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Regional Security as a Driver of Institutional Change in post-Communist Countries?

Empirical Evidence on NATO Accession Incentives

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Regional Security as a Driver of Institutional Change in post-Communist Countries? Empirical Evidence on NATO Accession Incentives[1]

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1. Introduction

A potential influence of NATO on institutional change was widely discussed in the course of NATO enlargement to Eastern Europe (Jureković, Malek et al. 1999; Rupnik 2000; Reiter 2001; Waterman, Zagorcheva et al. 2001; Epstein 2005). Some authors supported a "strategy first" view, arguing that NATO enlargement was not driven by a common commitment to democratic principles, as the Central and Eastern European countries (CEECs) that applied for membership in the early 1990s had been already committed to democracy well before the "carrot" of NATO membership was offered (Reiter 2001; Sjursen 2004). Other authors, however, argue that especially "democratic security" offered by NATO was one precondition for the consolidation of democracy in CEECs (Rupnik 2000).

In a recent paper, Gibler and Sewell (2006) confirmed that NATO's effect on reducing external threats has indeed acted as a precondition for any impact the EU might have had. They conclude that "...NATO has been an effective guarantor of territorial sovereignty and independence in the Baltic states, Ukraine, and Moldova, reducing the level of threat experienced by each state, thus assuring the survival of decentralized and democratic governments" while the other "former Soviet republics targeted by high levels of threat have

reverted to or maintained centralized, autocratic forms of government" (Gibler and Sewell 2006, p. 413). Basically, this implies an indirect effect of NATO enlargement, which is restricted to the stabilization and consolidation of democratic regimes in post-communists countries. We argue the impact of NATO enlargement is not that limited and restricted.

First, NATO incorporated democratic and free market conditionality as an essential part of its post-Cold War enlargement. In particular, NATO puts demands on democratic and free market reforms in the security and defence sector not only during accession negotiations, but also at the cooperation levels of the program „Partnership for Peace", which is still distant from membership, and even before conditionality became more formalized by Membership Action Plan (MAP). Furthermore, there is ample evidence provided by qualitative studies that NATO and EU accession conditionality matters for the outcome of the transition process towards democracy and market economy in former socialist countries (Smith 2001; Schimmelfennig 2005a; Schimmelfennig 2005b; Boonstra 2007; Pop-Eleches 2007; Armingeon and Careja 2008; Schimmelfennig and Scholtz 2008). In comparison to EU enlargement[2], however, NATO's conditionality did not figure prominently in the academic literature. The influence of NATO enlargement was re-discovered only recently, as the regional and functional limitations of EU enlargement became evident. The ENP and Eastern Partnership offers provide only small "carrots" and were not perceived as adequate substitutes for EU enlargement. In addition, the current tendencies in the Russian foreign policy created new security fears in its neighborhood, raising thereby the value of NATO's "carrot": regional security.

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[2] EU enlargement was seen as *the* most massive transfer of institutions in recent history (Schimmelfennig and Sedelmeier 2005).

Second, besides its conditionality NATO has the tools to pursuit institutional change towards democracy through socialization. NATO was perceived in Eastern Europe as determined by democratic values even more than the EU, which was seen as primarily an economic organization with complicated bureaucratic procedures (Waterman, Zagorcheva et al. 2001). Arguably, NATO's socialization process, i.e., transfer of institutions through linkage-mechanisms to the governments, militaries and population of post-communist countries, is more easy and more rapid than one of the EU (especially in the military sphere) and more meaningful than one of the OSCE (Waterman, Zagorcheva et al. 2001).

Third, NATO has the potential for triggering institutional change beyond democratic reforms, i.e. in terms of free market reforms. The analysis of economic consequences of NATO enlargement has been mostly limited to aspects of regional security (e.g. Sandler and Hartley 1999). Only a few studies analyze an impact of NATO's demands on transparency, accountability and efficient budgeting in defence and security sectors for an overall quality of economic institutions in post-communist countries (Gupta, De Melo et al. 2001; Pyman, Scott et al. 2008).

So far, rigorous empirical analysis on the effectiveness of NATO's accession conditionality as a driving force of institutional change in post-communist countries is missing. Recent econometric papers focus on internal – economic, political, and cultural – determinants of institutional change (Di Tommaso et al. 2007; Beck and Laeven 2006) and consider only an EU influence, but rather as a control variable than as a main determinant. Schimmelfennig and Scholtz (2008) analyze EU integration effects on democratic consolidation in more detail, by distinguishing between the size and the credibility of EU's conditional incentives, but neglect NATO effects. While comparing the influence of internal and external factors, Armingeon and Careja (2008) use a dichotomous variable to examine the

influence of both EU and NATO, but only consider membership effects on formal institutions (e.g., constitutions, electoral systems, party systems).[3]

In this paper, we complement the strand of research on external factors by providing econometric analysis of NATO's influence on institutional reforms. We are able to confirm a strong and robust impact of NATO's membership negotiations and MAP on institutions, measured by comprehensive governance indicators provided by the World Bank, i.e. the World Bank Governance Indicators. Thus, we argue that NATO accession may well have a direct effect on institution building in post-communist countries.

Section 2 gives a short overview of the existing literature which presents our theoretical argument supporting the hypothesis of a direct NATO impact on institution building in post-communist countries. We proceed by outlining the empirical strategy and operationalization of the theoretical concept into measurable variables in section 3. Our country sample includes 25 post-communist countries (CEECs, CIS, and Balkan countries). Using panel data allows us to jointly test the impact of NATO and EU and to consider control variables like capital flows as well internal (political, economic and cultural) factors in a multivariate approach. Section 4 presents the empirical findings and section 5 concludes.

2. NATO Enlargement and NATO Potential for Triggering Institutional Change

Explaining NATO's post-Cold War Enlargement

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[3] They assigned '1' to all the countries that joined the EU in 2004 and 2007 and to those countries that, as of 2004, were full members of NATO; and '0' for the rest of countries in the sample.

Some favorable geopolitical factors and external events beyond NATO's direct control have been necessary to accelerate the cooperation with post-communist countries and to put enlargement on the agenda during the Brussels Summit in 1994.

