

ROMANIAN ECONOMIC AND BUSINESS REVIEW

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ROMANIAN ECONOMIC AND BUSINESS REVIEW

JUNE 2006

VOLUME 1

NUMBER 1

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PUBLISHED BY THE SCIENTIFIC RESEARCH DEPARTMENT OF THE
ROMANIAN AMERICAN UNIVERSITY

ISSN 1842 – 2497

ROMANIAN ECONOMIC AND BUSINESS REVIEW

CONTENTS

FLORIN BONCIU European Union and the challenges of globalization	7
ANDRAS INOTAI Towards the new Europe: some reflections about the consequences of “eastern” enlargement(S)	14
GEORGE IONESCU The enlargement of European Union and the Romanian capital market	25
MARCEL MOLDOVEANU Reflections on European Union's opening process to the regional and global scale	30
SORINA COSTACHE ADRIANA POPESCU Will the anti-globalization movement save us from the globalization demon?.....	33
BOGDAN GLĂVAN Coordination, clusters and competition	39
ANTHONY J. EVANS The spread of economic theology: the flat tax in Romania	47
COSMIN NEGRICEA The challenges of the world economy cohesion factor – the Internet: world reorganization, vulnerabilities, discrepancies and power discernment	59
OLIVIA ȘTEFĂNESCU The romanian reform of education – moments of the post-communist transition.....	67
COSMIN MARINESCU On significance of transaction costs in institutional economics	75

EUROPEAN UNION AND THE CHALLENGES OF GLOBALIZATION

*Florin Bonciu**

Good news and not so good news: EU in search of itself

One may say that the European Union is a success story: it is growing and in 2004 it witnessed the most significant enlargement in its history up to now – 10 new countries have become members; two other new countries – Romania and Bulgaria – are ready to join the Union and they will most probably access the community by January 1, 2007; after some difficulties, during the autumn of 2005, the accession negotiation with Turkey has started. At the same time, in many booklets and in the articles of some hasty journalists the European Union is presented as the largest economic block in the world as result of an arithmetic operation of adding the surface, the size of population and the GDP of the member countries. Despite the hardships encountered by the Constitutional Treaty, many people speak about a European Constitution and about political union as things that already exist or are anyway well within reach.

Beyond these positive and encouraging facts the European Union seems to be confronted with a weakness with no self-evident cause, with an erosion of its future position: quite often the future seems to be a menace for the European Union. Some examples may substantiate this statement. Thus, the much debated Lisbon Agenda which boasted with pride at the beginning of 2000 that by the end of the decade the European Union will become the most competitive area in the world has proven to be a failure with no hope of redress – the economic growth is very low or even close to zero in the main economies like France, Germany or Italy; the unemployment reached in 2005 19 million and during the time span of a decade the ratio employed/retired will drop from 4 to 1 to only 2 to 1; demography is also a difficult problem to solve and determines for the European Union social and financial problems which can only deepen in the years and decades to come; from a technological point of view the European Union is lagging behind USA and Japan; so far as consumer goods are concerned the competition from China and more recently India, as well as from some other countries seems to be without solution and raise again the specter of protectionism in the world trade arena.

The two aspects mentioned above lead to the idea that at present the mood of the European Union is characterized by dualism and the balance seems to be condemned to instability in the long run. The cause responsible for this situation is globalization which substantially changes the rules of the game: in a nutshell, in the globalized context the new technologies enable that everything can be produced everywhere and everybody can compete with everybody. For the moment, EU seems ill prepared to live with this reality.

In fact, in the globalized economy EU seems to be sandwiched: the lower layer is represented by countries like China, India and other emerging economies which can not be competed in case of standard consumer goods; the upper layer is represented by USA,

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Japan and other innovative competitors which are well ahead EU in case of high technology products and services.

