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Formal Institutions and Regional Development. Considerations Regarding Romania

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Abstract. *Assuming that a theory of development is incomplete without a theory of institutions, we propose in this paper to analyze, in a first part, the interrelation formal institutions-regional development and the ways trough which these two components sustain themselves, then, in the second part of the paper, we will analyze the degree of convergence of the eight development regions in Romania, taking into account indicators such as: GDP per capita, average net wage gain, unemployment rate, labor productivity, the share of sectors in total employment.*

The results of our research we hope to lead us, in the final of the paper, to draw some future action directions by which to reduce development disparities between regions, both at national level and at European level NUTS2.

Keywords: formal institutions; regional development; convergence; regional gaps; measures.

JEL Codes: O1, O5, R1.
REL Codes: 16F, 16J, 19G.

1. The interrelation formal institutions - regional development

The scientific literature of the last years emphasizes the fact that a great part of the studies/inspiration from the field of regional development has its origin in institutional economy. Numerous empirical studies have proven the existence of a positive relationship between the institutional quality and economic growth, but other studies reached the conclusion that the states must have a minimum level of economic development in order to appropriately capitalize the institutional matrix. We can affirm that, in general, between institutions and development a mutual relationship, of reciprocal strengthening is established: the developed countries become stronger because development means supports of institutional efficiency, while the poor countries remain in a poverty trap due to the fragility of formal institutions.

When we speak about institutions, we refer to something more extensive than merely a set of legal entities easy to identify, such as parliaments, central banks or syndicates. The institutions represent a network of formal and informal rules meant to introduce order in the economic and social life and to edify a mechanism of applying and monitoring these rules in view of efficiently using the available national resources. The institutions form the environment that can influence positively or negatively the course of economic and social activities of a country.

The *formal institutions* (property rights, law's authority, free market, contract) must to consolidate the state of law and ensure the law's ruling, a moral political class, and a strong and independent justice. Through these institutions, we can eliminate social conflicts and, instead, promote cooperation relations that economize the resources and allow directing them towards useful, productive activities. The formal institutions are responsible for ensuring the normal functioning, without market obstacles. The effective and efficient functioning of market institutions is determined not only by the capacity of economic operators to organize themselves and operate in the competition environment, but, to a larger extent, by the capacity of governmental entities to establish and apply the rules of the game, to bring the necessary corrections to these rules when it is appropriate. (Iancu, 2008). Besides the formal institutions, there can also be *informal institutions,* made up of customs, traditions, way of life, cultural inheritance etc. These differ from country to country and from individual to individual, being much more difficult to change and having a more reduced influence on development. This is why we have chosen to focus on studying the formal institutions that determine the way the economic system functions. In order to have efficient economic processes, we must discover the inconsistencies that lead to the market failures and to the faulty allocation of resources, and then to find means of eliminating them. D. North, the most important exponent of the new wave of institutionalists, emphasizes that *institutions* represent the rules of the game in a society, configuring the relationships between people (North, 2005). In order to prosper, a nation must defend and strengthen its institutions. Gravitating around this idea, the following question was often asked: which institutions are important in generating economic performance? In this sense, the significance of formal institutions was mostly highlighted since they establish the framework where the economic activity is carried out and provides the norms to regulate the production and exchange of goods.

There is diversity between the countries as regards the economic growth, structure and efficiency of mentioned institutions. At a large scale, it is known for a fact that the property has a deep impact on innovation and entrepreneurial behavior. The significant growth of market economies since the industrial revolution has represented not only benefits in efficiency but moreover innovation rated unequalled in history. Property gives entrepreneurs the freedom to try new things, to earn profits, based on the previous economic calculation, which compensated the risks and investments it assumes. Moreover, there cannot be a competitive behaviour without dispersed power and responsibility. When the property rights are sure, the individuals have stronger incentives to attain profit earning, improving productivity, capitalizing innovations, achieving qualitative goods, signing contracts, solving the eventual disputes, investing both in the physical and the human capital (Boudreaux, Aligică, 2007, pp. 29-30). Only on a free market can we achieve a reallocation of property rights, based on voluntary exchange, towards the most efficient uses and relative correct calculations of transaction costs. Moreover, on a free market, the necessary connection between the healthy currency and the private property institutions is established, idea supported by the most important representative of the Austrian School of Law and Economy, Ludwig von Mises. The markets evolve when people are free to use and develop the goods and contractual rights. The private property institution determined that the allocation of resources is made in a reasonable manner, taking into account the needs of the future generations as well. The neo-institutionalists consider that the market is a complex institutions that demands, in order to function correctly, an organization based on some known rules: at the level of countries in course of development, it is firstly imposed to create an economic-social framework favorable for markets, afterwards they must adopt creative destruction, suggested by J. Schumpeter, by which everything old and unprofitable must be replaced by new productive activities that support an adequate economic growth. Another formal institution, that of contract, is especially important since the property rights are certain and the contracts are complied with, investments grow. The formal institutions imposed in a society are good when the result is the emergence of trust between strangers. The empirical studies emphasize the fact that there are multiple correlations between the level of trust between individuals and the welfare of a country (expressed in GDP), its growth rhythm and the economic climate. More exactly, there is a direct causality between trust and prosperity. Trust grows together with the perfecting of formal institutions and with the salaries' growth and decreases through the heterogeneous component of population and polarization (incomes' heterogeneity).