First, the anti-Gorbachev coup attempt in 1991 led to the final winding-up of the Warsaw Pact in July. The coup induced a sense of vulnerability among leaders of Eastern Europe, especially of Czechoslovakia, Hungary and Poland as being in the "security vacuum" between NATO and Soviet Union.[4]

Second, in assessing what lay behind NATO's initiatives on enlargement, one cannot ignore the coincidence of timing between the developments in NATO and those that were taking place concurrently in the EU. During the Cold War and before the creation of the EU by Maastricht Treaty, the idea of Europe as a power in its own right was irrelevant, as all Allies fundamentally subscribed to NATO's strategy in view of the dominating threat of the Soviet Union, while the EEC and WEU lacked the capacity to play such a role (Cohen-Tanugi 2003). Since then, however, the EU has not only increasingly fostered the ambition, but is also continuously developing its capacity to be a global strategic actor, especially since the initiation of the European Security and Defence Policy (ESDP) (Biscop 2007). Hence, NATO activities in the East were the results of the internal development in the EU, favoring the transplantation of the Western European Union (WEU) into the EU and strengthening of the Conference on Security and Cooperation in Europe (CSCE) in order to limit NATO hegemony on the issues of European security. The EU's Copenhagen decision of June 1993 to invite some Eastern European countries for membership and to define clear conditions for joining gave an additional impulse to NATO's enlargement strategy. Clearly, NATO

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[4] The Visegrad Declaration signed in February 1991 by Czechoslovakia, Hungary and Poland pledged mutual support towards entry into NATO and the EU, and was phrased within the context of a 'Return to Europe'.

enlargement was also perceived by the Clinton administration as being closely bound up with the maintenance of US leadership with NATO (Holbrooke 1995).

Third, the geopolitical obstacle to the enlargement disappeared, after joint Warsaw Declaration of 1993 agreed between Boris Yeltsin and Lech Walesa declared the Poland's intention to join NATO as one that "did not go against the interests of other states, including the interests of Russia" (Warsaw Declaration 1993). The similar statement during Yeltsin's visit to the Czech Republic gave the chanced for CEECs for actually joining. The May 1997 NATO-Russia agreement entirely removed the Russian obstacle to enlargement. The political and academic debates over NATO expansion that tended to revolve around the question of whether this move eastward would re-create the division of Europe or bring greater peace and stability to a fragmented region were solved (Asmus 2002).

At the NATO Summit in Brussels in January 1994 NATO leaders welcomed "NATO expansion to the East" and made future enlargement possible. The Madrid Declaration of 1997 invited the Czech Republic, Hungary and Poland to open accession talks. In 1999, they were the first former members of the Warsaw Pact to join NATO. Bulgaria, Estonia, Latvia, Lithuania, Romania, Slovakia and Slovenia were invited to begin accession talks at the NATO Prague Summit of 2002 and joined NATO in 2004. At the Bucharest Summit 2008, Albania and Croatia were invited to begin accession talks with NATO and entered NATO in 2009. The Former Yugoslav Republic of Macedonia will join NATO as soon as a mutually acceptable solution to the issue of country name has been reached with Greece. Ukraine and Georgia are the next countries in the front of NATO's "open door". At the Bucharest Summit they were not granted MAP, but received the assurances that they can enter NATO in the future. Furthermore, Bosnia and Herzegovina and Montenegro were invited to Intensified Dialog with NATO. A closer cooperation with NATO is also the priority of the foreign policies in Serbia and Kosovo.

Phasing-In Accession Conditionality

While the timing of enlargement was mainly driven by external events, especially by the relations with Russia, the choice of accession candidates was driven by values. In this respect, NATO clearly moved its focus from strategic issues to a convergence of institutions and values. In particular, NATO launched conditionality, based on democratic and market values. In 1994, the program „Partnership for Peace" defined the principles of NATO's cooperation with post-communist countries, among others: preserving democratic societies; maintaining the principles of international law; fulfilling obligations under the UN Charter, the Universal Declaration of Human Rights; refraining from the threat or use of force against other states; respecting existing borders and settling disputes peacefully; ensuring democratic control over their armed forces; facilitating transparency in national defense planning and budgeting (NATO 1994).

Furthermore, in its study on enlargement (NATO 1995) NATO formulated accession criteria, although not yet in a formalized way. The new NATO members were expected to conform to basic principles, like democracy, individual liberty and the rule of law; to demonstrate a commitment to OSCE norms, including the peaceful resolution of ethnic disputes; to promote stability and well-being by economic liberty; to establish appropriate democratic and civilian control of their defense force; to undertake necessary defense management reforms, such as transparent national defense planning, resource allocation and budgeting, appropriate legislation and parliamentary and public accountability.

Formalization of accession criteria took place after the first round of enlargement by the introduction of a mechanism called Membership Action Plan (MAP) approved at NATO's Washington Summit in 1999. A country's participation in MAP entails the fulfillment of five different groups of criteria. Four groups deal with organization, resources, safeguards, and compatibility. This "NATO acquis" focuses on the potential of (military) cooperation between

the accession country and NATO. However, the fifth group of criteria demands for the willingness to settle international, ethnic or external territorial disputes by peaceful means, to commit to the rule of law and human rights, to provide democratic control of the armed forces, and to establish market regulations for the defense industry. These criteria clearly target institutional reforms.

NATO's conditionality appears to be a filter that allows entry for countries that on one hand will not threaten the functioning of the organizations and the interests of their members and, on the other hand, will contribute to the accomplishment of NATO goals (Angelov 2004). Indeed, NATO accession requires a minimum of institutional standards. To some extent these are rather general demands on political culture which can also be found in the Copenhagen criteria of the EU. To another extent they seem specific and concerned about military capacities, democratic control over the security structures and market regulations in the defense industry. However, it is difficult to imagine that democratic control and market regulations in security and defence sectors can be introduced by candidate countries without any spillovers for other (civil) sectors. Quite to the contrary, introducing control and appropriate regulations in security and defense sectors can be assumed to be much more demanding due to the sensitivity of these sectors.

