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## **Institutional Dynamics versus Economic Dynamics in Romania**

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**Abstract:** Economic growth and development are undoubtedly the major objectives of every nation. From the large variety of determinant factors, institutional economy emphasizes the role of institutional efficiency in achieving such performances. In Romania, the binomial relationship between effective institutions and development tend to be a utopia, taking into consideration that responsible for poor economic performances is precisely the institutional inefficiency. There is a path dependency, which clearly explains the current stage of development, given the poisonous influence of ex-soviet regime. Hereditary mark of the past inhibits any chance of progress, inclusively in the context of EU membership, which certifies Romanian formal integration at the transnational European level. The purpose of this paper is to offer an overview of Romanian economic dynamics through the quality of institutional framework, and furthermore, to highlight the necessary measures for redressing the inland economic conditions.

**Keywords:** institutions; path dependency; institutional efficiency; institutional dynamics; economic dynamics.

### **1. Introduction**

Beyond classical and neoclassical perspective on economic growth and the determinants of wealth, currently the New Institutional Economics is required to explain development gaps between countries all over the world. It promotes a distinct approach of economic theory, where institutions are the central pillar of analysis, even if free market remains also a key element. Institutional quality determines the level of economic development, as it relates to both, incentives and factors which inhibit this positive evolution. Economic theory of institutions pleads for the biunique relationship between institutions, as the rules of the game, and economic performance. In other words, institutional dynamics influences economic dynamics; the quality of institutions derives from economic evolutions, as well as a healthy institutional system is able to promote economic growth and development.

### **2. Institutions – Pillar of Growth and Economic Development**

The multiple definitions of the term *institution* have a common denominator, the idea of *behavioral regularity* (Hodgson, 2006; North, 2003; Sugden, 1986). Its origins proceed from the particularities of social institution, allowing the expression of a certain behavior in some specific situations (Marinescu, 2004). Taking into account the bounded rationality of individuals, the uncertainty and risk specific for the economic environment, institutions are responsible for doubt reduction, structuring everyday life. Moreover, they constitute an existential premise of any society.

The generic title of *institutions* include on the one hand, *formal institutions* that support free market and its development, like: property rights, credit institutions, those for macroeconomic stabilization, such as fiscal or monetary policy, institutions for social insurances, or those for conflict management adjustment. On the other hand, there are *informal institutions*: habits, traditions, ethical rules, or codes of behavior (Rodrik, 2000). These two categories coexist and mutually interfere; consequently, we might endorse the idea that institutions should be perceived as a whole. The interaction between these

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two components of institutional matrix might be favorable for economic expansion, or adversary, depending on complementarities or disparities between created rules and genetic heritage of each nation.

There is a circularity relationship between institutions and economic development (Pohoață, 2009). Institutional background is strictly dependant on economic evolution, while national level of development is highly based on the efficiency and quality of internal rules and norms of conduct. Undoubtedly, labour division, innovation, capital accumulation, or efficient combining of production factors have a substantial contribution on growth and economic development, but even so, human action should not be neglected. In order to understand why individuals prefer saving money, investing it, or furthermore, to acquire knowledge, it is necessary to consider institutions. They belong and made part of human interaction, so, are able to encourage the welfare or the decline of a society.

Economic theory pointed out certain factors, which support economic progress as property rights, economic freedom, foreign direct investment attractiveness, competitive markets, freedom of trade relations, healthy currency, or low taxation. Among all these, property rights are “the fundamental institution of market economy” (Marinescu, 2004). Legal property existence cannot be analyzed in isolation from the economic perspective. Moreover, the creation of property rights was necessary in the context of resources rarity, when conflicts between individuals might be generated on their usage account. As owners and users of such resources, people were encouraged to use them with parsimony and responsibility. Hereby, human interaction became less problematical while economic behavior converges to efficiency. When property is most useful allocated to efficient practices, economic welfare appear as a natural consequence (Marinescu, 2007). Institutions are responsible for activating all these factors, which enforces the idea that in the process of economic growth, institutions do matter (North, 2003).

### **3. Institutional Dynamics vs. Economic Dynamics in Romania**

The phenomenon of economic dynamics illustrates a *permanent change* in both ways, positive, meaning economic growth, and negative with the sense of economic decline (De Giancarlo, 1997). The quality of institutions is responsible for economic oscillation between these two hypostases. Institutional dynamics is favorable to development when the metamorphosis of formal rules is in totally accordance with informal institutions. Hereby, the institutional mix will allow the decrease of transaction costs, stimulating economic growth, especially when rules are targeting individual freedom, or labour division (Kasper & Streit, 1998).