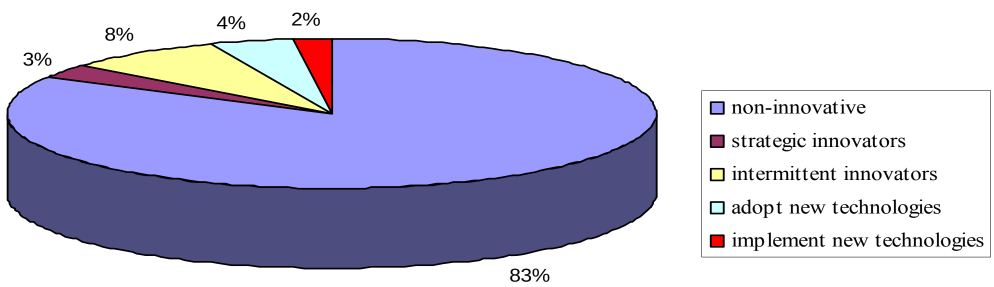
In essence, the institutions which favor development are those encouraging collective and individual freedom, favoring the adaptation to change, assimilating innovation, extending the common knowledge, accumulating social capital, emphasizing the performance of governing through a more reduced bureaucracy, a high degree of cooperation and flexibility, small corruption levels etc. In other words, the institutions and rules of law are the criteria and means for diminishing the potential conflicts and consolidating a social order. According to Freedom House and Heritage Foundation, the countries should take into account the quality of their institutions no matter the system they choose to rely on – German, Japanese or American – and correlate the formal institutions in a well-defined set, since these rationales will facilitate the path towards prosperity.

The identification of institutions and the differences between the countries represents the first step in understanding the manner in which an economy grows, stagnates or declines. The second step is that of knowing the manner in which business activities adapt commercial or change contracts to specific institutional environments. A thing is certain: if the institutions of the state of law, which are meant to control and sanction the abnormalities of persons, companies or organizations from the game rules, are weak, then the market economy functioning occurs chaotically, producing ample negative effects, from massive stealing and other frauds to wasting the resources and increasing social inequalities. To the extent that institutions concentrate their efforts to non-productive activities, making abstraction of the creative sphere, then, certainly, there are institutional rules incompatible with the economic performance. The differences between the formal institutions represent the main source of discrepancies between the countries as regards prosperity. However, we demand ourselves how we can obtain appropriate institutions. A possible answer is suggested by the institutionalist message which is a very clear one: in order to generate economic performances, it is necessary to transform the institutional framework or architecture of a social system in a certain direction.

The systems effectively combining institutions in order to foresee relatively low transaction costs, which promote voluntary exchange, reduce insecurity, grasp and distribute relevant information, encourage innovation, grow coordination and cooperation and control conflicts, determine better conditions for supporting economic growth (Steiger, 2006).

In the last years, the specialists in the endogenous growth theory emphasized in their works that a region can become a significant source of competitive advantage if it attracts local assets and associates externalities and economies of scale with spatial and specialization clusters. This supposes the reduction of transaction costs, agglomeration, concentration, technological innovations, qualified working force etc. This is where institutional economy comes forward, emphasizing the proximity and association character of the regions with a certain centre, which represents a learning and knowledge source. The main exponent of this vision is Michael Storper, who suggested that the core, place where globalization is in accordance with the localization of economic activity, is the power of relational assets or non-negotiated interdependencies. These include tacit local knowledge and open exchange, the quality of local institutions etc.