Effectiveness of Conditionality versus Strategic Interest

The fact that there is a clear conditionality demanding institutional reforms does not automatically imply that this conditionality is effective in the sense that it is actually implemented. From the perspective of potential accession countries, there seems to be no doubt that "carrot" for fulfilling NATO accession criteria - regional security – supports effectiveness of conditionality. As argued above, the attractiveness of NATO's conditionality was strong, as after dissolution of the Warsaw Pact Eastern European countries found themselves in security vacuum and had no other alternative to obtain security guarantees but

NATO.[5] NATO used the wider shared aspirations by the post-communist states for long-run security and prosperity and pushed them to transform from authoritarianism and plan towards democracy and market economy (Angelov 2004). Hence, the expectation of security guarantees in the future may have induced institutional reforms as demanded by NATO accession conditionality. Compliance is also supported by monitoring mechanisms - the PFP Planning and Review Process (PARP) and MAP annual progress reports - and socialization effects are achieved through linkage-mechanisms, e.g. meetings with accession and partner countries within NATO's central structures or joint working groups.

However, the effectiveness of conditionality also depends on NATO's own strategic interest in enlargement. In this respect, the recent round of enlargement including a country like Albania, which still shows certain deficits in institutional quality, may raise doubts about the strict interpretation of conditionality. Generally, the stronger NATO's own interest in enlargement, the less likely is a strict evaluation of conditionality.

On the one hand, the power of NATO's conditionality may have been reinforced by the fact that, initially, there was no urgent need for enlargement. The decision on enlargement was not clear from the start of transition. The London Declaration of 1990 offered the member states of the formally existing Warsaw Pact a "hand of friendship and cooperation", but not NATO's membership. Similarly, NATO's Rom Declaration of 1991 ignored the issue of enlargement, but offered the practical steps of the institutionalized cooperation between NATO, the non-Soviet former Warsaw Pact states, the three Baltic republics and the Soviet Union.

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[5] The capacity of transition countries to secure their states on its own was poor. A membership in the Western European Union presupposed EU membership that was not achievable in short-term. Russia, itself in transition, was not in power to provide security guarantees.

On the other hand, NATO's later decision in favor of enlargement was primarily driven by the challenge to adjust to the new global order and by its strategic interests to hold the leading position on security issues in Europe among competing international organizations. NATO was established out of European division and was seen by the Western European states as a necessary means of resisting military threat by the Soviet Union. Thus, after the collapse of the Warsaw Pact and the Soviet Union, NATO was enforced to redefine its identity and to justify its continued existence amidst expectations of a 'New World Order' and the anticipated peace dividend it would yield (Smith and Timmins 2000). Aside the inclusion of new aims to maintain regional stability, enlargement generated a new rationale for NATO's continued existence beyond the Cold War, extending security eastwards and providing a means of maintaining US engagement in Europe.

All in all, it cannot be ruled out that NATO's accession conditionality is effective and has driven institutional reform in accession countries. The strength of this conditionality remains an open question. Clearly, the "carrot" of joining a club providing regional security is large enough to support the willingness of accession candidates to comply with the criteria. However, NATO's accession conditionality has been formalized during the process of enlargement and may be watered down by NATO's own strategic interest.

Indirect versus Direct Effects on Institution Building?

The majority of academic analyses focus on an indirect influence of NATO on the development of good institutions. By demanding peaceful conflict settlement, NATO enlargement should indirectly assist in the stabilization of political tension in Central and Eastern Europe, especially contribute to the reconciliation of border relationships prone to conflict and damp down the potential for ethnic conflicts (Sandler and Hartley 1999). NATO also promotes institutional reforms by intervening to stop bloodshed and ethnic cleansing and by maintaining the subsequent peace. Peace and stability are the preconditions for the

implementation of institutional reforms. These indirect effects are stressed by studies on security aspects of NATO activities in terms of stability necessary to the establishment and consolidation of democracy (Barany 2004; Gibler and Sewell 2006). E.g., Boonstra (2007) argues that support for democracy has increasingly infused NATO policies, but that the NATO's role in democracy promotion is circumscribed by its strategic considerations; most often an indirect side effect of other aims; and most relevant to the niche area of defense reform.

However, the discussion of conditionality and its effectiveness has shown that besides indirect effects there is a clear potential of NATO to impact institution building in post-communist countries directly by demanding implementation of democratic and free market reforms. NATO's demands on civil and democratic control over military, transparency and accountability in defense budgeting can have direct effects on the overall level of democracy and market economy in a country. This does not exclude indirect effects. In a phase of close cooperation while preparing for membership any external threat can be assumed to decline compared to a non-cooperation case (Gibler and Sewell 2006, p. 417). I.e., it might be difficult to disentangle direct conditionality effects from indirect effects due to a decreasing threat level in the course of NATO integration.[6] In addition, the incentive to reap indirect effects that stem from full membership rights reinforces the effectiveness of NATO's conditionality by increasing the willingness for compliance in accession countries. Hence, the

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[6] A few analyses even support a direct effect not only in the course of membership, but also in a pre-membership phase. Applying constructivist approach, Gheciu (2005) demonstrates for the case of the basic Partnership for Peace (PfP) agreements a significant power NATO exercised as an "agent of socialization" in Central and Eastern Europe, projecting a particular set of liberal democratic norms of security. Furthermore, with reference to the "linkage"-mechanisms approach, intensive contact with NATO denationalised countries' defence strategies resulting in more stable relations among different states in Eastern Europe, and thus better opportunities for democracy to blossom (Epstein 2005).

effectiveness of conditionality depends on NATO's demand for such compliance in the first place.

Consequently, we do not deny the validity of the indirect security argument, but adopt an approach which is likely to give the direct effects a relatively high weight. First, we allow for a maximum of heterogeneity of the country sample in terms of external threat levels. By including Central and Eastern European countries (CEECs) in the sample, it is possible to take into account NATO effects in an environment with considerably lower levels of external threat. On the other side of the spectrum, we include Balkan countries, which experienced high levels of external (and internal) threat but which contrary to, e.g., Central Asian countries are targeted by both EU and NATO conditionality and incentives. Second, we consider EU *and* NATO effects in the pre-accession phase where conditionality can be assumed to matter most (Schimmelfennig, Engert et al. 2006; Pop-Eleches 2007; Schimmelfennig 2007). Finally, we also include a range of external and domestic as well as political and economic control variables in a multivariate approach where especially the political control variables account for initial conditions thus picking up some parts of the security argument.

