

# THE ECONOMIC TRANSITION OF ROMANIA FROM A BEHAVIOURAL ECONOMICS PERSPECTIVE

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**Abstract:** *The aim of this article is to briefly analyze the economic transition of Romania from a behavioural economics perspective. Despite the adverse effects experienced in the past regime, the paper finds out that the suitable macroeconomic policies implemented had fundamental effects, generating economic welfare and higher standards of living, life satisfaction, and happiness / subjective well-being.*

**Keywords:** behavioural economics, economic transition, macroeconomic policies

**JEL Classification:** D03, O11, P20

## INTRODUCTION

The problem of economic behaviour has preoccupied economist since the establishment of economics as a science. Even the first modern economist and philosopher, Adam Smith, wrote extensively on psychological and social dimensions of human action and economic behaviour. The later developments of economics, beginning with neoclassical theory, gave further stimulus to the use of mathematics, mostly in problems regarding the economic optimality. In this direction, William Stanley Jevons, stated: “It is clear that Economics, if it is to be a science at all, must be a mathematical science” (1888, p. 29). Since then, economic analysis tended to neglect the results of other social sciences. However, over time, a number of notable economists, like John Maynard Keynes, Friedrich von Hayek, or Herbert Simon used results from psychology, sociology, biology or philosophy, in their attempt to explain the economic behaviours and phenomena.

In the last decades the world economy and the status of economics as a social science were seriously endeavoured by the negative effects of some realities, such as the financial crisis or the command economic systems. That is why some theorists attempted to overcome the limits of mathematical modelling with the help of instruments from other social sciences, in order to improve the theory, to develop better policies, and to generate more suitable predictions. In these conditions, the new discipline of behavioural economics has drawn the attention by its attempt to “increase the explanatory power of economic theory by providing it with more realistic psychological foundations” (Camerer and Lowenstein, 2004, p. 3).

After the collapse of communism, great attention has been paid to the process of transition from a centrally planned economy to free market. Despite the adverse effects of the past regimes recent experiences have pointed out that the transition of a nation to capitalism and democracy depends, mostly, on its adherence to liberal policies.

This article will provide a briefly analysis of the context in which a nation can successfully shift from one politico-economic system to another. The discussion focuses on clarifying not only the economic, but also the psychological and sociological conditions for a favourable economic transition and the link between them. More specifically, the paper will analyze the case of Romania.

## **1. THEORETICAL INSIGHTS FROM THE FIELD OF BEHAVIOURAL ECONOMICS**

The technological advances of the last decades, mainly in neuroscience, have made possible a better understanding of the human brain and of the foundations on which certain behaviours arise. In addition, the onset of the actual financial crisis called into question the need of economics to return to “origins”, and admit that, beyond any mathematic and abstract model, economics is a social science.

The discipline of behavioural economics, also named “psychology and economics” (Rabin, 1998), provides a significant upgrade to mainstream neoclassical economics. Behavioural economics was variously defined in the literature as “the combination of psychology and economics that investigates what happens in markets in which some of the agents display human limitations and complications” (Mullainathan and Thaler, 2000, p. 2), or as “a field concerned with the empirical validity of neoclassical assumptions about human behavior, and, where these assumptions are found to be invalid, with describing behaviour more adequately” (Calhoun, 2002, p. 38), etc. This new school of economic thought incorporates knowledge and results especially of psychological studies, but also of other social sciences, like sociology, politics, anthropology, philosophy, or neuroscience into economic theory, in order to provide it more realistic structure.

Reviewing the literature we can conclude that some presumptions of behavioural economics correspond with those of traditional economics, but “others do not, or they do not in some contexts” (Schwartz, 2007, p. 4). On the one hand, mainstream economic studies how to allocate resources efficiently to maximize the welfare, on the other hand, behavioural economics attempts to provide an approach for handling with economic behaviour in the real world, for example the situation when

optimization is not suitable or the cost of the theoretically most advantageous solution would be superior to the obtained profits.