The economic potential of clusters enjoys attention at all the decision levels from Europe. As regards our country, the picture shows rather clearly the insufficient development of competitiveness clusters, the relatively incipient character of their formation, especially through the activity's profile, but also through the absence of some characteristics of mature clusters (Bîrsan, 2006, p. 39). The studies carried out at the national level by the Group of Applied Economy and the International Centre for Entrepreneurial Studies (CISA) emphasize a rather painful truth, namely that the native clusters are in an incipient stage. The Figure 1 suggests this.



Source: adapted after the data offered by GEA and CISA, in Bîrsan, M., 2006.

Figure 1. *The situation of the firm to national level*

Analyzing the data of the graphic, we observe that 85% of the companies have a non-innovative character, 3% are strategic innovators, 8% are intermittent innovators, 4% adopt new technologies and only 2% implement new technologies. We believe that this is mostly due to the problematic managerial capacity. This has determined us to establish one of the objectives of this project: showing the manner in which managers can initiate and develop activities of collaboration, of signing intelligent partnerships and emphasizing their impact on the reduction of regional discrepancies. Within the European economies, there are already examples of partnerships that could represent a model reuniting key both public and private actors, in view of generating the regional economic development. In this regards, we mention Strathclyde European Partnership.

2. Regional development strategies

The issue of disparities in the regional economic growth represents a reference element, which arouses lively discussions both regarding the field of conceptual-methodological approach and in that of implications on the economical-social practice. The existence of an inequality in the economic development of different countries or within the same country, between its different regions, represents an accepted reality, largely explained and partially remedied. The regions vary regarding their dependency towards the external market and their competitive goods, so that those who are in a strong market position can be much more selective regarding the types of development to choose while the others from the opposite pole can feel forced to reduce or eliminate the general social expenses, compete based on the cheap working force, reduce the environment standards or, in general, to adapt to the multinational capital. From an analysis of the tendencies and orientations, we can mention four types of development strategies (Keating, 2008):

1. *The strategy of bourgeois regionalism* encountered in strong regions from the economic point of view, and focused around a local business elite found in cooperation with the regional governments or agencies. The emphasis is moreover put on the economic competitiveness, on productivity, technology and added value rather than on employments. This is a growth model with high costs, with an important public expense in the field of infrastructure and other development elements such as professional training and education, research and technology transfer;

2. *The sweatshop economy,* a way towards competitiveness that supposes reduced costs and functions based on small salaries and taxes. The region accepts moreover its role in the global distribution of work rather than actively trying to create jobs. Such a strategy can produce benefits on the short term for the internal investments and for employment, but always risks to be outrun while other regions in the world come into competition. Its viability on the long term is also under the question mark, since it attracts social investments (in infrastructure, education and public services) without reinvesting in the future;
3. *The social-democrat project,* another model where there is a high public investment in development, but those elements that simultaneously increase social equality or access to the labour market are considered the priority;
4. *The project of creating a nation*, found in regions with aspirations to national autonomy or even independence. Here, independence is seen both as valuable for itself, and as a necessary component in the process of creating a nation as an action system and actor in the new Europe.

According to regional specificity, we can apply one of these strategies, which will certainly generate different levels of development and peripherality.

According to the neoclassical model, which emphasizes the offer's role, regional growth leads to convergence in the economic-social development of the regions, while in the vision of models based on post-Keynesian approaches of demand (model based on the export potential, cumulative causes model), the regional growth emphasizes divergence. Nevertheless, the relatively recent researches in the field have proposed not to consider these visions as being totally opposite, but to approach them from their possible complementarily angle, in such manner as to offer explanations as comprehensive as possible regarding the causes lying at the foundation of the different rates of economic growth at the regional level.

We mention that there is no universal model to follow as regards development but only alternative models specific to each institution, given by the historical time, geographical space and state of things from different countries, the conditions appropriate to a subsequent ascension. The change must be switched to the formula of sustainable development and capitalized as support generating modernization. In this sense, focusing the transforming effects on individual is essential (Dinu, 2006, p. 97). The changes can be slower or more sudden, according to the start positions in the transition process.