3. Empirical Model

In order to test our hypotheses, we analyze the development of institutional characteristics in a sample of 25 post-communist economies between 1996 and 2005. While institutions are often regarded as highly persistent and analyses of institutional change therefore rely generally on much longer time horizons, we expect to find significant changes in our sample. Post-communist countries undergo a period of accelerated institutional change. Therefore it is also justified to analyze time horizons of one decade. This is also why we restricted the data by excluding the early 1990s which were characterized by a wave of transition crises and by

excluding recent years after a significant part of the sample countries have entered the EU and thus completed convergence towards Western institutional standards which has gone along with substantially more volatility than in comparable countries.

Still, a simple regression analysis faces several difficulties. Heterogeneous country characteristics which cannot be completely observed and measured persist over time and affect both our explanatory as well as the dependent variable. We address this problem through two different strategies. First, we introduce several measures of country characteristics which can be expected to account for several dimensions of relevant country characteristics. Second, we introduce country fixed effects.[7] In either strategy we account for additional time fixed effects by including time dummy variables. Nevertheless, we use Pooled OLS (POLS) estimator as a starting point because they incorporate more information when the approximation of the fixed country effects is good enough to reduce the bias to a minimum.[8]

Another problem of identifying causal effects of the explanatory variables is posed by endogeneity. We account for this possibility by instrumenting possibly endogenous variables with their own lagged values. Given the persistence of institutions, we use lags of two and more periods to reduce problems due to autocorrelated disturbances. The assumption of

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[7] More generally, we transform our variables to deviations from country means to eliminate the time-invariant country-specific error term by introducing the country fixed effects. A first difference transformation, as used in Arellano-Bond and other GMM panel estimators, is not possible because the dependent variable is not observed for consecutive years. We also refrain from using two-step GMM for IV estimation and feasible GLS estimators ("random effects") because of the small size of the cross-section in our dataset.

[8] In a larger sample we would have employed the efficient GLS (random effects) estimator and used a Hausman test to assess the hypothesis of inconsistency of the pooled estimator formally. Given the small sample size, we refrained from doing so.

exogeneity of the instruments and exogenous regressors is then tested using a standard Hansen test. This instrumental variables (IV) estimation is combined with both the standard pooled and the fixed effects estimator described above.[9]

We measure institutional quality using the World Bank Governance Indicators (WBGI). The WBGI are calculated as the sum of six single indicators as provided by the World Bank (Kaufmann et al. 2007). We argue that this is the most comprehensive measure of institutional development which is available for international comparisons. The WBGI include indicators on voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Hence, the aggregate indicator integrates legislative, administrative and legal aspects as well as political and economic institutions. At the same time, the calculation of the indices considers measurement errors and provides standardized measures. By using the WBGI, we follow Beck and Laeven (2006), but we will consider a full model in terms of external and internal determinants of institutional change. In this respect, we modify and extent the framework of Di Tommaso, Raiser, and Weeks (2007). The fact that key variables are comparable allows us to compare our findings about institutional change to those in the earlier literature.

A variety of explanatory variables are employed not only in order to assess their coefficients, but also to proxy for important and otherwise unobserved country characteristics as previously described. All explanatory variables and their data sources are listed in Table 1.

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[9] The estimation is implemented using the –ivreg2– and –xtivreg2– commands for Stata (Baum et al. 2007; Schaffer 2007).

Table 1: Overview of variable specifications and data sources

Variable	Description	Source
Dependent Variable		
WBGI	Sum of the the six WBGI sub-indices (voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption)	WBGI; http://www.govindicators.org
Explanatory Variables - External Factors		
Membership		
EU BEGIN NEGOTIATIONS	Dummy variable equals 1 starting in the year accession negotiations with the EU began.	EU Agreement Database
EU BASIC	Dummy Variable, equals 1 for "potential members" if SAA ratified in the previous year or for other countries if PCA in force since previous year.	EU Agreement Database
EU POTENTIAL	Dummy variable, equals 1 for all countries except: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.	EU Agreement Database
EU STRONG NOTICE	Dummy variable equals 1 starting in the year in which the country received a strong notice of membership by the EU.	EU Agreement Database
NATO MAP	Dummy variable equals 1 starting in the year a membership action plan was established.	NATO; www.nato.int; http://www.bits.de/frames/databasesd.htm
NATO MEMBER	Dummy variable equals 1 starting in the year of NATO accession.	same
WTO	Dummy variable equals 1 for all years following WTO or GATT accession.	WTO; http://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm
Economic Relations		
FDI	Foreign Direct Investment, Net Inflows (Share of GDP), average over current and past two years.	WDI; http://ddp-ext.worldbank.org/ext/DDPQQ/member.do?method=getMembers&userid=1&queryId=136
AID	Official Development Assistance and Official Aid (Share of GDP), average over current and past two years.	WDI
Proximity		
WESTERN	Dominance of protestant or catholic Christianity (=1, otherwise 0).	CIA World Factbook; https://www.cia.gov/library/publications/the-world-factbook/
Explanatory Variables - Economic Factors		
Economic Policy		
LIBERALIZATION	Average of price liberalization and trade and foreign exchange liberalization. running from 1 to 4,66.	EBRD; http://www.ebrd.com/country/sector/econo/stats/tic.xls
Economic Performance		
GROWTH	Growth GDP, geometric average over current and past two years.	WDI
INITIAL INCOME	GDP per capita at PPP	WDI
INFLATION	Inflation, consumer prices (annual %), geometric average over current and past two years.	WDI
Explanatory Variables - Political Factors		
Opportunities		
COHESION	(absolute value of largest non communist party vote) - (ex KP vote in first post-transition election).	EBRD Transition Report (1999)
INITIAL RIGHTS	individual political rights, measured from 7 to 1 (highest)	Freedom House
TENSIONS	Binary variable: conflict yes or not.	Heidelberger Institut für Internationale Konfliktforschung; http://www.hiik.de/start/index.html
Incentives		
ENDOWMENT	Resource reserves, dummy variable, rich=2, moderate=1, poor=0.	de Melo (2001); Auty (2006)
MINERAL EXPORTS	Weighted average of fuel exports and ores and metals exports (% of merchandise exports), 3 year moving average. The relative weight of ore and metal exports equals 2.75; a restriction which could not be rejected in F-tests in several models.	WDI

The explanatory variables are grouped into external determinants of institutional development, internal economic determinants, and internal political determinants.[10]

External Determinants

Two NATO variables are considered: a NATO MEMBER dummy indicating membership and a NATO MAP dummy variable indicating whether a Membership Action Plan (MAP) has been established for a country. For the years before the MAP was introduced, we assumed that the formal invitation to open membership negotiations are comparable.[11]

EU Potential includes those countries with a membership perspective. In line with Di Tommaso et al. (2007), EU BASIC is a dummy variable which takes the value of one in a country for each year after a Stabilization and Association Agreement (SAA) has been signed or a Partnership and Cooperation Agreement (PCA) came into force. Additionally, two dummy variables are used denoting all the years following a strong notice of membership (EU STRONG NOTICE) and the beginning of accession negotiations (EU BEGIN NEGOTIOATIONS). Further steps of EU integration have to be seen as clearly endogenous since they are the outcome of Copenhagen convergence criteria. A WTO dummy indicates WTO membership.