EU, globalization and protectionism

As result of this situation the old world hierarchies were destroyed and some examples can be suggestive:

- in the past 20 years the Chinese economy has grown every year by an average of 9 % and the Indian economy by 6 %. The European Union massively exports on these markets but the imports increase faster. The economies of the European Union which rely more on services are less affected than the ones which rely on industrial activities.¹

- after 1992 the world trade has increased in annual rhythms of more than 8 % and it witnessed the emergence of new trade giants. Thus, 20 years ago only 10 % of the manufactured goods were made in developing countries. Much different from this situation, in 2020 only China and India will make 50 % of the manufactured goods of the world. In 2004 the weight of China in world trade with manufactured goods exceeded that of Japan. Other data of interest: the annual shoes production of the European Union with 25 member countries is produced by China in 6 days; in 2010 the funds allocated to research in China will exceed those of the EU under the circumstances in which in the past years the research investments of China grew by 20 % every year. At the same time the Indian universities produce about 250 thousand engineers every year.

All these global developments have determined in the EU-15 numerous fears and generated sometimes a rejection reaction or a tendency of isolation. In the EU – 15 the reactions were directed towards all potential competitors, even against member countries. Under stress companies and politicians have had the tendency to look back to the nation state as a sort of shelter of last resort. Some examples are again of help: in 2005 France and Denmark have rejected by referendum the project of the Constitutional Treaty because that seemed to open even more the national entities within EU and place decision levers more outside nation states; also in 2005 France and Germany rejected the plans for liberalization of the services for fear of an invasion from the low wage workers from Central and Eastern Europe; the representatives of the textile industries from France, Spain and Italy have requested with ardor the re-instatement of the textile quotas for the imports from China, when a decade ago the representatives of the developed countries envisaged the elimination of these quotas by January 1, 2005.

More interesting and even more worrisome, France has started to take position even against the free movement of capital by rejecting the possibility that PepsiCo could take over Danone and by announcing an unimaginable thing – the preparation of a list of 10 strategic sectors which they intend to protect against the possibility of acquisition by foreign investors.²

During the spring of 2006 this protectionist attitude emerged also in the field of energy. And this time the reaction of some Western European countries was against the

¹ Liam Halligan, "The UK failed the globalization challenge", The Telegraph, 12 September 2005.

² Graham Bowley, News Analysis: Globalization drives a wedge into EU, International Herald Tribune, 23 October, 2005.

intention of Russian companies to take over energy companies in EU countries. But this time, the negotiation EU position is not so strong because Western countries do need Russian energy. And Russians do have other options for selling their energy to big consumers like China or USA. This situation makes again EU countries learn about globalization the hard way.

Can EU change its paradigm?

Such reactions like those mentioned above do not have to be over-estimated. The European Union has anyway a number of ace cards which can be used in order to respond to the challenges of globalization: the existence of the economic and monetary union, the new approaches resulting from the reform of the Lisbon Agenda, the existence of the largest trade block in the world. These ace cards cannot be transformed into real advantages but by a concerted action from the part of all member countries. And also by a much more pragmatic approach than up to now in the design and implementation of EU policies.

The main problem is for all practical purposes a change of paradigm. The combination of free trade regime within Europe and protectionism in relation with the rest of the world has worked successfully as long as Europe could dictate the terms of trade. In the current stage of globalization this combination could no longer work. The interests of the European Union prevents the further application of this paradigm. If we only refer to the experience of 2005, what would be the sense for the European Union to block the textile imports from China worth 100 million Euro when it receives from China orders for Airbus planes for about 3 billion Euro ?

The problems of the European Union does not refer in any way to putting into question its existence. It is rather a problem which refers to direction, purpose, sense¹. Questions like this are asked: Which is the sense of the European project ? Where is the European Union heading to ? Which is the current role of the European Union ?

Another thing which is clearly needed by the European Union is a better communication with the citizens of the member countries. The main message to be sent across would be that: „ Globalization is not something that China imposes on us but something created by us. People must be informed that globalization is our policy.”² The need to improve the communication with citizens results also from the fact that if 20 years ago about two thirds of citizens agreed on their country membership to the EU, in 2005 this percentage was of only 50 %.

The paradigm of history as a continuous improvement has to be changed. The paradigm of a future which is not necessarily better but which is necessarily different has to be presented to all EU citizens, young or old. But who has the courage to tell the EU – 15 citizens this truth ?

In order to respond to these challenges the leaders of the EU member countries have met at Hampton Court in October 2005 for debating the hottest problem of the moment: how to maintain what was achieved in 60 years, starting 1945, against the challenges such

¹ Douglas Alexander, Europe in a Global Age, The Foreign Policy Centre 49 Chalton Street London NW1 1HY United Kingdom, 2005.