Referring to this subject, there have been a series of opinions expressed in different studies. Some claim that the experience accumulated in the last years, no matter whether it is analyzed informally or with the help of data, tables and regressions, support the idea according to which the most successful transition economies are those with comprehensive and stabilized reforms. Others emphasize the fact that the role of initial conditions in explaining the growth variations is surprisingly small. The difference between the performance of countries from the Central and Eastern Europe is best explained through the differences of structural reforms than the initial conditions. However, the majority of theses from the specialty literature assert the opinion according to which the initial unfavorable conditions should not become an excuse for the lack of action. First, their negative effects decrease along time. Secondly, the empirical studies suggest, clearly, that these effects can be compensated by a not too fast progress in the direction of reforms. Thirdly, the most important fact is indirect: initial unfavorable conditions result from a less political will and capacity for reform and less reform means less growth. We must remember the fact that the specificity of the institutional change process mainly finds its explanations at the level of informal institutions and their role in consolidating the capitalist system. From that perspective, the change is associated with a high level of uncertainty that results from the disparity of a certain order and the creation of an institutional gap: on the one hand, the institutions in the past are no longer appropriate for the new realities and must disappear, and on the other hand, we do not know too much about the new institutions which must replace them and especially, they do not develop over night. The structure and economic transformation differs from one country to the other. Although there are some common elements between them, we can really understand the unique properties of each one if we make comparisons with other countries (Kornai, 2007, p. 8).

We must mention that although the west European economies have implemented and were aware of the importance of institutions for development, those situated in the centre and East of Europe cannot import their institutional structures since these states are either too weak to act as guarantee of these rights and institutions, or are too rapacious regarding the imposed requirements (Pranab, 2005, p. 512). The facts show us that the developed European economies have been aware of the importance of welfare and protection of institutions, which explains their prosperity and the existence of a solid institutional framework, with high incomes, relatively certain property rights, this determining a diminishing of transaction costs and expropriation cases. In these states, the formal institutions have reduced insecurity, have provided information and have put contracts into application. In exchange, the post-communist European economies have ignored the institutions' roles in development, generating a defective institutional framework, with high transaction costs, uncertain property rights, not clearly imposed laws, barriers in the way of products' entry on the market, corruption and immoral activities, waste of available resources, uncompetitive services, high social costs, subverting property, weakening the enforcement of contracts, decreasing the foreign investors' interest for the business environment. Thus, the poverty heightens and that rod which contaminates with inefficiency is extended.

3. Notes concerning the indicators of regional development

The development disparities between countries or regions can be analyzed from different perspectives from the unemployment or employment rates – indicators relevant to the general welfare, productivity/capita, which measures the relative economic efficiency of regions, to indicators introduced recently in some reports of European Commission and which treats disparities in terms of demographic trends, levels of education of the population, level of investment in research and development, number of patented applications, etc. Although comparisons between these indicators may be useful in establishing trends in national or regional economic development, the major criterion for policy intervention is the regional disparities in terms of revenue and production. Without insisting on numerous indicators that can measure differences for the categories mentioned, we review some alternative instruments that can quantify the notion of *regional development:*

- long time, the main indicator used by the European Commission to establish eligibility for support through regional politics was *GDP per capita calculated on the basis of the exchange rate,* measured both at national and regional levels;
- gradually the standard practice became the use of *GDP per capita calculated on the basis of purchasing power parity* allowing considerable reduction of differences;
- development disparities are reduced, if *the standard purchasing power* is calculated at the regional level. In many states, there are significant variations in what regards the purchasing power between different geographical areas or between cities and rural areas;
- because it was very important to determine whether redistributive efforts of Member States should or not to be taken into account in defining progress in regional policy, a new indicator was introduced:

regional GDP per capita, adjusted by taxes, transfers and other public spending. According to the principle of additionality, the contributions of European funds should not replace national investments, but to supplement and expand them;