Proximity to the West is measured along additional dimensions. These include cultural proximity, i.e. a WESTERN dummy indicating whether a country belongs to the western Christian community. Additionally, measures of economic proximity to the rest of the world in general and developed countries in particular are included. These are measured by three year moving averages of FDI and AID inflows as well as by exports to non-transition

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[10] For a detailed discussion of determinants of institutions, see, e.g., Di Tomasso et al. (2007)and Beck and Leaven (2006).

[11] NATO invited the Czech Republic, Hungary and Poland to begin accession talks at the Alliance's Madrid Summit in 1997.

countries. When interaction with developed countries generates institutional spillovers, we would expect that these variables capture them. AID and FDI have, a priori, more ambiguous effects as they represent resource inflows which might ease the need of institutional reform or give incentives for rent-seeking behavior.[12]

Internal Economic Determinants

In line with Di Tommaso et al. (2007), we measure economic policy using the LIBERALIZATION indicator provided by EBRD (1999). They found a positive impact of an aggregated EBRD indicator on institutions and we expect a similar impact on a broader concept of institutions, not constructed by the EBRD itself.[13]

Economic performance is measured by moving averages of GROWTH of real GDP and INFLATION. Growth should matter if demand for institutions increases with income and GROWTH. Inflation is taken as a proxy for macroeconomic stability in a country and thus reflects the window of opportunity for regime changes. Together with INITIAL INCOME, measured in par capita terms, inflation can also be expected to proxy for country effects.[14]

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[12] See Way and Levitsky (2007) and in more detail, e.g., Kitschelt (2001) and La Porta et al. (1999) on society's culture, Busse et al. (2007) on trade flows, Hellmann et al. (2002) on fdi, and Claessens et al. (2007) and Rajan and Subramanian (2007) on aid. We do not consider geographical proximity, as reflected in the physical distance from the country's capital to Brussels because this variable is usually used as a catch-all for external influences which we model in detail. In the same vein, we did not include exports in the regressions which we present here because a potential impact of openness or trade liberalization is included by either cooperation or liberalization variables.

[13] On economic and political liberalization see also Havrylyshyn (2006).

[14] On the modernization hypothesis which states that higher levels of economic development will lead to better institutional quality see, e.g., Lipset (1959) and Acemoglu et al. (2007), on macroeconomic conditions see, e.g. Acemoglu and Robinson (2006) and Brückner and Ciccone (2008).

Internal Political Factors[15]

COHESION reflects whether the first post-communist government was relatively independent of the former communist party.

INITIAL RIGHTS measures the initial individual political rights as measured by the Freedom House indicator. Additionally,

TENSIONS is a dummy which measures whether the transition from communism involved conflicts.[16]

ENDOWMENT as well as a MINERAL EXPORTS account for the fact that incentives for building good institutions may well depend on resource abundance.

We always allow for possible endogeneity of the following variables: NATO MAP, NATO MEMBER, and WTO because countries, which have a low institutional quality, are also less likely to become members of these institutions. GROWTH and INCOME INDEX are instrumented because it is a well established fact in the literature that institutional development affects economic growth positively, although one might doubt if this effect would show up at the short time horizon of this study. Since countries with especially good institutions might attract more FDI and more (or less) AID, also these variables are instrumented. LIBERALIZATION is treated as possibly endogenous, too, since policies and institutional reform might go hand in hand. We do no treat EU BASIC as endogenous. While

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[15] A political economy explanation of why institution building has varied so much across transition countries is provided by Beck and Laeven (2006). They argue that political path-dependency and reliance on natural resources critically determines whether the behavior of the ruling elite and thus the transition process is catalytic or extractive. On natural resources, see also Auty (2001, 2007).

[16] These initial political conditions may also be measured by a dummy variable which measures if the country participated in an intensive violent conflict in a given year.

this assumption can be maintained according to Hansen tests of overidentifying restrictions, nearly all results are robust to relaxing this assumption.[17]

4. Empirical Results

We start by discussing an extended model of institutional quality from which we then derive our preferred specification. This specification is then assessed in several robustness checks.

Estimates for the extended model are shown in Table 2. For all IV estimates in this table, as well as in all following IV estimates, lags of two and three years were used to instrument for endogenous variables. In columns (2) and (4) the p-value of the Hansen test statistic shows that the Null of exogeneity of the explanatory variables and the instruments can be maintained. Wald tests for all explanatory variables except the time dummies show in each case that the models have significant explanatory power. The R-squared statistics show a generally satisfactory fit of the different models. However, in case of the FE IV model, the partialling out of the time dummies causes the R-squared statistic not to be bounded by [0,1] any longer. While the explanatory power of the model is worse than in the standard FE model, it is positive and around 0.16 when the dummies are not partialled out.[18]

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[17] See also Schimmelfennig and Scholz (2008) on the exogeneity of EU integration variables.

[18] Notice that because of the large number of regressors, only heteroskedasticity robust standard errors are reported whereas subsequent estimates use clustered standard errors which allow for autocorrelation. Clustered standard errors could be reported for POLS and FE estimates, but for the sake of comparability with the IV estimates in both cases only heteroskedasticity robust standard errors are provided. Generally, one would expect the resulting standard errors to be excessively small and the t-statistics therefore to be excessively large. The Null of no significance would thus be rejected too frequently. Since the results in Table 3 are presented to select a reduced model, this bias seems acceptable.

