A general perspective regarding the relation between institutional efficiency and (economic) development in Eastern Europe

Ramona ȚIGĂNAȘU*, Sorin MAZILU**

Abstract

Informal institutions such as culture, trust, social relations, norms or values have a strong effect on countries' development patterns, their role being enhanced in those states where formal institutions are poorly regulated. Therefore, in order to foster economic development, institutional change remains one of the core issues, and differs depending on the levels of social analysis. The current paper aims at outlining a general perspective regarding the relation between institutional efficiency and economic development within the European Union, with a specific focus on the Eastern member states. These have similar development patterns and structural challenges, considering their shared communist past and inheritance which have left strong imprints on Eastern European societies and welfare. Overall, the paper argues that institutional efficiency is closely linked to the countries' levels of prosperity, and consequently, to the manner in which their governments pay attention on development policies, especially in those states that are economically and spatially more peripheral.

Keywords: formal and informal institutions, economic freedom, development, European Union

Introduction

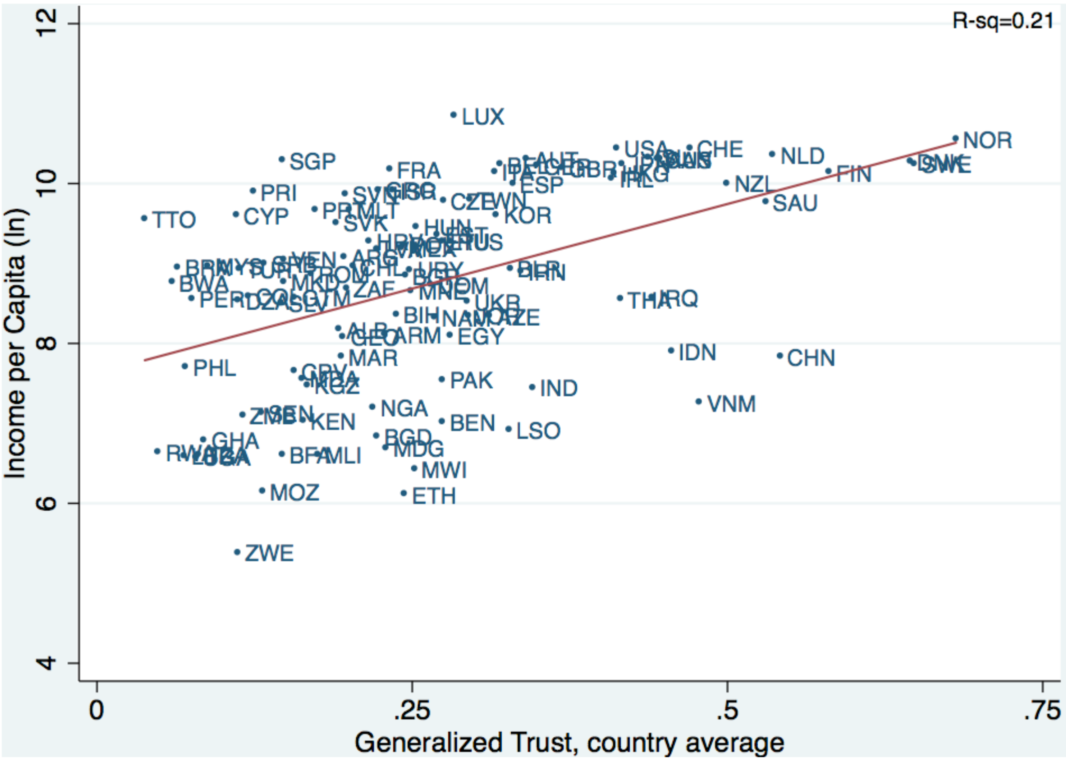
The differences of development among countries is based on the analysis of a cumulus of conditions such as: historical incrementalism, culture, trust, social relations, social norms and values, moral considerations, personal motivation, cultural stereotypes, habits and customs, traditions, cultural heritage, social conventions, religion. Essentially, all these are what is called *informal institutions*, whose influence on people's behaviour has a decisive impact on the state's development trajectories.