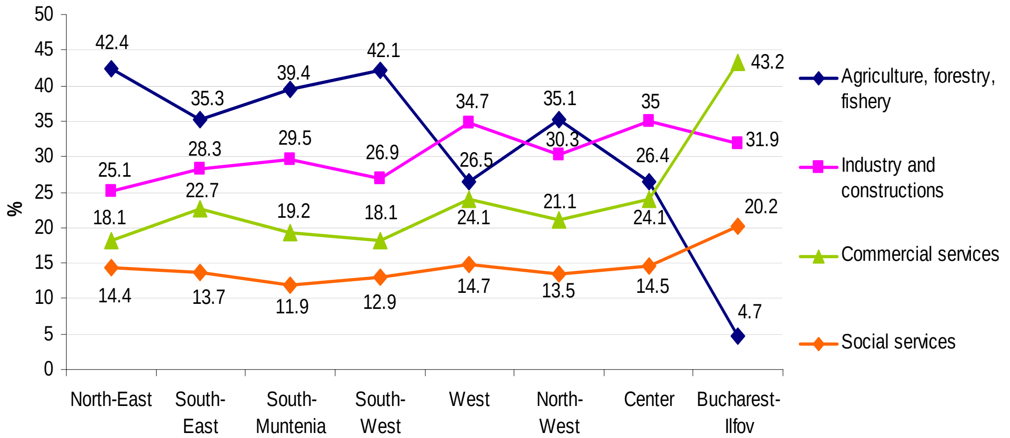
- there are studies that demonstrate the regional distribution of income after the deduction of taxes is more modest than the values recorded for regional GDP disparities. *Disponible income (individual)* is an indicator that, unlike other indicators, includes private capital flows, which may be relevant to less developed regions, where local population is dependent on the support of those who emigrated.

Obviously, indicators we spoke about, whatever the successive attempts of using in a way as accurate and representative as possible in the analysis of regional convergence processes, provides only one image of synthesis, prevailing economic.

4. The analysis of regional development in Romania

In recent decades, emerging countries reduce the disparities compared to developed countries but also the disparities within them grow. It is what Robert Barro and Xavier Sala-i-Martin, in the 90s, have defined as "beta convergence" and "range convergence" (Barro, Sala-i-Martin, 1991).

To highlight the inter-regional differences, we will examine several indicators which reflect the economic situation from Romania. One of them refers to *the share of sectors in total employment* (Figure 2). Of the eight development regions of the country, half are based on agriculture, with its share of overall regional employment between 35% and 42%.



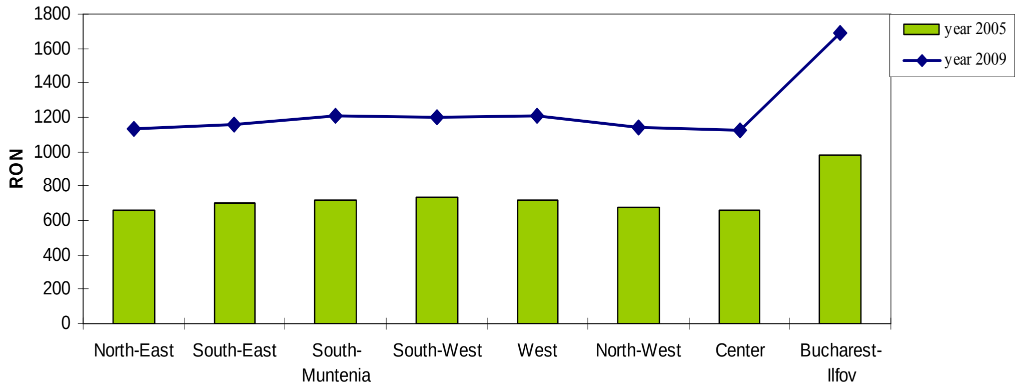
Source: data provided by the National Commission of Prognosis, 2009.

Figure 2. *Share of sectors in total employment (%)*

Industry and constructions have an average of 30% of total employment, the regions that are above this level are Center (35%), West (34.7%), Bucharest (31.9%) and North - West (30.3%). The Bucharest region is the only region of the country where services, which at national level are 38% of total employment, generates the most important jobs, bringing to 43.2% of total employment of the region. The North-East region is the poorest, contributing with 15.2% of total employment in the country, holding, at the same time, the highest participation in employment in agriculture, forestry and fishing (42.4%), followed by industry and construction (25.1%), services (18.1%), social services (14.4%).

We mention that reducing the gap between developed areas and those left behind is a durable phenomenon, as well as reducing disparities between countries because the areas/developed countries advance in time, even if in slower growth rates.

And on *average net wage gain*, the situation is not very pleasant (Figure 3).



