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# BETWEEN FRAILTY AND INSTITUTIONAL REFORM. THE CASE OF ROMANIA

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**Abstract:** *Our approach aims to emphasize the role that the institutional legacy of the past has in generating institutional blockages in transition countries (including Romania), while advancing several courses of action in order to overcome the difficulties found in the socio-economic frameworks. We believe that the success of the transition to capitalism equals most often with a institutional reconfiguration supported by the participation and active involvement of civil society.*

**Keywords:** institution; performance; legal system.

**JEL Classification:** E02; K4.

## INTRODUCTION

The legacy of the past (the path dependency of a post-communist country involved in the transition towards market economy) is an issue that should not be neglected, as it often generates distorted formal and informal institutions, which alter economic performance to date.

The complexity of the transformations that took place in Central and Eastern Europe after the collapse of communist regimes, had some defining characteristics formed by the interaction of these mutations with the Western-European mainstream, defined by capitalism (in economic terms) and democracy (in political terms); such transformations were found in all the spheres of life of individuals – ideology, economy, politics and social order; they were not generated by wars or military requirements, but they were adopted at a fast pace within the institutional frameworks.

Success of the transition to capitalism depended largely on the extent to which the adequate institutions were present; ultimately, the established theory of transition is equivalent to a theory of institutional change, which deals with the redesign and reconfiguration of institutions in the countries who once owned a centralized economy (Raiser, 1997).

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## 1. PATH DEPENDENCE AND INSTITUTIONAL FRAILTY

By using economic and geographic variables (initial level of development, urbanization, unbalanced distribution of industries, governmental intervention over trade mechanisms paralleled by black market operations), some authors establish a direct link between the initial conditions found in the states with a planned economy and economic performance (De Melo, 1997). This interrelation is investigated amid the analysis of a key institutional variable – the market imprint, representing the number of years spent under a centralized-economy regime.

Other studies establish baseline conditions as determinants of economic performance, in a number of 25 countries (including Romania), using certain variables of institutional development – reform index and state capture index (Fisher and Sahay, 2004). The reform index requires the quantitative determination of institutional changes and adopted reforms, and it is calculated as the average of the indices of liberalization and financial and market reforms. State capture index measures the proportion in which businesses in general are subdued by a ruling system of private interests (Helmann, 2000).

If some of the contributions in the literature have been concerned with establishing a causal link between initial conditions and institutional change, as the hard core of the alleged transition reforms, others have been interested in establishing the optimal rate at which these changes should occur (Aghion and Blanchard, 1994). Executive role is valued here as a prerequisite for establishing a rhythm of transition from gradual to sudden (a big-bang type), where two approaches emerge: shock therapy and gradualism (Roland, 2000). In this respect, the shock therapy proponents propose changes made at a fast pace, to eliminate the risks of gradualism and individual resistance to change, while those who support a gradual approach rely on a reduction in transition costs related to generating high rates of unemployment.

Another category of concerns focuses on determining how institutional change will alter the path-dependent formal and informal institutions that may not be in harmony with the new socio-economic order.

For some authors, planned economy has had an impact on society as a whole, by promoting a climate of distrust both among individuals and between them and the state per se (Rose and Mishler, 1997). For others, paradoxically, the imperfections of the state economy have had a beneficial social effect, leading to the creation of a second economy (a parallel economy, yet bearing the seeds of

capitalism) with its own regularities and institutions, ready to assist the transition towards a competitive-market climate (Stark, 1997). We are tributary to the first view point, although we acknowledge the existence of a second economy with its own regularities, formed during the communist age, characterized by multiple failures that disrupted the interaction with the market forces (the high incidence of bribery offences in awarding public-procurement contracts). For example, the business ties established between the communist elites remained internalized by the state capture paradigm, thus removing open competition and fostering a general distrust in state institutions, regarded as unable to dismiss such behaviours.