Given that the models pass necessary specification checks, it is sensible to assess whether the results are economically meaningful. Starting at the bottom of the table and focusing on the pooled estimates in columns (1) and (2), all political determinants have the expected sign, although INITIAL RIGHTS is not significant. An increase in MINERAL EXPORTS by one

Table 2: Determinants of Institutional Development in Transition Countries, 1996 – 2005

	(1) POLS	(2) Pooled IV	(3) FE	(4) FE IV
EU BASIC	1.410 ***	1.455 ***	-0.173	0.345
	(4.74)	(4.33)	(-0.51)	(0.56)
EU POTENTIAL	0.662	0.183		
	(1.26)	(0.26)		
NATO MAP	1.376 ***	1.852 ***	1.505 ***	2.755 ***
	(4.01)	(2.69)	(5.75)	(3.81)
WTO	-0.005	-0.919	0.416	-0.968
	(-0.01)	(-1.40)	(1.34)	(-1.16)
FDI	-0.003	-0.008	0.009	0.002
	(-0.21)	(-0.38)	(0.65)	(0.09)
AID	-0.122 **	-0.120 *	-0.132	0.076
	(-2.13)	(-1.90)	(-1.28)	(0.33)
LIBERALIZATION	1.473 ***	2.098 ***	0.954 *	2.433
	(3.74)	(3.19)	(1.92)	(1.27)
GROWTH	0.058	0.050	0.029	0.022
	(1.54)	(0.89)	(0.88)	(0.38)
INFLATION	0.409	0.539	0.066	0.197
	(1.32)	(1.62)	(0.29)	(0.45)
INITIAL INCOME	-0.000	0.000		
	(-0.02)	(0.06)		
WESTERN	3.566 ***	3.793 ***		
	(9.00)	(9.09)		
TENSIONS	-2.007 ***	-2.157 ***		
	(-8.31)	(-8.25)		
INITIAL RIGHTS	-0.145	-0.080		
	(-1.13)	(-0.62)		
COHESION	0.008 ***	0.007 ***		
	(2.91)	(2.63)		
MINERAL EXPORTS	-0.058 ***	-0.069 ***	0.004	-0.000
	(-4.91)	(-4.90)	(0.17)	(-0.01)
R-squared	0.96	0.95	0.48	-0.05
adjusted R-squared	0.95	0.94	0.41	-0.50
No. observations	123	123	123	123
Wald test, p-value	0.00	0.00	0.00	0.03
Time dummies	yes	yes	yes	yes
Hansen test, p-value	n/a	0.25	n/a	0.82

Note: Dependent variable: aggregate WBGI; for the definition of variables see Table 3. Heteroskedasticity robust t-statistics in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

standard deviation causes WBGI to decline by roughly 0.77 to 0.91 points. An increase of one standard deviation in the share of non-communist parties in the first election significantly increases the WBGI by roughly 0.35 to 0.36 points.[19] The incidence of TENSIONS drastically decreases institutional quality. When controlling for fixed effects, MINERAL EXPORTS cease to have a significant effect.[20] All in all, the variables describing political determinants seem to succeed in accounting for significant variation in the institutional quality.

With respect to economic determinants, i.e. the rows from FDI to INITIAL INCOME, shows also economically sensible, but largely insignificant results. The effect of LIBERALIZATION is positive and significant in the estimates using pooled least squares, while one of the fixed effects estimates of its coefficient is insignificant. Otherwise only AID is significant and exerts a negative influence. However, this effect shows up only in the pooled estimates. When taking the negative sign literally, we would interpret this as tentative evidence that the negative incentives for political reform through development aid outweigh in our sample possible positive effects.

Two of the four external determinants show up as significant. EU BASIC and NATO MAP exert a positive influence of comparable size according to models (1) and (2): Countries which have the corresponding relationship with EU or NATO have a WBGI which is 1.4-1.9 points higher compared to otherwise identical countries without these relationships, roughly one third of a standard deviation of WBGI. The implication of these estimates is that

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[19] This corresponds to an elasticity of WBGI with respect to MINERAL EXPORTS of 1.57 to 1.86 and with respect to COHESION of roughly 0.08.

[20] However, this might be due to the lack of variation of resource exports within countries over time.

international organizations like the NATO and the EU can exert a positive influence on institutional development when they establish tighter relationships with these countries. Introducing country fixed effects shows, however, that only the effect of NATO remains significant. Neither EU POTENTIAL nor WTO are significant.

For the following estimations, we drop all regressors that are always insignificant in Table 2. The resulting baseline estimates are shown in columns (1) and (2) as well as (7) and (8) of Table 3. For the sake of comparability with the earlier estimates and across all extensions, all estimation samples are restricted to the sample used in Table 2. As before, the estimates satisfy necessary specification tests, with the FE IV model passing the Hansen test of instrument validity by a wider margin than the pooled IV model. Also as before, the R-squared values for the FE IV are problematic because of the partialling out of the time dummies. All coefficient estimates are of similar magnitude and of the same sign as in the extended model, implying economically meaningful results. Now, however, LIBERALIZATION is also significant in the FE IV specification. The coefficient of LIBERALIZATION therefore suggests that an improvement in economic policies also has positive effects on a broader set of institutions. This effect is not only due to countries having better policies also having better institutions, i.e. unobserved heterogeneity, or better institutions causing better policies, i.e. endogeneity. The same holds true for NATO MAP, which is the only other variable which is significant across all specifications.

The results in columns (3) to (6) in Table 3 suggest that ENDOWMENT has an effect very similar to that of the other variable measuring resource endowment. Additionally, the negative effect of the two types of extractable income seems to reinforce each other, as shown by the fact that the individual coefficients as well as the cross-term have a negative sign.