Each country's economic performance depended, critically, on its institutional construction. Informal institutions exist in all countries, but their role is higher in those states in which formal institutions (such as contract legislation, rule of law, property rights, free market) are poorly regulated. Although informal institutions can have some superficial similitudes – for instance, all related systems are based on family, ethnic or religious connections – in practice, they are very

*Ramona ȚIGĂNAȘU is researcher at Centre for European Studies, Faculty of Law, "Alexandru Ioan Cuza" University, Iasi, Romania, e-mail: ramona.frunza@uaic.ro.
**Sorin MAZILU is researcher at Centre for European Studies, Faculty of Law, "Alexandru Ioan Cuza" University, Iasi, Romania, e-mail: mazilu.sorin@yahoo.com.

miscellaneous depending on place and time (Prasad, 2003). For example, if we look at the relationship between trust in people and income per capita, there is a tendency that the higher the income level is, the trust in people is growing (direct correlation if we consider trust as dependent variable). Algan and Cahuc (2013) capture this connection in a study of 106 countries across the 1981-2008 period. According to their analysis, it is confirmed in proportion of 21% that countries with high levels of trust have high levels of income (Figure 1).

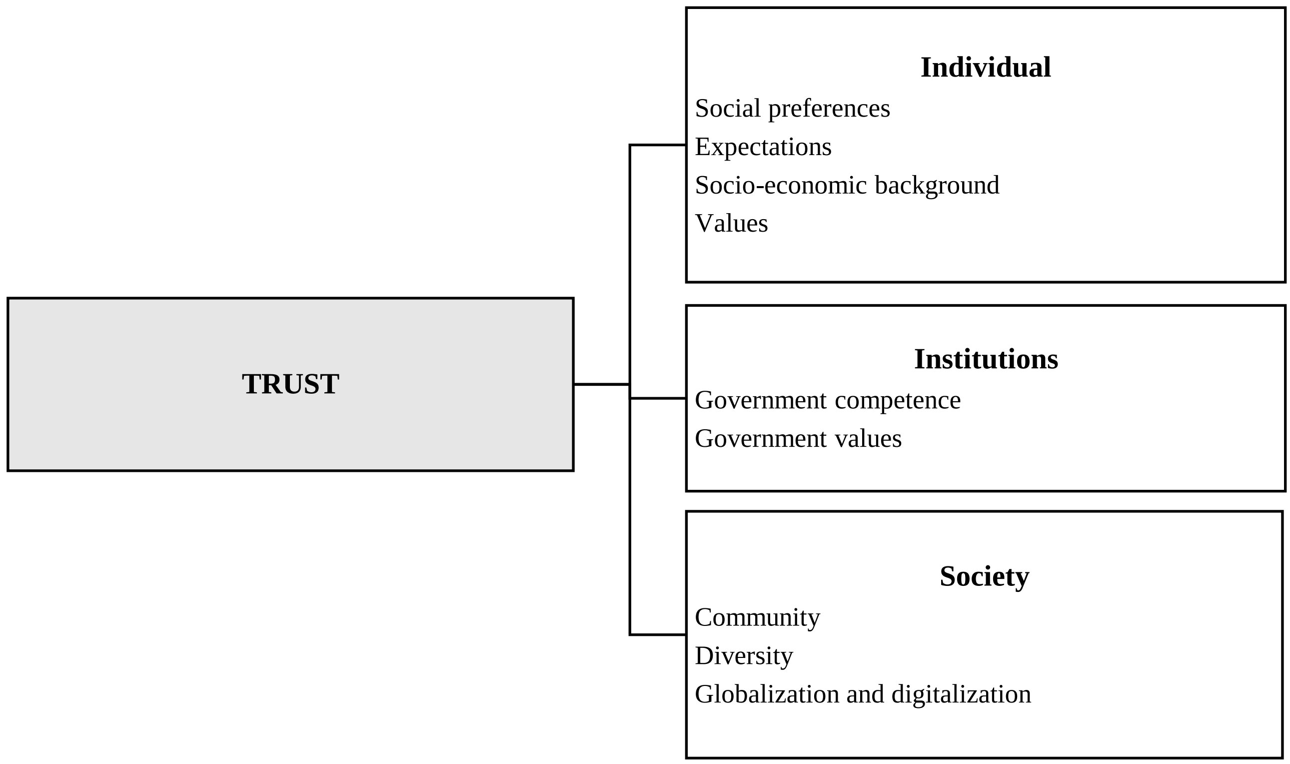
Figure 1. Correlation between trust and income per capita