Moreover, neoclassical economic analysis assumes that individuals are self-interested, well-informed, and rational, that they are endowed with sufficient reasoning ability to solve simple problems in the best way possible or look for appropriate help in resolving more complex ones (when the benefits for doing so seem to be larger than the costs) (Schwartz, 2007, pp. 1-5). On the opposite side, behavioural economics was developed around the concepts of *irrationality*, in human population in general and in markets in particular (Berg, 2010, p. 869), synonymous with bounded or limited rationality (Simon, 1955) and *procedural rationality* (Kahneman and Tversky, 1979). Nowadays, in the Digital Age, when information, knowledge and situation change very quickly and world's economies are interconnected more than ever before, the emerging field of behavioural economics take into account the fluctuations in human rationality, whether disturbed by emotions, key informational gaps or the inability of people to make economic calculations mentally. Furthermore, behavioural economics focuses on inter-temporal choice that describes what people do when they make choices with future consequences; enrich the model of the utility function by including into analysis the role of fairness, altruism and other non-egoistic behaviours, together with social preferences, justice, and happiness (Schwartz, 2007; Maky, 2001).

According to psychologists, people are different (disproportionately) influenced by the fear of failure and regret and will often give up to certain benefits just to avoid even a little risk to feel that they have failed. Furthermore, people are often influenced by outside suggestions, are guided by stereotypes or mental emotional filters, and make decisions based on approximate rules of thumb and not strict logic (Ariely, 2008). Hence, this new discipline of economics, tries to improve the theory by providing a better understanding of the realities in which economics agents behave, in order to ensure, in the last instance, a high standard of living for all citizens.

Although, most behavioural economics have focused on microeconomic analyses, some deal with macroeconomic analysis (Schwartz, 2007, p. 5), which are relevant to the applied analysis of transition economies, as, for example, the function of consumption or investment can be influenced by the role of motivation and preferences, emotion and beliefs, cognitive anomalies, standards, norms, and time.

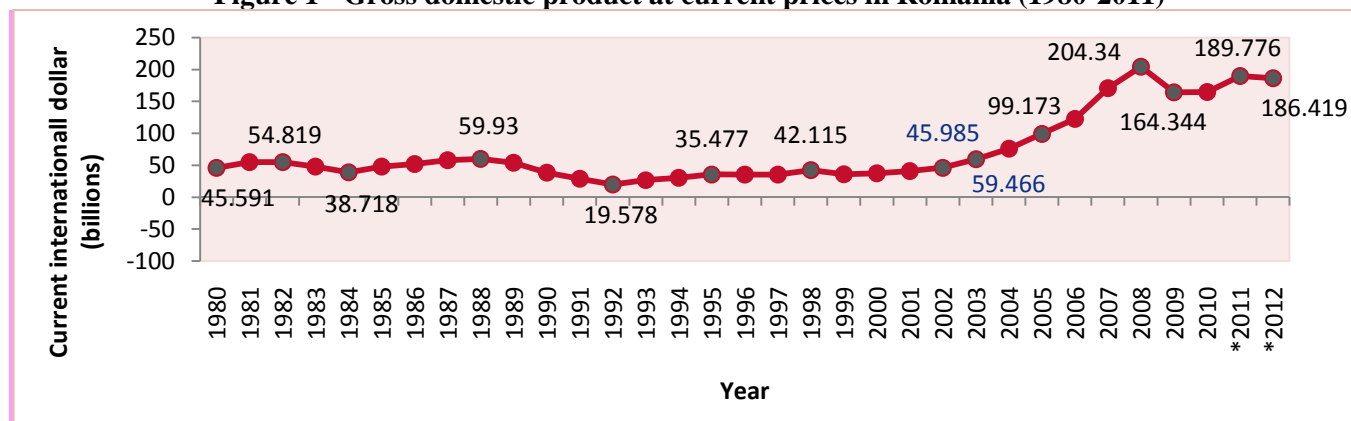
## 2. EVIDENCES OF THE ECONOMIC TRANSITION IN ROMANIA

In 1989, communism crashed and Romania together with other countries from Central and Eastern Europe started a challenging experience - the transition to a free-market economy.

To determine, even theoretically, the point in time when the economic transition ends, there are some procedures, like the political approach, the economic approach, the management approach, and the econo-statistics approach. According to the economic approach, the transition process gets to its end when the country's yearly **Gross Domestic Product** equals the highest point acquired in the period before transition (Scarlat and Scarlat, 2007, pp. 319-320). The Romanian economy has reached this value, according to the International Monetary Fund statistics, in 2004, at current prices, in USD, as it can be observed in the *figure 1*.