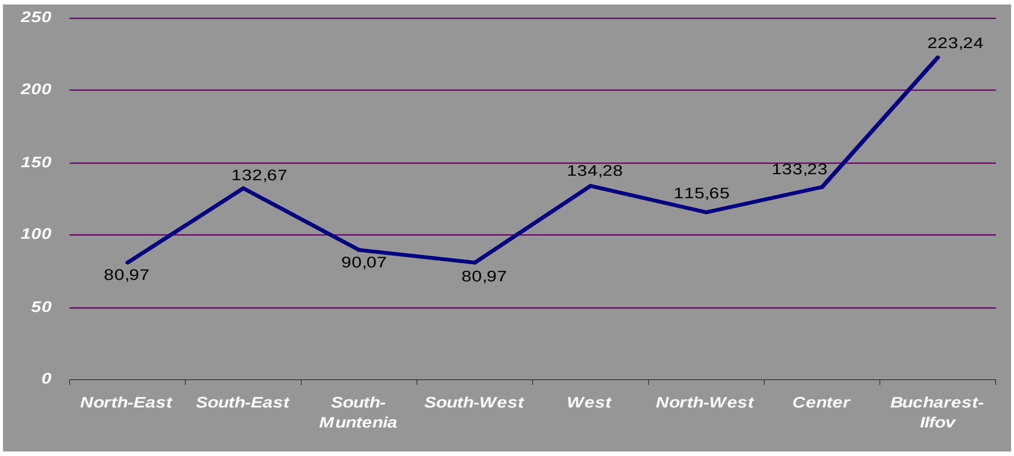
Source: data offered by National Institute of Statistics, 2009.

Figure 3. *Average net wage gain in the development regions of Romania*

Thus, we see that in the Bucharest-Ilfov region, which contributes significantly to national economic growth, the average net wage gain in 2009 is 1,692 RON (402.85 Euro). However, we point out a significant increase from 2005 when it was only 977 RON (232.61 Euro). North-East recorded the lowest earnings in 2005, 663 RON (157.85 Euro) and in 2009, 1,129 RON (268.80 Euro).

Besides all these statistics which places the North-East region on the last place, *The fourth report on economic and social cohesion*, since 2008, confirms that this is part of EU regions with very low GDP, with regions that Ipeiros (Greece), Calabria (Italy), Extremadura (Spain), Burgenland (Austria), Dessau (Germany), Lubelskie (Poland), Severozapaden (Bulgaria) etc.

Also, another important indication of development refers to labor productivity (Figure 4).

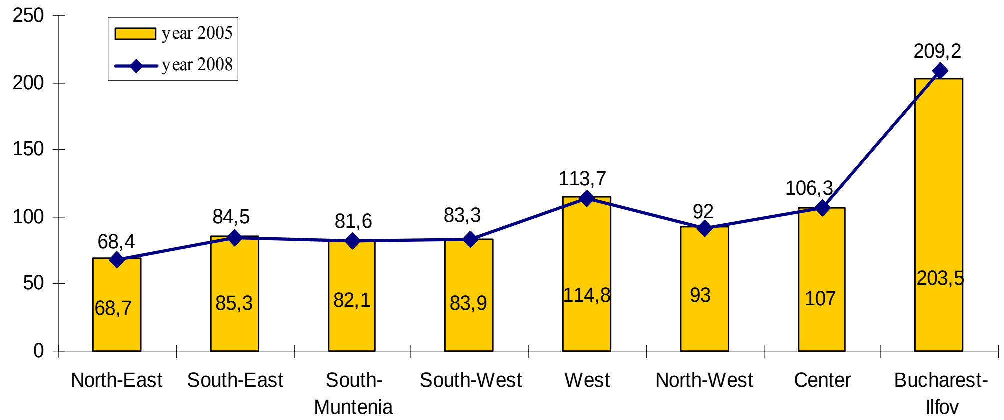


Source: data provided by the National Commission for Prognosis, 2009.

Figure 4. *Labor productivity*

Thus, five of the eight development regions (South-East, West, North-West, Centre and Bucharest-Ilfov) have labor productivity above the national average.

To see how these differences are reflected, in the graphic bellow we represent the disparity of the eight development regions comparing with national average in 2005 and 2008, respectively.



Source: data provided by the National Commission for Prognosis, 2009.