Source: after Algan and Cahuc (2013), p. 63
Note: the question applied to the respondents was "Generally speaking, would you say that most people can be trusted, or that you need to be very careful in dealing with people?"). For data normalization, trust variable is equal to 1 if the answer was „Most people can be trusted" and 0 if the answer was "Need to be very careful".

Of all analysed countries, Norway holds the highest degree of trust (68,1%), with Trinidad and Tobago (3,8%) being at the opposite side of the scale. At European level, northern countries enjoy high levels of interpersonal trust (Sweden 64,8%, Denmark 64,5%, Finland 58,1%). Referring to Romania, the trust level is around 17%; a special situation is encountered in France, which has a trust level of 23,2%. A possible explanation for this positioning would be the fact that many minorities meet here, and according to Helliwell and Putnam (2007), when ethnic diversity occurs, trust decreases, friends are fewer and altruism and cooperation are rarely meeting. Ostrom (1998) argues that trust, reputation and reciprocity are three key attributes of human behaviour that influence the willingness to establish cooperation and sustain it over time.

Figure 2. Determinants of trust



Source: adapted after Murtin *et al*., 2018, p. 12

The level of education strengthens the quality of human resource and can generate a higher degree of interpersonal trust as the preferences and values of the people are different and their behaviour is shaped by factors such as socio-economic background, life expectations, etc (Figure 2). The focus on human capital is essential in an economy in order to achieve transformative effects (Dinu, 2006), but, in the process of development, the government also has a significant role because it must have the capacity to establish and defend the institutions of economic competition, concurrently with the elimination of corruption and the promotion of public-private partnerships. Institutional change remains one of the core issues of any development, whether economic or political, and differs depending on the levels of social analysis (Table 1).

Table 1. Level of social analysis

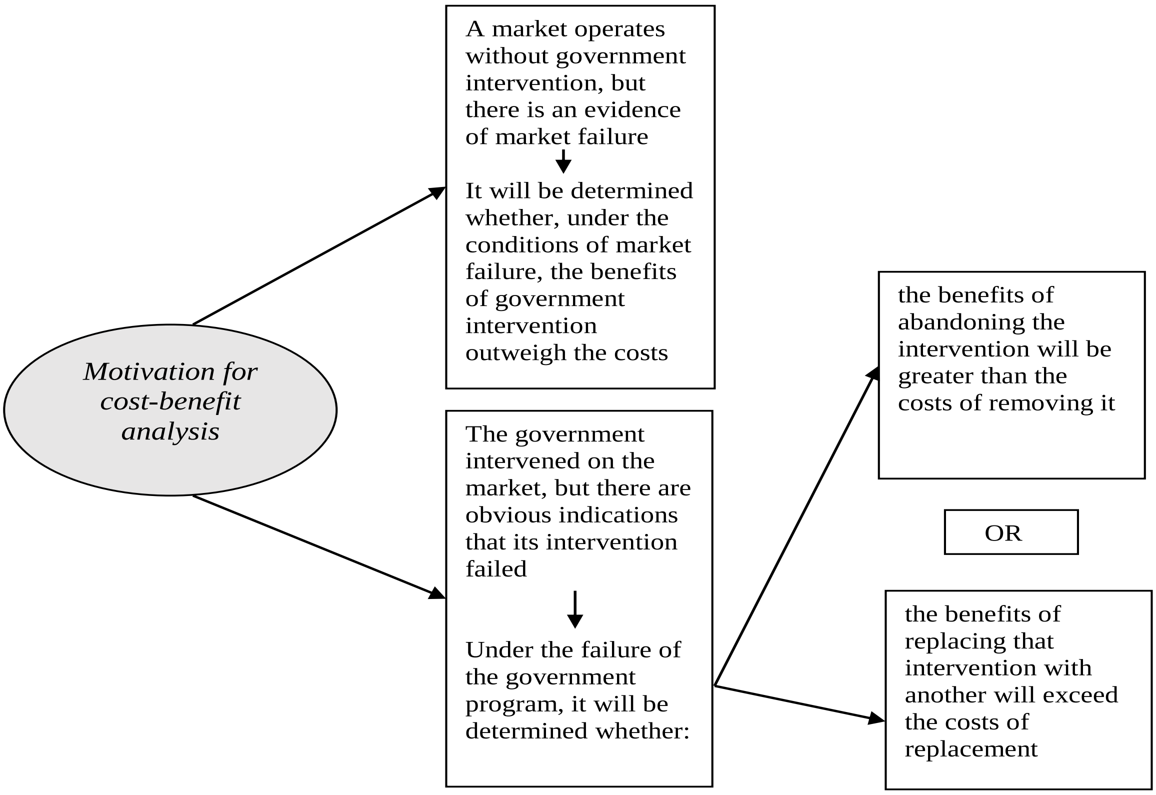
Level	Social analysis	Rate of change
1	Habits: customs, ethics, norms, traditions, religion	100-1000 years
2	Basic institutional framework: property rights, political and legal institutions	10-100 years
3	Governance: contracts, firms, internal organizations, hybrid forms	1-10 years
4	Resource allocation: standard microeconomic theory and agency theory	Continuously