Since 1989, when the transition process started, Romanian economy experienced a decade of economic instability and decline, reflected in low values of GDP from \$ 19.578 billion in 1992 (the minimum level of this period) to \$ 42.115 billion in 1998 (the maximum level of this period). However, from 2000 onwards, the country has experienced macroeconomic stability, and has known until the crisis, a strong growth. Thus, after in 2004 the Romania's GDP at current prices reached the pre-transition maximum level of 59.466 USD billions, it followed an upward trend until 2008, when it was recorded the 204.34 USD billions historical maximum. The global economic crisis has affected Romania's economy since 2009 when the GDP's value at current prices diminished to 164.344 USD billions. Romania's economy returned to the growth in 2011 and, according to the IMF statistics, the latest projections estimate a value of GDP at current prices around 186.419 USD billions in 2012.

**Figure 1 - Gross domestic product at current prices in Romania (1980-2011)**



Note: \* estimates data

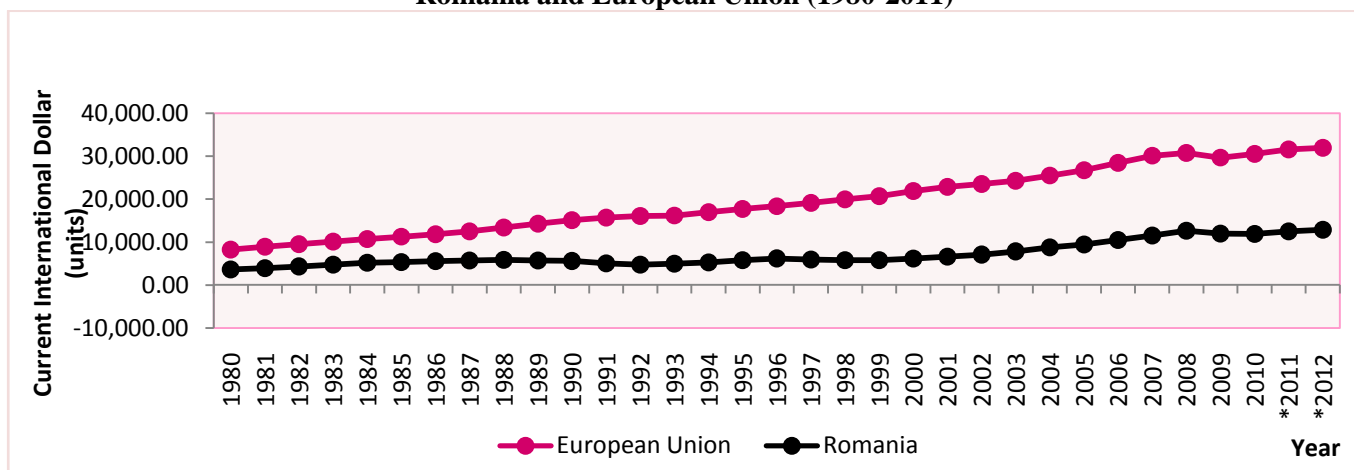
Source: processed by data from International Monetary Fund, *World Economic Outlook Databases April 2012*, <http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx>.

Romania's prudent macroeconomic management and the EU ascension from 2007 have enabled it to record a fast and stable growth. Furthermore, the entry in EU and the pre-adherence process helped Romania to change its customs, traditions and even mentalities, not only by providing the physical access to the European free market, but also by providing a conceptual model of high economic and social standards, norms, and behaviour.

A more relevant indicator for a country's economy is **Gross Domestic Product per capita**, which is often considered an indicator of a country's standard of living. As shown in *figure 2*, from an economic point of view, in present, Romania is still in a disadvantageous position if compared with the European countries. For example, compared to the EU 9 average of 1980 (when Romania was a communist country), Romania's GDP per capita calculated by the purchasing power parity (PPP) was 2.25 times lower (\$ 3 633.40 compared to \$ 8 200.14).

In the period of economic transition the gap has widened, Romania's GDP per capita was being 2.69 times lower than the one of EU 12 in 1990 (\$ 5602.94 compared to \$ 15 068.92). However, from 2000 onwards, the country's GDP has experienced significant increases: Romania's GDP per capita was 3.57 times lower than the one of EU 15 in 2000 (\$ 6130.24 compared to \$ 21 903.22); four years later, in 2004, Romania's GDP per capita was 2.9 times lower compared to the one of EU 25 (\$ 8769.015 compared to \$ 25 495.976); and in 2007, Romania's GDP per capita compared to the EU 27 average was 2.62 times lower (\$ 11 494.495 compared to \$ 30 123.605).