² Gunter Verheugen, vice president of the European Commission, June 2005

as the growing competition from the part of China and India, the increase of energy prices and the increase of the age of European population¹.

The analysis of the historical evolution of European countries and of the European Union itself indicates a number of characteristics which requires specific solutions for Europe. The European model by which we mean the elements common for all European countries is a model based on the social market economy. The public sector is much more present in Europe than in the USA or in Asia and this fact is accompanied by a tradition of three party dialogue including government, patronates and trade unions. It is clear that European solutions cannot be found outside this frame of reference.

The problems facing EU in the context of globalization are structural and they are mainly the following²:

- low levels of employment and persistent high levels of unemployment;
- weaknesses of the education and research system. It is estimated that two thirds of the differences in the living standards between the USA and the EU are due to differences in productivity. In this context France proposed to the European Investment Bank to provide 10 billion Euro until 2013 for research and innovation projects³;
- the barriers for entering and exiting the labor market are too high compared to the situation in other parts of the globe;
- the gaps between the rich and poor is considerable both within member countries and among these countries.

If the aspects mentioned above refer mostly to the internal causes of the difficulties in competitiveness of the European Union, there are also other causes which are outside the Union:

- the globalization of the financial markets and the increase of the volume of foreign direct investment flows. These developments allowed for the rapid economic growth of other areas of the globe which became strong competitors;
- the opening of the markets and the communication technologies favored the economic growth in new areas of the globe;
- the differences in the labor costs favored the development of the countries with low costs. From this point of view the European Union cannot compete but by increase of productivity and stimulation of innovation;
- the increase of the world demand for energy correlated with a rigid offer raise problems in the long run. In 25 years the European Union will import 90 % of its energy needs. This fact will require more efforts for the increase of energy efficiency and for the development of new energy sources. The European Union should, among other measures, to secure a coordination of its policies in the field of energy given the fact that up to now many major actions, such as the relations in the field of energy with the Russian

¹ Timothy Garton Ash, Europe needs 'experimental lab' for success, The Asahi Shimbun, 11/09/2005.

² Commission Of The European Communities, European values in the globalised world, Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions, COM(2005) 525 final, Brussels, 20.10.2005

³ Radio Free Europe, EU: Bloc Tackles Thorny Issue Of Globalization Thursday, 27 October 2005.

Federation, has taken place at a bilateral level with the participation of France, Germany, Italy or Great Britain.

The need for a long term, large scale partnership in Europe

The dimension of the problems mentioned above due to their global sphere of content and due to the fact that they will persist for many decades to come require large scale solutions which will imply at the same time the institutions of the European Union, the governments and the European citizens.

At an individual level these solutions will imply a new attitude towards labor, and at the level of social systems these will have to imply of a new attitude towards people.

In order to face the challenges of globalization the European Union will have to finalize what it already began and to add new dimensions of its programmes:

- EU will have to complete the single market with the dimensions regarding services, telecommunications, energy, financial services;
- EU will have to further liberalize its markets and to secure the observance of competition rules;
- EU will have to encourage the entrepreneurs and the companies by means of flexible and dynamic market rules;
- EU will have to improve the quality of business environment;
- EU will have to advocate for the opening of other markets for products made in the EU;
- EU will have to improve the European economic governance and the coordination of the social and economic policies.

Beyond all these options the European Union will have probably to give up some of its extravagances which now erode its position in the global competition. Examples are easy to be found: the European Parliament keeps commuting between two buildings in Brussels and Strasbourg at an annual cost of 200 million Euro. It is not surprising that there were proposals that envisaged the re-allocation of the modern buildings in Strasbourg and the amounts related to this commuting for the scientific research, an area where the European Union has many things to recover. To make things worse, in April 2006 it was just revealed that the European taxpayers paid for many years more than 2 million Euro per year in excess than normal renting rates for the European Parliament premises.

EU, globalization and enlargement: can EU manage diversity ?

Because globalization is an all pervasive phenomenon, it can be also found in the EU enlargement towards Central and Eastern Europe. From an economic point of view enlargement can be seen as a solution for improving the chances of EU in the global competition. For one thing, the enlargement helps Western Europe companies to lower costs. For another, enlargement brings to the same Western European countries markets and economies of scale.