Figure 5. *Disparity index versus total country (national level=100)*

As discussed above concerning the indicators, we see that the North-East region is below to the national average in terms of level of development, with the South-East, South-Muntenia, South-West and the other four regions is above national average.

To see how it reflects the effect of the peripherality of the North-East region and which its economic implications are, we will use statistical analysis, using variables as: GDP/capita, average net wage gain, the unemployment rate.

Thus, the results revealed that, in the year 2008, the Pearson correlation coefficient, which describes the relationship between GDP/capita and average net wage gain, has a value close to 1 (0.862), which shows that between two variables is a direct relationship (Table 1).

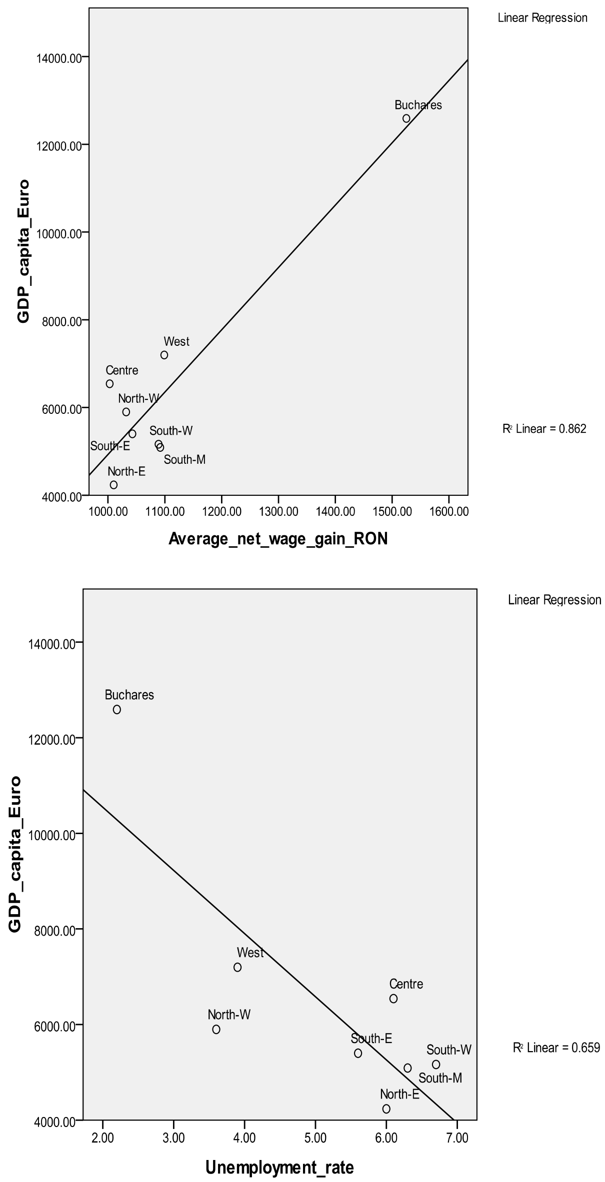
Table 1

Correlation index

		GDP_capita_Euro	Unem-ployment_rate	Average_net_wage_gain_RON
GDP_capita_Euro	Pearson Correlation	1	.659(*)	.862(**)
	Sig. (2-tailed)		.014	.001
	N	8	8	8
Unemployment_rate	Pearson Correlation	.659(*)	1	-.704
	Sig. (2-tailed)	.014		.051
	N	8	8	8
Average_net_wage_gain_RON	Pearson Correlation	.862(**)	-.704	1
	Sig. (2-tailed)	.001	.051	
	N	8	8	8

* Correlation is significant at the 0.05 level (2-tailed).
** Correlation is significant at the 0.01 level (2-tailed).

The diagrams confirm all mentioned above.



Source: Own calculations based on the indicators offered by the National Commission for Prognosis, 2009.

Figure 6. *Correlation diagrams*

Analyzing the two diagrams we find that in 2008 the region that knows the slowest economic development (measured by the indicator GDP per capita) is the North-East. In this region, the average net wage gain is the lowest (1,010 RON) and the unemployment rate is 6%. To the opposite pole is the Bucharest-Ilfov region, with an average net wage gain of 1,525 RON and an unemployment rate of 2.2%.