We are witnessing the continued presence of anachronistic behaviours for economic performance (as informal institutions), derived from the legacy of a generalized, resistant-to-change mistrust. The phenomenon can be explained if we consider that certain aspects are difficult to change only within formal institutions (legislative), hence a typical case of lack of harmony between formal and informal institutions (Elster, 1998). The aspects that remain difficult to change are: cultural patterns, identity crisis, path-dependent informal institutions, the various behaviours that inhibit or promote the adoption of solutions to the problems that society, as a whole, is facing, as well as the vigour with which the incentives for entrepreneurship and economic performance are initiated.

The lack of harmony between the two institutions has led to the proliferation of opportunistic individual behaviours that are detrimental to overall economic performance and social conduct rules – tax evasion, corruption, bribery, organized crime, theft of public property assets, components of an underground economy.

## **2. THE REFORM OF INSTITUTIONAL ARRANGEMENTS**

Reforming institutional arrangements is the only way to stimulate economic performance by considering both formal and informal institutions, as well as their interaction (Raiser, 1999). Thus, the reform paradigm of institutional arrangements is structured around a series of informal (moral norms, trustworthiness and the way these values are imposed by the civil society) and formal institutions (governance, rules, laws, regulations).

The existence and propagation of such institutions are under the impact of historical, ideological, technological exogenous variables. Technology and preferences are important to institutional arrangements in that, as North (1981) postulated, they determine the level of costs and benefits resulting from the compliance with the set of formal and informal institutions, through the process of social and economic interactions between given actors.

From a dynamic perspective, we can say that social morality is influenced by ideology, history (e.g. the influence of Ottoman institutions on Romanian social life has resulted in the manifestation of a so-called *Balkan* behaviour) and leadership (the degree to which society adheres to the idea of institutional change). The presence of moral norms in a society (generalized or specific to certain structured groups, according to certain criteria) is associated most often with civil society involvement (media, churches, etc.), that supports and catalyses the manifestation of individual moral tendencies. In its turn, this leads towards social harmony, by increasing trustworthiness between economic actors as a prerequisite for trade facilitation, even under the circumstance of imperfect information – a feature of modern societies.

But ideology and history, along with social norms, may influence the effectiveness of governance, i.e. its active manifestation as a system of laws and regulations that punish disruptive behaviours and value constructive ones.

Seldom are the cases in which a society based on honesty, solidarity, decency, simplicity (i.e. moral norms that are scarcely found in the Romanian society) culminates by having an aggressive, wasteful, dishonest government that encourages state servitude to private interests. In contrast, the prevalence of particularism, individualism, formally or informally unsanctioned opportunism, represents a fertile ground for such a government (i.e. a more than familiar Romanian scenario). The type of governance will influence the adoption and effective implementation of a set of rules and regulations that will structure the socio-economic interactions and potential economic trade.

In our opinion, governmental leadership plays an important role in institutional change, as it acts as an interface between government and society; it also indicates the pulse of civil society and its effective involvement in the proposed formal changes, thus ensuring future harmony (convergence) between the newly introduced formal institutions (whether imported or not) and the existing informal infrastructure.

Of course, the existence of such a mechanism is a matter of political will, if political leaders understand to engage in a dialogue with their society members. The reward will match the efforts – society will gain trust in political actions. Only then can we talk about a high complementarity between the level of trust (social capital) and government effectiveness.

When trust in government is low, the society's pressures on officials to promote measures that stimulate economic performance are also low (such an approach is viewed as lacking purpose, as those in charge of governing are only there to preserve their acquired power *status*). Poor governance leads to poor performance, reducing society's trust in the political factor.

Given the foregoing considerations, we consider that the institutional change conducive to promoting economic performance (in general, and Romania, in particular) can occur in various situations.

Firstly, the modification of institutional arrangements may occur due to the impact of exogenous variables. E.U.'s post-accession pressures and its recommendations for the strengthening of jurisdictional capacity and elimination of corruption are a good example of this.