It is very simple to look at the trade balances with the EU of all Central and Eastern European countries after 1990 to see that the old trade theories are still valid: if countries with different levels of development are doing trade, the more developed ones record

excedents just because the prices of goods and services with higher value added grow faster than prices of goods and services with lower value added. In this context the EU15 exports to new member states have risen from 56% in 1993 to 62% in 2005 while imports from new member states have risen by from 5% to 13% in the same period.

The European Commission said at the beginning of May 2006 in a report on the economic impact of the Union's biggest expansion ever that the EU's 2004 enlargement has proven an "economic success" for both the new and the old member states.

The report stated that this enlargement of the EU acted as a catalyst for economic dynamism and modernisation, helping all 25 countries face the challenges of globalisation. In the words of EU Economic and Monetary Affairs Commissioner Joaquin Almunia: "The re-unification of Europe is not only a huge political achievement it is also an economic success,". "We all win as the citizens in the new member states see their standards of living increasing. We win because companies in the EU take advantage of new business opportunities, become more efficient and, therefore, more competitive on the world scene. The enlargement is helping the EU cope better with the new world economic order."¹

Despite these positive things that stimulated and supported the enlargement towards Central and Eastern Europe, EU is confronted with some problems due to enlargement. And these problems are just smaller scale versions of the problems determined by globalization. The most important one is diversity. Diversity has been present from the very beginning: the six founding countries were not identical. But they were indeed similar. The enlargement of 2004 brought with it an unprecedented diversity: levels of development, culture, history, the centrally planned economy experience, to mention just some of them. The forthcoming enlargement of 2007 with Romania and Bulgaria will only amplify this diversity. And then the Western Balkans will continue to amplify diversity.

For the moment EU has no operational concept for dealing with that diversity. In recent times EU has been compared with a "voluntary empire", meaning by that an empire in which new countries and territories are added because they want to, not because they are compelled to. In our opinion this name has a lot of truth in it, but it needs and adequate system of institutions and rules in order to become functional.

An example will be useful: in 2006 Romania has had a GDP level of about 30 % of EU-25 average. At such a level Romania is a developing country which needs development policies specific for a developing country. But for the moment there is no Directorate General for developing countries in Brussels and the adoption of the *acquis* in the sense of overall implementation of the same rules in Germany and in Romania might, just might, be as efficient as the IMF standard recommendations for Latin American countries.

¹ Commission says 2004 EU enlargement an "economic success", EurActiv - 04/05/06; EUROPA, AFP, AFX, AP, EUobserver, EUpolitix, Finfacts - 03/05/06.

Towards an EU with variable geometry?

Is there a solution for that ? In our opinion that solution would be accepting and managing diversity. This is easier said than done but from a logical perspective this management of diversity would imply an EU with variable geometry. That would imply a core zone of common rules and institutions including areas like trade, capital flows, labor, partially environment.

Beyond that area of common denominator rules and institutions would be just a dynamic world of associations of those member countries willing and able. Such an approach is not a setback from the present state of play in the EU. It does not mean in any way that EU is disintegrating. It just mean that those countries (or even regions) with common interests and levels of development can move forward faster implementing solutions adequate to their situation. If others find those solutions useful for them at a later stage they can join also. If some of the initial members of a group of further integration decide at a certain point in time to step back they would be able to do so according to certain procedures. And all could be done having a permanent set of common denominator rules and institutions that are permanently maintained. In time, this set of common denominator rules and institutions can be enlarged according to the new realities of every period.

Such an approach would be based on the idea that in the EU of today and tomorrow diversity will be the rule and not the exception. This approach would try to capitalize diversity instead of regarding it as an exception. Countries in the new EU do have different levels of development, different social patterns, different values based on different historical experience. The new idea proposed here is not to regard this situation as an obstacle to further EU integration, but rather to determine a new approach to EU integration. European countries can do a lot of things together accepting they are different and using their differences instead of trying to be as similar as possible.