Table 3: Baseline model estimates and extensions involving aid and resource endowments, 1996 – 2005

	(1) POLS	(2) Pooled IV	(3) POLS	(4) Pooled IV	(5) POLS	(6) Pooled IV
EU BASIC	1.301 ***	1.268 ***	1.450 ***	1.522 ***	1.336 ***	1.423 ***
	(3.88)	(3.33)	(4.07)	(4.08)	(3.42)	(3.54)
NATO MAP	1.512 ***	1.539 ***	1.720 ***	2.011 ***	1.660 ***	1.919 ***
	(5.27)	(3.21)	(5.45)	(3.97)	(5.32)	(3.73)
LIBERALIZATION	1.400 ***	1.512 ***	1.686 ***	1.582 ***	1.706 ***	1.574 ***
	(5.67)	(3.67)	(5.73)	(3.30)	(5.90)	(3.22)
AID	-0.139 **	-0.152 ***	-0.237 ***	-0.230 ***	-0.209 ***	-0.205 ***
	(-2.79)	(-2.91)	(-4.11)	(-3.50)	(-3.97)	(-3.11)
WESTERN	4.091 ***	3.995 ***	3.912 ***	3.823 ***	3.981 ***	3.900 ***
	(9.34)	(10.17)	(7.85)	(8.20)	(8.05)	(8.40)
TENSIONS	-2.023 ***	-1.981 ***	-1.228 **	-1.230 ***	-1.219 **	-1.221 **
	(-9.01)	(-8.82)	(-2.53)	(-2.62)	(-2.24)	(-2.41)
COHESION	0.008 **	0.008 ***	0.004	0.005	0.006 **	0.006 ***
	(2.63)	(2.71)	(1.34)	(1.61)	(2.69)	(3.09)
MINERAL EXPORTS	-0.062 ***	-0.061 ***				
	(-6.37)	(-6.73)				
ENDOWMENT			-1.056 ***	-1.027 ***	-0.670 **	-0.679 ***
			(-5.43)	(-6.16)	(-2.43)	(-2.91)
ENDOWMENT x AID					-0.151 **	-0.141 ***
					(-2.59)	(-2.66)
R-squared	0.96	0.95	0.95	0.95	0.96	0.95
adjusted R-squared	0.95	0.95	0.95	0.94	0.95	0.95
No. observations	123	123	123	123	123	123
Wald test, p-value	0.00	0.00	0.00	0.00	0.00	0.00
Time dummies	yes	yes	yes	yes	yes	yes
Hansen test, p-value	n/a	0.27	n/a	0.25	n/a	0.15

	(7) FE	(8) FE IV	(9) FE	(10) FE IV	(11) FE	(12) FE IV
EU BASIC	0.012	0.196	-0.007	0.258	0.020	0.303
	(0.03)	(0.47)	(-0.02)	(0.62)	(0.06)	(0.75)
NATO MAP	1.542 ***	3.282 ***	1.550 ***	3.461 ***	1.520 ***	3.569 ***
	(5.24)	(3.92)	(5.35)	(3.77)	(5.51)	(4.00)
LIBERALIZATION	1.287 ***	3.148 *	1.269 ***	3.157 *	1.273 ***	3.090 *
	(3.31)	(1.73)	(3.20)	(1.90)	(3.02)	(1.91)
AID	-0.109	-0.133	-0.111	-0.194	-0.089	-0.215
	(-0.88)	(-0.54)	(-0.88)	(-0.65)	(-0.70)	(-0.76)
MINERAL EXPORTS	-0.004	0.004				
	(-0.23)	(0.14)				
ENDOWMENT x AID					-0.337	-0.245
					(-1.33)	(-0.79)
R-squared	0.46	-0.11	0.46	-0.18	0.49	-0.21
adjusted R-squared	0.41	-0.51	0.42	-0.59	0.44	-0.65
No. observations	123	123	123	123	123	123
Wald test, p-value	0.00	0.02	0.00	0.03	0.00	0.03
Time dummies	yes	yes	yes	yes	yes	yes
Hansen test, p-value	n/a	0.66	n/a	0.71	n/a	0.70

Note: Dependent variable: aggregate WBGI; for the definition of variables see Table 3. Heteroskedasticity and autocorrelation robust t-statistics in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

Another robustness check is the inclusion of additional variables describing the accession process. NATO Membership Action Plans (MAP) were established roughly at the same time as many countries received the strong notice of membership by the EU and began accession negotiations, which can be expected to have given strong incentives for institutional reform. We test whether NATO has significant additional explanatory power by including two dummy variables for the additional steps of EU integration into the baseline model. Table 4 reveals that the results change little. LIBERALIZATION loses its significance in the FE IV specification, but is otherwise robust. Columns (5) and (6) as well as (11) and (12) indicate that EU BEGIN NEGOTIATIONS has the conjectured positive incentive effect, although it is not present in the FE IV specification. EU STRONG NOTICE has, against intuition, a negative sign or is insignificant. In all cases, however, NATO MAP remains highly significant with an effect of slightly lower magnitude than in the baseline model. EU BASIC only remains significant when not accounting for fixed effects.

We additionally test whether our measurement of the NATO variable might be flawed by including a variable measuring actual membership. Columns (3) and (4) as well as (9) and (10) give the results for the extension of the baseline model by NATO MEMBER. It shows that using IV estimators, NATO MEMBER actually performs better than NATO MAP, with the latter have a practically zero coefficient in the pooled IV specification. For pooled IV estimation, also EU BASIC becomes insignificant. In the case of FE IV, both NATO variables become insignificant. However, performing a Wald test on their joint significance clearly rejects the Null of no significance, especially for the FE IV specification.[21]

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[21] The p-value in the case of pooled IV is 0.02 and in the case of FE IV 0.00.

Table 4: Robustness of the baseline estimates with additional NATO and EU variables, 1996 – 2005