Secondly, institutional evolution can be under the impact of mutations happening in the political sphere, i.e. changes in the ideology and / or leadership, or in the economic sphere, i.e. the evolution of preferences, the (discontinuous) technical and technological progress.

The government may adopt effective laws and regulations, while ensuring an optimal infrastructure for their *de facto* implementation. Changes can be promoted more or less voluntarily (E.U. recommendations), even if they *harm* the existing power *status* (state capture).

Also, the political factor may adopt measures likely to reduce the possibility of the arbitrary actions of public organizations through institutional restriction of their power and effective control over decision-making processes.

Eliminating corruption (as an informal institution) may occur as a result of shifting the decision-making responsibilities towards other institutional levels, strengthening the organizations responsible for fighting corruption (Romanian National Anti-Corruption Department) or increasing the salary level of the state apparatus to ensure a decent standard of living and eliminate propensity towards crimes consisting in bribery, undue acquisition, influence peddling etc.

Such actions must coincide with the initiation of a participatory dialogue with the civil society that will ensure the latter's agreement with the proposed institutional changes. Even if we are in the presence

of a low credibility level in the executive, legislative and judicial powers, the best way to increase their credibility is to demonstrate a high determination in adopting institutional reforms designed to stimulate overall economic performance.

We believe that, at least initially, the adoption of strategic alternatives may underlie the valuation of existing formal institutions and increase their predictability, through legislative stability. Their modification can only be achieved gradually, in parallel with the evolution of specific informal institutions, to promote harmony and avoid frictions in the structure of institutional arrangements. However, such a strategy should be relaxed, if we consider E.U.'s claims of *de facto* institutional changes, not *de jure*. The costs of failing to rapidly adopt these normative changes, in this case, could exceed the costs of virtual friction between formal and informal institutions.

An alternative strategy involves sudden institutional changes of normative and judicial frameworks, to comply with the new requirements supporting economic performance; this strategic decision is relatively risky in terms of the formal-informal relationship. This strategic choice is not exactly new, as Lipton and Sachs (1990) were the first who valued the specificity of this course of action. In these circumstances, the costs of introducing and maintaining the new *de facto* formal institutions will be high at first, keeping the same trend for a good period of time, given the lack of convergence with the existing informal institutions. Costs will be higher if we consider that the new formal institutions may require other (secondary) formal institutions in order to help them become effective and efficient, thus the formal institutional system becoming lush. From the social point of view, we can expect the possibility of an institutional reluctance to coercion (coercion being the method that ensures institutional implants, amid the resistance to change of existing informal institutions).

Another strategic alternative to institutional change is subsumed to political feasibility, revolving around the adoption of reforms in formal institutional frameworks, characterized by low implementation costs, due to the simplicity of the new institutions or the existence of an average convergence with the informal ones. For example, in Romania, progress was faster in areas that have not required extensive institutional changes in the design or conduct of public and private actors – price and trade liberalization, small-scale privatization. Things were different when the privatization and restructuring of large public enterprises were imposed, along with the regulatory reform in the areas of competition, finance and law (EBRD *Transition Report*, 1997).

The main drawback of this approach is that at some point reform no longer multiplies itself in the institutional sphere which is the most important for economic performance (also due to state capture and opposition of the bureaucratic network that internalizes the benefits of political and economic power *status*, thanks to corruption, arbitrariness etc.); ultimately, the change lacks depth.

In our opinion, a feasible strategy to promote institutional change is the one that considers this process as having a dual determination: exogenous and endogenous. From an endogenous perspective, the process of institutional development can be viewed as Darwinian, as institutions adapt and are being influenced (in a one-way relationship) by human behaviour on which there is a wide range of temporary contextual constraints (Tridico, 2004). Thus, we have shown during our research that technological changes may cause changes in the formal and informal institutional context, which in its turn transforms the actors' behaviours and habits. Also, redesigning formal institutions may alter the formal framework; this phenomenon transposes an evolution of behaviour and habits of the actors, which in turn changes the informal paradigm; the latter subsequently reconfigures the formal paradigm. At another level, developments registered in the transformation of social values determine behaviour and habit evolutionism, whose *status* carries a mutation within society's institutional arrangements (formal and informal).