Culture has a great impact on the process of society change, taking into account that informal rules are genetically inherited from the past. This explains why some nations are wealth oriented and promote *just institutions* able to induce growth and development, while others are power oriented, resistant to the process of institutional change and have significant difficulties in improving their own economic performances. Romania is representative in this case and is suffering from what Romanian economist Paul Fudulu calls *cultural handicap* (Fudulu, 2007). This means the inability to adapt to free market conditions, due the persistence of the ex-soviet values.

From the beginning of 1990, Romania was under the permanent changing process generated by reconversion from plan to the market oriented economic system. All these mutations involved institutions, economic and social sphere, but also a reconfiguration of inland mindsets. A new challenge came along with the EU accession process, but having different dimensions. Economic development was extremely important, however, the reality of the past few years highlights precisely the opposite (Jain & Ohri, 2007), given the national *institutional sclerosis*. Usually, institutional transformation is able to change and support the evolution of society; unfortunately, in Romania this transformation never took place. Old values of the communism continue to survive under the mask of democratic ideas, being responsible for corruption, bureaucracy, public sector inefficiency, poor economic performances and so on.

### 3.1. Transition Challenges in Romania

Post communist conversion was very complex. Measures like price liberalization, privatization, or economic stabilization were essential for setting up the new market economy, but were not able to guarantee even the success of transition. Building the institutional framework was the greatest challenge so far (Dăianu, 2003). Reinforcing institutions needs time, and is extremely important for the proper work of each society, mainly for developing countries. In all this period, Romania had to face inconveniences related to institutional building and adaption, the need to catch-up developed countries in a short period of time, and furthermore, to procure social and political stability (Idem).

First, transition is a process of *institutional transformation*, which involves starkly changes of nodal society rules and institutions that shape human behavior and coordinate economic activities (Marinescu, 2004). Second, the transition to free market economy means *destruction, creation, and adaption* (Idem). Everything connected with ex-soviet regime must be replaced with new rules and new mechanisms consistent with the free market economic system. From a Schumpeterian perspective, transition might be perceived as a creative destruction. Elimination of old values will generate new ideas, attitudes, knowledge, mindsets, or ideologies and all these will support the consolidation of a new prosperous society.

Social norms have a great influence on economic development (Putnam, 1993), but Romania is the example of unhealthy principles and behaviors persistence, which came from the communist regime. The shadow of the past identifies today with bureaucracy, corruption, indolence of authorities, high uncertainty, and abundance of laws, the lack of effectiveness, or low national productivity, all generating chaos and disorder. The gradual transition is responsible for these problems. After more than two decades, we are witnesses of economic failure and social abjection. As the quote says, a chasm cannot be crossed in two small jumps, one big step is needed. In other terms, a radical change implies a total detaching from the previous condition. Regrettably, the progressive metamorphosis is not compatible with the idea of successful transition and economic performance. This reluctant attitude brought the transition process on *the third way*, a sort of fusion between socialism and pure capitalism (Pohoă, 2000). Thus, private property was belated defined and is far from being connected with the notion of productivity. As Douglass North noted, institutions are not necessarily created in order to be socially efficient, but to satisfy the needs of those who have the power to negotiate them obstruction (North, 2003). Weberian “nouveau riche” are to be blamed; the ex-socialist dictatorship ardent followers, actually disguised in capitalist initiators have guided from shadow the processes of privatization with the purpose of serving their own interests.

### 3.2. Path Dependence - the Source of Institutional Disease in the “European Romania”

Romanian social organism is suffering from an institutional “disease” defined by poor market activity, fragile democratic and institutional framework, and the inability of the state to activate proper institutions, based on rule of the law. In such circumstances, opportunistic behaviors and bureaucracy tend to expand alienating Romanian society from European values. Changing of political regime, democracy and liberty were not sufficient for shaping a new society. Old values are still alive. As Veblen sustained, “institutions are products of the past process, are adapted to past circumstances, and are therefore never in a full accord with the requirements of the present” (Veblen, 2009, pp.168). Even so, the consistency of past beliefs and values is able to influence present and future economic situation; this is what institutional economists call, *path dependency* (Witt, 2008). In other terms, individuals have the propensity to perceive the present and future using some pre-existent mental constructs, or clichés from the past. Douglass North for example, used the concept of path dependence to explain poverty and poor economic performances of the nations. Therefore, we can assume the idea that countries governed by healthy institutions have the necessary basis for further development, while the future of transition countries remain unclear due to their institutional fragility (North, 2005).