Source: after Williamson, 2000, p. 597.

The first level is represented by customs, norms, traditions, religion, etc., which are specific to each state. With regard to the countries of Eastern Europe, after almost 30 years of transition, changes in informal institutions are rather marginal, the highest weight on efficiency coming from the second and third levels of social analysis where key formal institutions interact with the internal organizations. At these levels, a complete set of both incentives and constraints creates opportunities on the basis of which economic agents, more or less rational, orient their preferences. The fourth level is a typical subject of standard neoclassical microeconomic analysis and the constraint solution is given here by budget and technology. The neoinstitutionalists share the idea that economic performance (level four) is not solely determined by optimizing a perfectly rational and informed *homo oeconomicus* but is a function of institutional structures at the first three levels (Kudrna, 2004; Bokros *et al*., 2000). Hamilton (1932, p. 84) states that "institutions are changing as much as people gain experience and realize that there are better ways to organize certain aspects of their lives. Very often, institutions are changing due to technological progress and as a response to contacts with other cultures". In the future, institutional changes will probably occur as a result of the changing power relationships between actors. In such a context, the transformations related to trust will cause mutations depending on the size and form of cooperation between individuals. In other words, the institutional change can be associated with transformations in the way in which the fruits of cooperation are shared. These changes in social relations will generate new social expectations, more concrete, that will also be translated into new sets of informal institutions. The existing institutions, that reflect previous social beliefs of individuals, will be replaced by new rules designating the new form of power relations (Bakir and Gunduz, 2017; Farrell and Knight, 2003).

If the government intervenes to regulate any deficiencies in the economy, it is preferable to previously carry out a cost-benefit analysis, and this for the motivations set out in the Figure 3.

Figure 3. Motivations conducting a cost-benefit analysis



Source: after Boardman, A. *et al*., 2004, p. 86.

If the markets work perfectly, Pareto's efficiency will be achieved without government intervention. Under these circumstances "a set of prices will be imposed on the market if that version of resources allocation to firms and of goods to individuals is found, so that a reallocation variant would not be possible to improve the situation of a people without harming the situation of another. However, the perfect functioning of the markets is far from being pure reality. As a result, certain inevitable gaps in market mechanisms require the existence and intervention of the state, which, in turn, introduces costs and distortions in relation to the ideal functioning of a market economy" (Brăilean, 2006, p. 74). The inevitable distortions constrain the achievement of the best optimum, having to look for the conditions of an optimal second best[1], which can prevent their negative effects.