The character of change can shift from an incremental to a discontinuous one, catalysed by radical changes, wars, revolutions, dictatorship or by the promotion of harsh sanctioning measures, as the state's response to the breach of the prearranged conduct of formal institutions.

However, formal institutions do not generate the immediate change of informal ones (as true as the reverse), given that they require additional time for the new institutions to resonate with individual behaviours that, in turn, evolve under the influence of old informal institutions and customs, as inertia manifests itself.

The idea according to which technological changes matter only within their institutional framework, is also found in the work of Veblen (1961) and Neale (1998). According to the latter, an institution cannot exist in isolation, but only as part of an institutional ensemble, and, consequently, a change in an institution generates the need for transformation in the others as well, in order to preserve the existing interrelations within this whole.



A change in the value system will cause mutations within the spheres of attitude change, knowledge, behaviours, habits, but a possible source of institutional change can also be found in the idea of reform.

But institutional change can also be a discontinuous process, intensified by revolutions, radical changes and power imbalances, by dramatic changes in the economic and political system. Such changes will only reconfigure, at least initially, the formal institutions, not the informal ones. So can we explain the discrepancies between *de jure* and *de facto* existence of institutions designed to stimulate economic performance in Romania – a path-dependent mentality.

The survival of old informal institutions is virtually responsible for the institutional collision, where the formal and informal diverge, as institutional frameworks become characterized by a striking inconsistency (in the context of informal inertia and path dependency). The imminence of institutional blockage becomes more likely as formal institutions are urged to be implemented, without having sufficient time for institutional harmonization.

Factual evidence in Romania confirms our assertions. Economic performance will not be enhanced by introducing, redesigning and importing formal institutions (even if done under the impact of E.U.'s post accession recommendations). It will ultimately remain dependent on mentality, on the level of confidence in the political factor and in its commitment to reform institutional frameworks.

As a result, institutional change is not only path-dependent (this concept explains why some ineffective institutions continue to survive), but it is also related to the human behaviour's reaction to formal change. Given the foregoing arguments, we consider the process of institutional change as being a complex one, whose consequences can often be unreliable, inconsistent with the initial objectives of those who support reform, largely determined by the legacy of the past, a possible antithesis between the formal and the informal, new constraints triggered by old behaviours that characterized the actors / organizations of public or private law.

The task of the institutional-change promoters in Romania becomes more difficult, not necessarily from this perspective, but because the evolution of the institutional paradigm has been imprinted with some features related to: path dependence, alteration of the state law, lack of interpersonal trust, lack of individuals' trust in the ability of the state to impose equitable laws and contracts, *de jure* introduction of formal institutions under the influence of national and international political factors, disregarded by

individuals, *de facto* operational inefficiency of these institutions which failed to eliminate opportunism and to decrease transition costs, formal climate instability and persistence of conflicting statutory provisions, the prevalence of diachronic institutional relations which trigger possible discrepancies in the process of institutional synchronization.

From another perspective, the institutional reform can be achieved by promulgating laws and regulations that support direct foreign investments. We make this assertion not necessarily thinking that FDI bring certain advantages to the economy of the host country, related to improved employment rate, capital inflows and so on, but rather highlighting that they bring with them the seeds of capitalism (as a lifestyle, valuing individual performance, removing private interests and the mentality of socially-assisted citizens). Moreover, FDI introduce new ways of organizing the technological progress as a source – as we have earlier revealed – of formal institutional change and behaviour transformation.

When the institutional change paradigm will support cooperation between formal and informal institutions, by overcoming tensions due to the survival of an archaic mentality, the frailty of economic performance will be removed.