5. Lines of action to reduce the development gaps

Romanian realities point out that current policies, structures and mechanisms aimed at reducing economic and social disparities among regions are not useful as long as these differences are increasing. The achievement of some cohesion objectives at national level should not be based on increasing disparities but rather on their reduction. Therefore, must be put in place policies and strategies of real convergence in order to ensure a higher growth rate of the less developed regions compared to developed ones. It is the obligation of the authorities and citizens to take actions, through solidarity and responsibility, to take advantage from the opportunity to reduce economic and social disparities and to benefit from multilateral progress promoted by the European Union Member States.

But we consider what can be done to improve the economic situation of North-East region, which is on the last position regarding the degree of development at regional level, as we found in the analysis conducted, aimed the decision makers. In this direction, it is necessary: the provision of the increasing accumulation of detailed information about region (depending on the scale of analysis) for the purpose of diagnosis and forecasts; the need to deepen and update ongoing studies to ensure correct information of the decision factors and based on more current data; rationalize public expenditures, focusing on investment in human capital; more accurate allocation of funds to those who truly need them; strengthen the business environment, transparency of public administration and policies implemented; boosting the rural economy.

Only an institutional and functional transparent, non-bureaucratic regulation framework facilitates the economic development and ensures the accomplishment of exigencies imposed by the integration into the EU. Following the example of western economies, it is necessary that Romania and, in general, the Central and East-European countries understand that the definition, assigning and protection of the property rights represent one of the most complex and difficult problems that they must solve, one way or the other. Moreover, we must adopt a comprehensible and coherent implementation strategy. The institutional development is, before everything, a social transformation exercise and, as a result, needs a systematic support. Therefore, a coherent and solid institutional construction is that of responding to a certain reality in which the institutions interact, support and complete each other, the property rights are clearly defined, correctly and efficiently applied, the citizens are able to get information about the way they can begin and extend a business, there is a high quality of infrastructure necessary to a democratic system based on the market, the emphasis is placed on property and contract protection, the private investments are supported, mentalities are changed. Moreover, in a moment when Europe confronts with the globalization challenges, the bottom-up concept – based on identifying the problems and some concrete modalities for solutions offered by the local actors – must also be identified in the process of formulating the regional politics at the community level, with the purpose of not attaining an artificial construction, with objectives declared at the declarative level, which are not feasible because, on the one hand, they do not take into account the potential or the specificities of the regions aimed at, and on the other hand the regions do not assimilate them. The politics aiming at regional development cannot be taken from the shelf and universally applied for all the types of regions since in the centre of economic success there is a set of common elements (for example, rationality, profit maximizing, free market etc.). We must know to attract both the hard benefits, resulted from more efficient business transactions, more profitable investments, reduced expenses, which generate profit and jobs and soft benefits, obtained by accumulating knowledge, innovation. If we are indifferent regarding our capacity to create economy based on innovation, which is supported by institutions adequately, it is obvious that we will lose the potential growth poles.

6. Final remarks

We conclude that the regional development must adapt in the future to two types of challenges, both pressing, and which require immediate action: 1) it must face the competition pressures that EU is confronting with on the world plan and which were concretized in reactions of the Lisbon Strategy type or Europe 2020 Strategy and 2) it must answer the challenges regarding the achievement of convergence between the member states and the EU regions, especially through formal institutions. Therefore, adapting the regional development politics to these two challenges practically supposes a synergic action through concrete measures at the level of two pillars, which must be approached distinctively, not together, as it happened until now: outlining some strategic directions through measures aiming at achieving a real convergence, diminishing the development potential differences between the regions. Also it is necessary to shape a clear framework which to provide support and a precise direction of action that a free market, especially the private firms and decision makers to follow in order to obtain competitive advantages.

According to "The National Strategy for Sustainable Development of Romania", the main objective pursued at national level and desired to be achieved by 2013 is that "to support economic and social development of regions, in correspondence with their needs and resources, focusing on urban growth poles; improving the infrastructure and the business environment to make from the regions, particularly those lagging behind, more attractive places to live, to visit, invest and work".

Starting from the premise that things not should remain as they are and that we deserve what we do, we consider that both Romania and other European countries will find their place in economic, political, social, depending on the efforts which they submitted and on the implemented strategies for proper management of existing resources, based on an effective economic policy, contributing to reducing the competitiveness disparities. We believe that the way in which the competitive authorities will know how to implement the best measures, adapted to national specificities, will make the difference between the states. History demonstrates this fully.

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