	(1) POLS	(2) Pooled IV	(3) POLS	(4) Pooled IV	(5) POLS	(6) Pooled IV
EU BASIC	1.301 ***	1.268 ***	1.178 ***	0.677	0.608 **	0.649 **
	(3.88)	(3.33)	(3.95)	(1.34)	(2.39)	(2.38)
NATO MAP	1.512 ***	1.539 ***	1.331 ***	0.032	0.946 ***	1.195 **
	(5.27)	(3.21)	(5.23)	(0.05)	(3.04)	(2.13)
LIBERALIZATION	1.400 ***	1.512 ***	1.449 ***	2.281 ***	1.424 ***	1.493 ***
	(5.67)	(3.67)	(5.92)	(4.15)	(6.38)	(6.40)
AID	-0.139 **	-0.152 ***	-0.138 **	-0.219 ***	-0.110 **	-0.120 ***
	(-2.79)	(-2.91)	(-2.82)	(-3.87)	(-2.68)	(-3.64)
WESTERN	4.091 ***	3.995 ***	3.992 ***	3.833 ***	3.514 ***	3.480 ***
	(9.34)	(10.17)	(8.70)	(8.46)	(11.92)	(13.08)
TENSIONS	-2.023 ***	-1.981 ***	-2.052 ***	-2.013 ***	-1.658 ***	-1.672 ***
	(-9.01)	(-8.82)	(-8.57)	(-7.86)	(-8.41)	(-7.82)
COHESION	0.008 **	0.008 ***	0.008 **	0.007 **	0.009 ***	0.009 ***
	(2.63)	(2.71)	(2.65)	(2.26)	(3.16)	(3.29)
MINEREAL EXPORTS	-0.062 ***	-0.061 ***	-0.061 ***	-0.071 ***	-0.053 ***	-0.053 ***
	(-6.37)	(-6.73)	(-6.27)	(-5.82)	(-5.51)	(-6.53)
NATO MEMBER			0.590 *	1.066 **		
			(1.86)	(2.36)		
EU BEGIN NEGOTIATIONS					1.854 ***	1.790 ***
					(6.03)	(5.46)
EU STRONG NOTICE					-0.192	-0.367
					(-0.75)	(-1.16)
R-squared	0.96	0.95	0.96	0.95	0.97	0.97
adjusted R-squared	0.95	0.95	0.95	0.94	0.96	0.96
No. observations	123	123	123	123	123	123
Wald test, p-value	0.00	0.00	0.00	0.00	0.00	0.00
Time dummies	yes	yes	yes	yes	yes	yes
Hansen test, p-value	n/a	0.27	n/a	0.39	n/a	0.33

	(7) FE	(8) FE IV	(9) FE	(10) FE IV	(11) FE	(12) FE IV
EU BASIC	0.012	0.196	0.129	0.250	0.042	0.010
	(0.03)	(0.47)	(0.35)	(0.39)	(0.13)	(0.03)
NATO MAP	1.542 ***	3.282 ***	1.489 ***	1.342	1.315 ***	2.568 ***
	(5.24)	(3.92)	(5.42)	(0.98)	(4.76)	(5.11)
LIBERALIZATION	1.287 ***	3.148 *	1.541 ***	2.541	1.568 ***	1.590
	(3.31)	(1.73)	(3.51)	(0.86)	(4.04)	(1.15)
AID	-0.109	-0.133	-0.114	-0.035	-0.086	0.112
	(-0.88)	(-0.54)	(-0.95)	(-0.13)	(-0.70)	(0.59)
MINEREAL EXPORTS	-0.004	0.004	-0.006	-0.020	-0.020	-0.016
	(-0.23)	(0.14)	(-0.34)	(-0.43)	(-1.25)	(-0.82)
NATO MEMBER			0.448 **	0.753		
			(2.23)	(0.73)		
EU BEGIN NEGOTIATIONS					1.038 ***	0.472
					(3.35)	(1.14)
EU STRONG NOTICE					-0.549 ***	-1.072 ***
					(-3.11)	(-3.97)
R-squared	0.46	-0.11	0.48	0.30	0.53	0.18
adjusted R-squared	0.41	-0.51	0.42	0.03	0.47	-0.15
No. observations	123	123	123	123	123	123
Wald test, p-value	0.00	0.02	0.00	0.00	0.00	0.00
Time dummies	yes	yes	yes	yes	yes	yes
Hansen test, p-value	n/a	0.66	n/a	0.17	n/a	0.37

We offer the following interpretation of these results: The introduction of a MAP induces a dynamic process of institutional improvement which takes several years to completion. When NATO MEMBER is introduced additionally, this variable captures some of the dynamic improvements triggered by the MAP.

5. Summary and Policy Conclusions

Focusing on a sample of 25 post-communist countries, this paper provides a comprehensive analysis of potential internal and external determinants of institutional change as measured by the World Bank Governance Indicators (WBGI). While we are able to confirm results of the existing literature on a positive impact of EU agreements, we, additionally, show that integration into NATO is an important determinant of institutional reforms.

Integration into the EU clearly matters. As in Di Tommaso et al. (2007), basic relationships of a country with the EU improve its institutional quality beyond merely economic institutions. This result is, however, not robust to a control for country fixed effects. We find instead suggestive evidence, in line with Haughton (2007), that the beginning of EU accession negotiations might have a stronger and more robust effect. Available natural resources and capital inflows are found to exert an insignificant or negative influence. We also find that country-fixed effects as well as variables characterizing initial (political) conditions matter for institutional development can be taken as evidence of path-dependency as in Beck and Laeven (2006). However, economic policy also matters, as shown by the relatively robust and positive influence of economic liberalization as measured by the EBRD index. Hence, in line with Havrylyshyn (2006), economic policies allow to break path-dependency even when focusing on a rather broad concept of institutional development.

The novel finding of this study is that also the perspective of NATO membership has influenced institutional development positively. Measuring this influence by the existence of a NATO Membership Action Plan for a country, we find strong evidence for this positive influence. Using different estimators which account for unobserved heterogeneity and endogeneity, we find a sizeable positive and significant coefficient across many different model specifications. While, to our knowledge, this influence of the NATO has been neglected in the existing literature, we offer an explanation of this influence similar to that used in earlier papers for the EU's membership perspective: Via one of its five groups of membership criteria, the NATO induces countries to commit to the rule of law and human rights, to establish the democratic control over the armed forces and market regulations in the defense industry, and to settle conflicts peacefully. It offers regional and international security in return and is therefore able to provide additional incentives beyond economic incentives supplied by the EU. Thus, NATO is a transformative power, complementary to the EU, pushing for institutional change in post-communist countries.

All in all, our results imply that internal and external factors can influence institutional development in post-communist countries positively. This allows for some optimism about the effectiveness of EU ENP policies and supports the argument that NATO may provide significant additional incentives for good governance. Given the importance of regional security, NATO's conditionality may even figure more prominently in the future. Based on our finding, future research has to analyze the effectiveness of tools and mechanisms of NATO's accession and non-accession conditionality. Furthermore, due to a functional and regional overlap between the EU and NATO policies, the paper also raises new research questions on an optimized cooperation of EU and NATO for providing effective multilateral approaches towards better democratic and market institutions in neighboring regions.

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