TOWARDS THE NEW EUROPE: SOME REFLECTIONS ABOUT THE CONSEQUENCES OF “EASTERN” ENLARGEMENT(S)

Andras Inotai*

For several reasons, the "Eastern" enlargement of the European Union can be considered unique. However, the most important factors of this enlargement process are not just those that have generally been emphasized in the "old" member countries and that, unfortunately and absolutely unjustified, in the last period, happened to become part of the populist arguments put forward not only by smaller status-quo-oriented groups but by "responsible" politicians of several EU countries alike. This paper tries to identify some of the strategic changes Europe in general, and the European integration in particular, has to face not only as a result of the ongoing enlargement process but, more importantly, as participant and active player in the globalizing economy.

1. Introductory remarks

The fifth enlargement of the EU (not considering the German unification as a special form of enlargement) is embedded into a different framework as compared to the environment of previous enlargements.

First, global economic conditions have dramatically changed. The centre of world economic growth shifted from Europe and the transatlantic area to the Pacific Rim and, more obviously, to China and India. Most production factors encounter less barriers than earlier (trade, services), and international capital is moving almost absolutely free around the world. For economic, social, psychological and administrative reasons, labour only faces substantial hindrances so that it is mainly capital that goes to labour and not the reverse. This process is not restricted to Europe but, much more importantly, has a global character. Whenever we try to assess the benefits and costs of enlargement, this element has to be seriously considered.

Second, the European integration needs a number of internal reforms on the community level. Most of them have become overdue in the last years, irrespective of the "Eastern" enlargement (common agricultural policy, British rebate, new community budget, institutional changes). Moreover, the deepening of the integration requires the definition and implementation of new community policies, mainly in the field of foreign and security policy, justice and home affairs, or the community-level regulations of parts of the internal market (financial services, transportation, energy, *etc*). One should not forget that all previous enlargements have been organically linked to an ongoing process of deepening that started well before the enlargement took place. Britain, Ireland and Denmark joined at the moment where the implementation of the common trade policy reached its last stage. The accession of Spain and Portugal coincided with the starting of the ambitious programme of creating the internal market. Finally, Austria, Finland and

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Sweden entered when the timeframe of implementing the economic and monetary union and creating the new common currency was already accepted. In this comparison, the "Eastern" enlargement is not accompanied by any large-scale programme of deepening (the constitution, irrespective of its acceptance or rejection in the different member countries, cannot be considered as such). To be sure, the enlargement in general, and the new member countries in particular, cannot be blamed for this missing link. This should have been created by the EU-15 in the years following the unprecedented transformation of the military, political, economic and social map of Europe following 1989. Concerning the new members, they are expected to generate this development and make Europe fit for challenges deriving from the global environment and from the internal dynamism of integration.

Third, a number of economic and social reforms are badly needed in several member countries. Unlike in periods of previous enlargements, the core economies of the EU, namely those of Germany and France (but also of Italy), became the sick members of the integration. While the geographic periphery of the integration generally reveals normal or high growth rates, rapid structural change, more and more signs of the information society, the large countries of the EU are hardly growing. Not only for themselves, but for the future of Europe, they would need bold reforms, a new social mentality and a renewed responsibility for the continent. Unfortunately, this is not or only very slowly happening. Instead of taking the enlargement as a unique opportunity, many politicians, and, unhappily, a large part of the society as well, consider the "Eastern" enlargement as a risk factor. In addition, the domestic problems of France and Germany have paralyzed their cooperation in deepening the process of integration. Just the opposite, if there is any cooperation it aims at keeping the status quo instead of formulating future-oriented strategies for Europe. It is another question that the Franco-German alliance, a product of history, cannot serve as a model and a driving force in the enlarged European Union. Even if both countries were economically healthy and dynamic, a Europe of 25+ has to be organized in a different framework, with the active contribution of the new member states.

The current paper does not deal with the experiences of the new member countries in the first year of membership, however important and interesting some of them might be. Our attention is focused on the fundamental changes produced (and partly to be produced) by the last enlargement (wave) that are expected to create a new Europe. Whether this Europe will be more or less competitive on the global scale, and, whether the new Europe will move towards a more federal structure or intergovernmental patterns remain dominating, cannot be told at the moment. One can only hope that all or most new member countries keep on being interested in a globally competitive, strong and cohesive (solidarian) Europe based on institutions and decision-making processes characterized by the growing weight of federalism.