**Figure 2 - Gross domestic product based on purchasing-power-parity (PPP) per capita in Romania and European Union (1980-2011)**



Note: \* estimates data

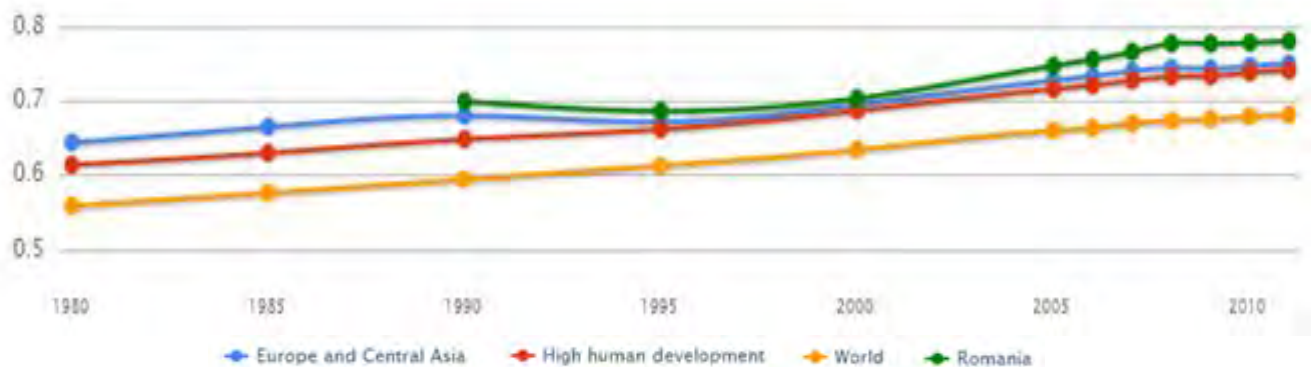
Source: processed by data from International Monetary Fund, *World Economic Outlook Databases April 2012*, <http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx>.

The global economic crisis affected both economies. In 2009 Romania's GDP per capita was 2.48 times lower than the one of the EU 27 average (\$ 11 944.967 compared to \$ 29 678.092). In 2011, the difference between living standards of Romania and the one of the EU average have amplified, EU's standard being 2.53 higher than the ones of Romania (\$ 31 607.394 to \$ 12 476.463).

Another appropriate indicator, introduced as a substitute to traditional instruments (such as level of income or economic growth) used to measure the development of a country or territory is **The Human Development Index** (HDI), published in the Human Development Report since 1990. The HDI represents an extension to the ample definition of well-being and furnishes a composite measure of three fundamental dimensions of human development: health, education and income (Human Development Report 2011, p. 13).

In 2011, the HDI value for Romania was 0.781, placing the country on 50 out of 187 countries considered, ahead of countries like Bulgaria (55), Russian Federation (66), or Ukraine (76); the first three positions in this classification were occupied by Norway, Australia and Netherlands, and the last ones by Burundi, Niger and Congo. Although, as shown in *figure 4*, a year ago, in the 2010 Human Development Report Romania was ranked 50 out of 169 countries and the HDI value was 0.779, which means that in 2011 it improved with 0.2 percent.

**Figure 3 - National Human Development Index trends from 1990 to present for Romania**



Source: International Human Development Indicators, *Romania. Country Profile: Human Development Indicators*, <http://hdrstats.undp.org/en/countries/profiles/ROU.html>.

The HDI trends capture aspects regarding countries development at a national (compared with other countries) and regional level (compared with the regions from Europe and Central Asia) and draw attention to any shortcomings in well-being and life chances (International Human Development Indicators). In this direction, as *figure 4* reveals, Romania's HDI value has changed over time from 0.700 in 1990 (the earliest date available) to 0.781 in 2011 (the latest data available),

an increase of 12.0% or, on the average, an annual increase of about 0.5%. The HDI of Europe and Central Asia, as a region, augmented from 0.644 in 1980 to 0.751 in 2011, placing Romania over the regional average.