[1]The theory of second best was formulated by R. Lipsey and K. Lancaster in 1956.

2. Institutional efficiency and economic freedom in Europe

In order to see how some of the free market conditions (respect for property rights, private initiative, etc.) have been fulfilled in Romania compared to other European countries, we will briefly analyse the Index of Economic Freedom (IEF) in 2018. IEF is a synthetic index that considers liberties specific to the economic environment: business, commerce, tax, government, monetary, investment, financial, property rights, corruption, labour market etc. Economic freedom is a broad term that denotes a functioning market economy, an effective institutional framework that ensures the stability of the macroeconomic environment and enables the efficiency of economic agents. As demonstrated by prolific economists (Smith, Say, Mises, Hayek, Friedman, North, etc.), *the economic freedom is the essential condition of development*. To increase the degree of economic freedom, some instructions are given: special attention should be paid to the protection of property rights, the efficiency of the legal system and of the state apparatus, the clear rules in society etc.

In the Table 2 (Annex 1) is presented the ranking of the countries in Europe in 2018 for the IEF, an index obtained by the arithmetic mean of the values of the 12 freedoms. From the data presented in the table, it is noticed that Switzerland ranks first in Europe, followed by Ireland, Estonia, United Kingdom, etc. Referring to Romania, it has accumulated 69.4 points, the lowest performance being observed in terms of government integrity (score 40) and in terms of financial freedom (score 50), and this situation is explicable, on the one hand, by the fact that in Romania the laws change, in an unpredictable way, and do not apply uniformly, but selectively, causing the spread of corruption, weakening trust in institutions and politicians and, on the other hand, the fragility of the financial system. The detailed analysis of the table highlights the fact that Western European countries knew how to implement adequate institutional systems so as to gain competitive advantages and thus occupy the top positions within European and world rankings regarding the level of economic development. However, it is noteworthy that half of the world's "most free" countries are on the European continent. The distribution of economic freedom in the European countries is shown in Figure 4.

Figure 4. The distribution of economic freedom in Europe, 2018

Source: *2018 Index of Economic Freedom*, The Heritage Foundation and Dow Jones&Company, Washington, D.C., 2018: www.heritage.org/index

Many European countries have a largely free economic environment (Finland, Estonia, Lithuania, Latvia, Sweden, Norway, Germany, Denmark, Netherlands, Czech Republic, Austria, etc.), a moderate economic freedom existing in Poland, Slovakia, Hungary, Romania, Bulgaria, etc. As a rule, ex-communist states have relatively low IEF scores.

Adam Przeworski argues that communist states, with command economic systems, were not actually planned economies but negotiated economies, in which negotiation took place between central governments, firms and their branches: “out of economic and political reasons, eastern European governments were vulnerable to the pressure of large firms, often granting them subsidies or protecting them” (Przeworski, 1996, p. 151). This tendency continued even after the fall of the communist regime. Therefore, the differences in the performance of the economies that went through a period of transition are explained by the efficiency in meeting the requirements of the market and of the newly created institutions.

Conclusions

The communist inheritance has left strong imprints on Eastern Europe. First, laws, institutions and the property structure in the communist regime differ extensively from what is necessary in a modern, capitalist economy. Second, some eastern European countries tried to put an end to the command-based economic system, by replacing it with reforms based on free decisions which, indeed, have brought some improvement but they did not lead to the emergence and development of normal completion-based market relations. Briefly, each country from the region underwent economic collapse and their growth slowed down, whereas in certain cases there were acute shortages and crises in the balance of payments (Lipton *et al.*, 1990). All these inconveniences could be eliminated only by the consolidation and the efficient enforcing of institutions. The entry on the market remained relatively blocked for poor citizens, with a low income and few properties, without formal rights on goods and who could not benefit from safe transactions (O'Driscoll and Hoskins, 2003). Consequently, the post-communist countries have developed a distinct type of capitalism. In the 1990s, the institutional framework was unstable and very changing, which led to radical alterations in individual behaviour: opportunism, bribe, favouritism etc. As expected, these contributed to the development trajectories that were different from those of Western Europe states, and this has strengthened the core-periphery structure.