2. Too many countries

In fact, the European integration has never experienced an enlargement by such a large (and such a heterogeneous) group of countries. Not less importantly for the future, promise has been given to further countries to join in case they fulfil the changing and ever stronger accession criteria. Bulgaria and Romania have completed negotiations,

signed the accession documents and expect membership in 2007. The enlargement program beyond 2007 is not linked to any fixed date, but negotiations may start soon with some Western Balkan countries (the starting of talks with Croatia was already postponed) with potential membership between 2010 and 2015. Moreover, official negotiations are scheduled to start with Turkey in October 2005.

Looking back from the anticipated date of 2015, the process of "Eastern" enlargement comprises a period of 25 years. Three basic elements characterize this process. First, in most of the nineties, the EU did not have a clear strategy of enlargement. In contrast to other strategic developments of the integration, as the common trade policy in the seventies, the creation of the single market in the eighties, or the implementation of the economic and monetary union in the nineties, all of which followed a clear timeframe, the enlargement did not evolve according to a strategic plan. Second, all countries wishing to join have undertaken fundamental and, both in economic and in social terms, often costly reforms in order to fulfil the criteria of joining the club. These countries, together with global and European developments, have produced the dynamism that paved the way of enlargement and forced Brussels to enlarge. Third, most of the old member countries delivered political declarations in favour of enlargement but did little, if any, at home to prepare their economies and societies for the challenges and chances of an enlarged/enlarging Europe. Just the opposite, all of them exploited the possibilities provided by the transformation and uniquely rapid liberalization of Central, Eastern and Southeastern Europe in order to further finance their status quo and delay partly painful changes at home.

In case of a clear enlargement strategy, the "big-bang" enlargement could have been easily avoided, most probably with the same number of members by 2004 as it really happened. Some transforming countries have been in favour of small group enlargements, based on their development (EU maturity) level and considering the absorption capacity of the EU. From the very beginning of the transformation,¹ it was obvious that the applicant countries had substantial differences both in their economic performance and in their political culture as well as in their social mentality. Disregarding their „flexible" and politics-driven interpretation, the fulfilling of the Copenhagen criteria did not mean by any instance that the candidates, with which negotiations were finished and appropriate documents signed, would have achieved the same level of development and EU maturity. However, narrow-minded political considerations in Brussels and in the key national capitals have regularly swept away such considerations and concerns. As a result, the large-group enlargement could not be avoided - with all of its positive and negative consequences, both for the old and the new members.

The same applies for the next stages of enlargement, for the EU does not have any clear strategy concerning the geographic borders of Europe and the sequencing of further accession. On the one hand, the extension of the zone of stability in Europe and towards the neighbouring region of the EU is of key importance for the continent. On the other hand, however, the internal cohesion of the integration has to be maintained. Otherwise the anchor role of the EU may be seriously questioned or even damaged. Moreover, some countries wishing to join the EU may be forced to introduce domestic reforms, as a precondition of membership that would undermine internal stability. As a result, the balance between the positive impact of importing stability from the EU and creating instability at home may end up in a negative sum game with serious consequences both

for the given applicant country and for the entire integration. This imbalance is already visible in some candidates and would certainly be exacerbated in the case of Turkey, Ukraine or the Caucasian countries - all of them looking for EU membership in the future.

The EU committed *a fundamental error* by not developing a clear plan of enlargement in the early nineties, immediately following the collapse of the divided Europe and the reunification of Germany. The result is the big-bang enlargement that, hopefully, still can be managed and exploited for a future-oriented Europe. The related political decisions have not been taken in the candidate countries but in the "old" EU, both in Brussels, and in the key national capitals. Therefore, none of the new member countries can be blamed for eventual problems resulting from the enlargement. At the same time, it is the common responsibility of the EU-25 to determine a clear enlargement strategy for the next decade and draw the obvious conclusions and lessons from the mistaken approach to enlargement of the last 15 years.