In our opinion, the register of institutional changes should include primarily active measures meant to eliminate the negative effects of corruption (informal institution), in order to overcome a possible institutional blockage, given that recent studies show Romanians' low level of confidence in the legal effectiveness of regulations and public organizations designed to restrict the effects of pervasive corruption, considering that this phenomenon is the main problem that society is currently facing.

Moreover, the vast majority of people participating in the conduct of these studies believes that this informal institution underwent a resurgence in recent years, affecting the public health, border protection and judicial systems. In this respect, *The Global Competitiveness Report* for 2011-2012, identified corruption as the fifth largest obstacle for the Romanian business environment. Therefore, we believe that economic performance will be boosted by the resolution of such issues which have been found in Romania for a long time (perhaps due to the informal institutional heritage of Ottoman or Tsarist origins?).

We believe that in the eradication of such phenomena, not only the state (through its normative regulations) or the supranational bodies promoting exogenous institutional change (European

benchmarks) will have an important role, but civil society as a whole as well, as the main actor designed to achieve the creative destruction of the Balkan mentality and particularism.

*Ab initio*, to highlight the role that civil society plays in eradicating corruption, we should highlight the concept of social responsibility, as a civic engagement designating a wide range of actions and mechanisms that citizens, communities, the (independent) media and other civil society organizations use to obtain a reasonable level of control and transparency for the actions of individuals (those involving the exercise of public functions and dignities) and public organizations (adapted from Malena, 2004).

But in order to have the expected results, the involvement of civil society has to fulfil a number of criteria related to the effectiveness of this involvement (Fukuyama, 1995; Rose -Ackerman and Kornai, 2004; Putnam, Leonardi & Nanetti, 1993; Almond & Verba, 1963). First, the prevalence of honesty and integrity, as informally imposed values by the society. Then, the existence of NGOs and a civil society-engagement tradition in promoting integrity and common values shared by societal frameworks, is another prerequisite for structuring behaviours and actions that restrict the manifestation of corruption, along with the participation and commitment of the political to work in favour of the community (as part of the civic culture). According to recent studies, the effectiveness of civil society is responsible for about 70% of the level of corruption in a country, while representing an important indicator of a country's development level and consistency of government policies (Mungiu-Pippidi, 2010).

Consequently, solving the problem of the persistence of informal institutions that alter economic performance would involve primarily a set of measures meant to strengthen the active and effective involvement of civil society. Against this background, tangible measures should be taken to eradicate corruption, instead of measures that consider this phenomenon *in abstracto*, as a *sine qua non* trait implied by the transition to capitalism. In fact, this scourge spreads to society due to the specific self-reproductive effects of the way individuals understand to preserve clientèle, by vitiating the fundamental mechanisms of resource allocation and economic performance.

Designing and implementing an anti-corruption strategy requires the involvement of NGOs and the independent media as an infrastructure meant to support the dissemination of information, impact and awareness measures among individuals and the social values to defend, including the fact that the capitalist doctrine requires, in Romania, first and foremost, a mind-set change related to the exclusion of clientèle and private interests from socio-economic interactions.

## CONCLUSIONS

The lack of convergence between formal and informal institutions has led to the proliferation of opportunistic individual behaviours that are detrimental to the overall economic performance and standards of conduct. The current transition period wears the flaws of the former regime, characterized by an institutional vacuum, in which the partial lack of adequate formal institutions that could have stimulated economic performance, has been replaced by informal institutions that translate deviant economic behaviours and allocate resources and activities to a second (underground) economy.

Government leadership may play a special role in the process of institutional change, as it could act as an interface between society and its government; it could also indicate the pulse of civil society and its effective involvement in the proposed formal changes, thus ensuring future harmony (convergence) between the newly introduced formal institutions (whether imported or not) and the existing informal infrastructure. Addressing the persistence of informal institutions that alter economic performance also requires a set of measures designed to strengthen the active and effective involvement of civil society.

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