The path towards development is substantially conditioned by the inheritance of an ensemble of institutions that determine people's expectations and constrain the development of new market-based incentive structures (Raiser, 1997). As a result, the complexity of transformations occurring in eastern European area cannot be captured via standard theories alone. The premise that social interventions are not performed in a vacuum, as it was believed and supported, refers to and resorts to the explanatory force of neoinstitutional theories. Levi *et al*. (2005, p. 49) define this process in the following terms: "path dependency means (…) that once a country or a region set off on a path, costs to return are very high". There will be other possibilities to choose from, but the fortification of certain institutional arrangements will limit each inversion of the initial choice. Hence, knowledge of the institutional matrix can provide serious indices about the sources of inertias and hardships incurred when its components disagree with progress requirements. It is not by chance that in the jargon of national government representatives one can often find the phrase "institutional reform", although in eastern European states, institutional reconstruction is a weak link, due to the state's incoherence in its actions, to mechanisms designed to implement contradictory and unstable institutions, and maybe especially to old mentalities, to informal institutions that have still failed to gain a pro-market and pro-democracy dimension (Pohoaţă, 2006). This is why, the integration of both formal and informal institutions must be included in the study of a state's transformation capacity, all the more that they form an environment that can have a positive or negative influence on a country's economic and social activities and they establish a connection between the past, the present and the future (North, 2003). In the context of the present economic challenges, the major issue is represented, therefore, by the good governance (the way in which the institutions' action is reflected at local/regional/national level).