3. Are the new members too poor...?

Based on official figures of the Eurostat, none of the ten new members, let alone those waiting for membership in the next decade, reaches the average GDP per capita level of the EU-15. Still, as most average figures, this indicator is also misleading, thus the new group contains countries on rather different levels of economic and social development. The gap between the richest and poorest new member countries and regions is 1 to 2.6, or higher than among the EU-15 (excepting the figures for Luxembourg). More importantly, some new members are much closer to the poorer old members than to other countries belonging to the group of the ten countries that joined in May 2004. Cyprus, Slovenia, but also the Czech Republic and Hungary are better to be compared with Greece or Portugal than with Latvia or Lithuania (or even Poland). This gap widens even more if we take into account the GDP per capita figures of the two countries that are expected to join in 2007 (Bulgaria and Romania). Excepting Croatia, the accession of the Western Balkan countries and later the potential accession of Turkey would create a completely new map of "richness" and "poverty" in Europe.

It has to be emphasized that GDP per capita figures (even calculated at purchasing power parity), although the relatively best comprehensive indicator, do not necessarily truly reflect the development level of a given country. What really matters is the presence or lack of dynamism behind this figure on the one hand, and the sustainability of the catching-up potential, on the other. Most new member countries have shown a rapid take-off following the first years of transformation characterized by crisis and rapidly declining GDP figures. From the mid-nineties on, the Central European countries started a quick and sustained process of growth, accompanied by the Baltic States after the financial crisis and, most recently, also by Southeastern Europe. Evidently, the starting level was rather different from country to country. Therefore, high growth rates in themselves do not necessarily create immediate positive changes that would be visible and tangible for a large part of the society. However, growth rates two or three times higher than in the EU-15 have already initiated a catching-up process that can be proved by statistical figures as well. For instance, Hungary stood at about 45 per cent of the EU-15 average of GDP per capita in 1995. In turn, a decade later, its comparable figure was

about 55 per cent of the EU-15 and slightly above *GO* per cent of the EU-25. Similarly, Slovenia has reached the Greek-Portuguese level already at the moment of membership. Still, a warning should not be neglected. For simple mathematic reasons, the initial level from which higher growth starts may substantially influence the speed and nature of the catching-up process. Average growth rates twice the EU-15 average are able to reduce the GDP per capita gap if the starting level of the given country is higher than 50 per cent of the EU-15 average (see Slovenia, the Czech Republic, Hungary). However, a higher growth rate differential (sometimes three to four times the EU-15 average) would be required for countries starting high growth at 30 to 45 per cent of the EU-15 average in order to start reducing the "development gap". Positive examples have already been delivered by the Baltic countries, but also by Bulgaria and Romania. The real question remains the sustainability of the process, since the catching-up process is likely to be rather long (even to 50 per cent of the- EU average, let alone to the "magic" 75 per cent under which, according to the current rules of the game, regions are considered to obtain automatic financial support from the community budget).

Another important factor of the catching-up process is the continuous appreciation of the national currencies *vis-a-vis* the euro. Most currencies of the region (the Polish zloty, the *Czech* and Slovak crown, and even more, the Hungarian forint) were constantly exposed to an external pressure of appreciation. As a result, their growth rate expressed in euro was even more impressive and could substantially reduce the "development gap" between the old and the new member countries. The basic question for the future is to what extent and under what kind of economic policy mixture can this process be sustained without negative impacts on the rapidly increasing competitiveness of the new member countries. This is a particularly interesting issue for those countries that have already joined the exchange rate mechanism of the monetary union and want to introduce the euro in 2007 or 2008. In addition, the same problem has to be faced by future member countries that had introduced either a currency board (Bulgaria) or fixed to or partly replaced their national currency by the euro (Montenegro, Bosnia).

Finally, the impact of EU resources has to be considered when comparing GDP per capita figures. Until the end of 2006, the new member countries receive a fraction of the financial resources that old member countries gain from the community budget. While some old net beneficiaries used to have access to EU funds in the amount of 2 to 4 per cent of their GDP, the money available for the new countries generally remained well below 1 per cent of GDP. Even without taking into account the potential multiplier impact of such resources on the overall economic development, just the sheer size of the transfers explains part of the "gap". In other words, the GDP per capita difference would be even smaller if, from the very beginning of membership, the new members could have relied on the same share of EU transfers as the old member countries did. Thus, taking into account this factor as well, the statistical difference could be reduced by another 1 to 3 percentage points.

4. ...but they are dynamic and competitive economies

In a rapidly changing world and in a new Europe facing global and regional challenges, new factors have to be identified in order to adequately measure the

performance capacity of the EU member states. Among others, the following factors have to be reckoned with.

