIs, such as ‘Control of Corruption’, ‘Government Effectiveness’ and

‘Regulatory Quality’. Meanwhile, Political Stability and Absence of Violence’, ‘Rule of Law’, ‘Voice and Accountability’ proved to be statistically insignificant. Thus, the first hypothesis is completely verified; the second one – not verified; and the third hypothesis is partially verified.

Numerous surveys indicate that corruption hinders investment and impedes economic growth, thus having a considerable influence on economic development. It is a significant problem of developing countries, as corruption may reduce the effectiveness of aid allocations by transferring funds to unproductive and superfluous government expenditures. This is also directly associated with the effectiveness of governance and regulatory quality. Potentially, in response, many donor countries have fixed their attention on issues of good governance, and in circumstances where governance is judged to be particularly weak, some benefactors have lessened their support. Besides, corruption may lead to loss of tax revenue because of improper tax exemptions, thus influencing public budget as well as business. Through corruption, government expenditure may be severely distorted. It may result in fiscal difficulties if public financial institutions extend loans at below-market interest rates. The allocation of public procurement contracts through a corrupt system may lead to lower quality of infrastructure and public services. Moreover, the distribution of public procurement contracts through an illegal process may lead to a decline in the quality of infrastructure and public services.

Consequently, in order to remain competitive in the global economy, it is highly important to shape a proper quality of institutional governance within implementation of sound policies and regulations that support and foster private sector development, as well as to employ the best practices in combating corruption.

The article successfully revealed the impact of institutions on state competitiveness in European countries, however, it has some limitations – it was unable to provide an in-depth overview of the individual countries’ practices of good governance, which could be a good foundation for further research.

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