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Annex 1

Table 2. Index of Economic Freedom in Europe, 2018

Country	2018 Score	Property rights	Judicial effectiveness	Government integrity	Tax burden	Gov't spending	Fiscal health	Business freedom	Labour freedom	Monetary freedom	Trade freedom	Investment freedom	Financial freedom
Switzerland	81.7	84.2	82.1	82.8	70.5	65.4	95.9	75.7	73.9	85.2	90.0	85	90
Ireland	80.4	87.7	79.0	79.0	76.1	69.6	80.8	81.8	76.4	87.4	86.9	90	70
Estonia	78.8	80.4	83.9	75.7	80.7	52.6	99.8	75.6	54.8	85.1	86.9	90	80
UK	78.0	92.2	93.8	79.0	65.2	44.4	53.5	91.1	74.4	85.2	86.9	90	80
Iceland	77.0	86.7	72.6	77.3	72.1	44.2	94.3	89.5	61.8	81.7	88.5	85	70
Denmark	76.6	84.8	83.6	84.1	41.4	10.6	96.7	92.5	82.8	86.4	86.9	90	80
Luxembourg	76.4	82.7	77.9	79.0	65.1	48.5	99.0	69.2	46.2	87.6	86.9	95	80
Sweden	76.3	92.6	88.2	92.9	43.9	23.2	96.1	89.3	53.7	83.8	86.9	85	80
Georgia	76.2	62.8	64.2	61.8	87.0	73.3	91.8	86.9	77.3	79.6	89.4	80	60
Netherlands	76.2	87.9	74.1	86.0	52.5	39.1	88.2	80.5	61.5	87.5	86.9	90	80
Lithuania	75.3	73.8	66.7	50.9	86.4	63.9	96.7	73.4	64.5	89.9	86.9	80	70
Norway	74.3	86.4	86.0	93.6	56.4	29.2	97.8	90.4	54.6	73.9	87.9	75	60
Czech Republic	74.2	73.0	57.9	51.1	82.9	48.6	96.2	72.5	76.8	85.2	86.9	80	80
Germany	74.2	81.0	78.0	75.3	61.3	41.3	90.8	86.1	53.3	86.2	86.9	80	70
Finland	74.1	89.0	82.7	89.8	66.5	2.3	81.1	89.9	50.5	86.0	86.9	85	80
Latvia	73.6	68.3	58.9	45.4	84.0	59.0	95.3	80.1	72.5	87.3	86.9	85	60
Austria	71.8	83.5	80.9	73.5	49.9	19.4	81.1	75.5	66.7	83.7	86.9	90	70
Macedonia	71.3	64.8	57.0	47.4	91.6	70.3	78.1	82.9	69.0	81.8	87.8	65	60
Romania	69.4	61.0	59.7	40.0	87.3	66.9	91.1	65.2	66.8	82.8	86.9	75	50
Armenia	68.7	55.3	47.4	40.5	84.7	80.0	67.2	78.7	69.9	75.8	80.0	75	70
Poland	68.5	61.8	56.6	50.9	75.9	47.8	81.5	67.2	63.9	85.0	86.9	75	70
Malta	68.5	68.1	62.8	49.9	64.7	51.0	90.0	64.0	61.1	78.8	86.9	85	60
Bulgaria	68.3	63.6	42.5	38.2	90.9	60.5	94.3	64.3	66.1	82.8	86.9	70	60
Cyprus	67.8	71.2	56.7	41.3	75.2	52.9	79.3	77.0	55.7	83.0	86.9	75	60
Belgium	67.5	81.2	69.5	70.9	44.0	12.1	67.9	80.6	59.5	82.6	86.9	85	70
Hungary	66.7	57.6	57.1	36.4	78.6	29.4	82.4	61.8	68.7	91.6	86.9	80	70
Kosovo	66.6	52.3	59.0	45.4	93.2	77.9	92.8	72.6	58.3	81.2	70.8	65	30
Turkey	65.4	54.7	54.5	42.0	74.7	68.1	93.6	63.3	47.6	72.3	78.6	75	60
Slovakia	65.3	68.2	38.8	38.2	78.9	44.3	84.9	63.9	54.0	81.0	86.9	75	70
Spain	65.1	73.1	62.0	51.5	62.0	42.8	36.1	66.3	59.0	86.7	86.9	85	70
Slovenia	64.8	76.6	57.7	52.1	58.7	31.2	66.3	79.5	61.3	87.3	86.9	70	50
Albania	64.5	54.1	25.4	39.9	85.1	72.7	67.5	69.1	50.4	82.4	87.8	70	70
Montenegro	64.3	54.2	51.3	38.1	85.2	35.7	69.1	72.9	70.9	84.9	84.7	75	50
France	63.9	84.0	72.7	65.1	47.3	2.7	60.8	80.2	45.0	81.6	81.9	75	70
Portugal	63.4	69.2	70.1	56.8	59.8	29.8	46.0	83.2	44.1	85.3	86.9	70	60
Italy	62.5	71.2	60.9	40.1	55.2	24.1	68.2	70.3	50.3	88.2	86.9	85	50

Serbia	62.5	46.2	48.2	36.5	83.5	40.6	67.0	68.3	69.2	82.9	87.4	70	50
Bosnia and Herzegovina	61.4	39.5	43.7	28.4	83.5	41.5	94.4	49.3	59.6	83.5	87.8	65	60
Croatia	61.0	65.9	56.5	40.5	66.0	32.5	67.2	58.9	43.0	79.1	87.4	75	60
Moldova	58.4	53.5	26.3	26.6	85.3	56.7	90.0	66.0	39.9	73.2	78.3	55	50
Russia	58.2	48.7	46.9	38.1	85.8	62.5	87.7	77.0	52.0	60.8	79.4	30	30
Belarus	58.1	53.5	57.3	42.0	89.8	47.9	75.4	74.1	73.1	62.3	81.4	30	10
Greece	57.3	52.3	59.0	37.9	60.4	20.9	70.5	74.4	54.4	81.0	81.9	55	40
Ukraine	51.9	41.0	29.5	29.0	80.2	45.0	75.9	62.7	52.8	60.1	81.1	35	30

Source: 2018 Index of Economic Freedom, The Heritage Foundation and Dow Jones & Company, Washington, D.C., 2018: www.heritage.org/index.
Note: The scale is between 0-100, where 0 denotes the rejection of freedom and 100 means maximum freedom.