**Table 1 - The HDI trends of Romania**

Year	Life expectancy at birth	Expected years of schooling	Means years of schooling	GNI per capita (2005 PPP\$)	HDI value
1980	69.6	12.3	7.9	-	-
1985	69.6	12.3	8.6	-	-
1990	69.4	12.4	9.0	7,803	0.700
1995	69.4	10.9	9.5	7,150	0.687
2000	70.5	12.0	9.9	6,759	0.704
2005	72.4	13.5	10.0	9,270	0.748
2010	73.8	14.9	10.4	10,863	0.779
2011	74.0	14.9	10.4	11,046	0.781

Source: *Romania: Explanatory note on 2011 HDR composite indices*, United Nations Development Programme (UNDP), p. 2, <http://hdrstats.undp.org/images/explanations/ROU.pdf>.

Furthermore, *table 1* analyzes the progress of Romania in each of the HDI basic components: health, education and income. Between 1980 and 2011, Romania's life expectancy at birth increased with 4.4 years from 69.6 to 74, expected years of schooling increased with 2.6 years, from 12.3 to 14.9, and the average years of schooling increased with 2.5 years, from 7.9 to 10.4. The Gross National Income (GNI) per capita increased from 7.803 to 11.046, by about 42.0 per cent, between 1990 and 2011 (*Romania: Explanatory note on 2011 HDR composite indices*, p. 2).

By recognizing the human aspects of economics and, by that, the role of psychology and other social sciences, the new discipline of behavioural economics indirectly arguments that societies should support the well-being and happiness of their citizens. Regarding to this, in the last decade, two composite indexes were developed in order to measure human well-being: the **Satisfaction with Life Index (SWL)** and the **Happy Planet Index (HPI)**.

In 2006, the SWL value for Romania was 173.33 (the maximum of 273.5 was recorded by Denmark and the minimum of 100 by Burundi), placing the country on 136 out of 178 countries considered (White, 2007). In the same year (2006), the HPI value for Romania was 37.72 (the maximum of 68.21 was recorded by Vanuatu and the minimum of 16.64 by Zimbabwe), which gave the country a rank of 120 out of 178 countries considered (*The (Un)Happy Planet Index 1.0*, p. 20), followed by a decrease in absolute terms in 2009 with a 43.9 HPI value (from a 76.1 maximum recorded by Costa Rica and 16.6 minimum recorded by Zimbabwe), which placed it on rank 70 out

of 143 countries considered (The (Un)Happy Planet Index 2.0, p. 61). The HPI, which measures both the human well-being and environmental impact, had in 2012 a value of 42.2 for Romania (relative to a maximum of 64 recorded by Costa Rica and a minimum of 22.6 by Botswana), which ranked the country 75 of 151 countries considered (The Happy Planet Index: 2012 Report, p. 25). Overall, it can be said that Romania is not a very happy country.

Some of the greatest **weaknesses** of the Romanian economy are the high degree of *bureaucracy*, which reminds of the past centralized economy, and *corruption*. The indicators, which have been dealing with this problem, recorded consistently high scores. For example, **Corruption Perceptions Index** in 1998 ranked Romania on 61 place out of 85 countries with a score of 3; in 2000 it ranked it 68 out of 90 countries with a score of 2.9; in 2005 Romania was on 85 out of 158 countries with a score of 3; in 2010 it ranked 69 out of 178 countries with a score of 3.7; and in 2011 it ranked 75 out of 182 countries with a score of 3.6 (Transparency International). Furthermore, in Romania corruption is seen as a matter of state and it occurs significantly in the public domain, most often in the case of politicians and magistrates (Maha and Popescu, 2005, p. 397).

In line with *behavioural economics*, it can be concluded that despite adverse economic effects of customs and traditions "inherited" from the past command regime, the economic transition of Romania, the economic perceptions, incentives, and behaviour have changed in accordance to the principles of free economy.

## CONCLUSIONS

Expressly, in a generally permissible environment, Romania's economic transition was not affected excessively by the customs and traditions of the old regime. On the contrary, in Romania the economic and societal standards, norms, perceptions, incentives and behaviours of the market economy have been accepted pretty quickly. In the first decade after the Revolution, from 1990 to 2000, the transition was slower, after 2000 the process experienced an accelerate increase, noticeable in the economic indicators.

In the medium term the essential challenge for Romania is to ensure a stable economic growth, to improve living standards, and to continue its structural reforms and modernization, in order to offer a better life satisfaction and well being to its citizens, in accordance with the principles of free economy.



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