This is also the situation of Romania, where corruption is still a nodal problem despite EU membership. Both, public and private sectors are “contaminated”; bribe and power abuse are

frequently encountered and almost assimilated in the society behavior. The lack of transparency of public expenditures and government decisions, the instability of government policies, economic fragility, asymmetric dispersion of wealth, or the privatization of public resources, are sources of inland corruption (Richter & Burke, 2007). This is becoming a measure unit for institutional inefficiency while public sector is responsible for promoting it (Baciu, et. al., 2009).

The trust of population in institutions of state is extremely low. Only 2% of Romanian citizens would seize upon a corruption case to authorities<sup>1</sup>. Romania is not able to learn from the past, in order to narrow the possibility of a further replication of institutional inefficiency (Pohoața, 2009), or moreover, to imitate successful models of European developed countries. Despite European Union membership, seen before as the “necessary vaccination” for economic retrieval, actually the situation is totally different. Institutional sclerosis obstructed the ability of magnetizing European funds, encouraged improper activity of Justice and corruption and economic problems have no solving hope for the moment. There are huge disparities between national background and European forms, which highlights the idea of a *formal insertion* of Romania in EU community. Development gaps between member states are becoming more and more obvious and hard to remove; further progress inside the EU community remains a mystery, but also a challenge for our country. Romania definitely needs a total change, a redefinition of rules, internal norms, codes of conduct, mentalities, in one-word new institutions, in order to provide the necessary stimulus for further economic and social expansion.

Romanian mindset definitely contributed to actual development level. First, political class and then the public sector take advantage of their position in order to satisfy personal interest to the injury of national convenience. Ostentatious consumption, luxurious cars, or houses, are made from illicit activities specific for those who have overnight enriched. They are the agents of *the leisure class* from descriptions of Thorstein Veblen, so their ability to procure wealth is only to themselves oriented. Second, individuals and society tend to comply with the unfair treatment of authorities and refuse to take a position in this respect, which encourages corruption and inland inefficiency. Both, society mindset and the role of the state in Romanian society need capital reconsideration. State must be a sort of guardian, able to provide certainty and a stable environment for economic and social activities through clear rules and strict sanctions for those who disobey the law. These rules and norms of conduct adapted to efficiency and a proper and responsible conduct might generate a deep transformation of social behavior, able to promote honesty and equity. Incremental changing remains the only hope, while institutions are the only way to improve the standard of living.

#### **4. Concluding Remarks**

Accumulation of wealth and factors that are able to encourage this process was for decades the nodal aspect of economic theory. The New Institutional Economics reveals another perspective, according to which rules and social norms are essential in achieving economic performances. Modern economic growth implies knowledge accumulation, political institution to guide individuals to productive activities, economic institutions to induce market efficiency, markets expansion, and proper institutions in educational system to ensure growth of human capital quality and innovation possibilities. Unfortunately, in Romania all these conditions are impossible to acquire because of institutional inefficiency. The inland corruption, bureaucracy or the fragile legal system are responsible for poor economic performances. State ineffectiveness to activate the proper democratic institutions encourages opportunistic behavior and narrows national productivity and credibility.

The excessive political involvement in economic and social life has a great contribution to what we call *the institutional disease*, because it promotes the wrong values of the past. The path dependence is able to explain the poor economic performances and inability to join European requirements. Important is that Romania does not have second chances anymore. The fundamental reconversion is

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<sup>1</sup> See *Special Eurobarometer 374, Corruption Report, February 2012*, European Commission, retrieved from <http://ec.europa.eu> on 21 February 2012.

waited, but also needed, is the condition for a better future. This major changing process is impossible to accomplish without institutions, they are the guiding rules that definitely influence economic and social dynamics of every nation worldwide. The latest studies in the field converge on the idea that Romania needs a process of institutional change, but unfortunately, this transformation presumes a long period. Romania will have the insertion opportunity among prosperous states only when the public authorities will focus on providing clear rules and proper methods in order to put these conventions in practice.

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