First, most new member countries have introduced fundamental reforms in the last ten to fifteen years. They liberalized trade, capital flows, large part of services and opened up to the external world in general, and to the EU in particular, at an unprecedented speed. Not less importantly, this process was carried out not only in periods of high growth, but, mainly in the first years, in a deep transformation crisis. In such a situation, most countries, not least the developed EU members, would have immediately resorted to protectionist measures (even in slow growth periods or facing sectorial problems, we can see this practice). In contrast, the new members did not interrupt their opening up, and did not protect their companies that lost most of their external markets as a result of the collapse of the "socialist integration", and also part of the domestic market due to intensive external competition. Maybe, a small part of the economic and social costs could have been saved or better distributed over a longer time period. However, this was probably the price they had to pay for sustainable growth, rapidly increasing competitiveness and the development of locational advantages for international (and domestic) capital.

Second, as a heritage of the previous decades and a basic difference to most other emerging economies, the new member countries linked structural change and opening up to the availability of highly-skilled labour and well-educated societies. In the era of globalization and technological revolution, this asset must not be underestimated. It is not only a potential source of further sustainable development in the new member countries, but also a relevant contribution to the shaping of a more competitive European integration. In this context, the ranking of the new member countries in the framework of the basic goals of the Lisbon agenda is instrumental. The first interim report (prepared by Murray in 2003) on the time-related fulfillment of the Lisbon agenda pointed out that in four out of the eight basic objectives, the average of the best three - at that time candidate - countries of Central and Eastern Europe was nearer to the Lisbon goals than the average of the EU-15 (and not that of the worst performing old members). It is too early to state whether this favourable position can be maintained for the next decade, but, evidently, national economic policies, supported by EU financial resources, should do the best to keep on exploiting this potential.

Third, economic liberalization, higher competition and rapid structural change have substantially enhanced the social and institutional flexibility of the new member countries. It seems to be easier to introduce fundamental reforms in the new Central and Eastern European EU members than in the status-quo-oriented Western European countries. For instance, large-scale pension reforms started in Hungary or in Poland much earlier than in selected old EU member countries. Also, labour markets became more flexible, institutions had to be restructured, and social mentality had to be changed. Obviously, this process was not without losses and also the future contains some uncertainties. Concerning the first, and at least temporarily, institutional break-up led to the weakening of the legislation and the enforcement mechanism, negative selection of professionals (partly due to better opportunities in the private or the international business, partly as a result of mistaken party politics following national elections), and weakened interest implementation in negotiations with multinational companies and international organizations (including negotiations on EU accession). Second, it would be

premature to provide a definitive assessment of the impact of transformation and liberalization, as well as EU accession on the behaviour of the society. Political, economic and socio-cultural developments usually have different time spans, with longer digestion and reaction periods for the latter. The emergence of some negative fallout of the too rapid changes of the last 15 years is not unlike. Therefore, it is extremely important that politicians and experts be prepared to face eventual challenges. Not less important is, however, the positive experience with EU membership just in the first and critical years after accession.

Fourth, at least some of the new members were better prepared for membership than the current net beneficiaries of the EU-15. Although their GDP per capita level may have lagged behind, their opening to international trade and capital flows, the rapid spread of privatization including not only classic manufacturing and service activities but strategic sectors as well (banking and insurance, public utilities) and quick transformation of whole sectors with low level (if any) of adjustment support or subsidies can hardly be compared with the slow process of changes that took place in the Mediterranean countries before and after accession. The list of transitional measures is a clear proof of the different situation. While Greece, Portugal and Spain enjoyed several-years-long transitional periods, even including free trade issues, the documents of the "Eastern" enlargement contain less than 300 such measures, of which part was introduced at the request of the old member countries (transportation, free flow of labour). The difference is even more striking if we take into account that the *acquis communautaire* to be accepted and enforced by the new member countries was about the double of the volume the Mediterranean countries had to take on (let alone the "quality" of the requirements).

Fifth, due to the above mentioned factors, the catching-up process in most of the new member countries started years before accession. In turn, it proved to be a sometimes longer term consequence of membership in the net beneficiaries of the EU-15. For instance, the best performing country, namely Ireland, needed 15 years of membership to start reducing the initial gap in GDP per capita terms. Neither the global challenges nor the dynamism of the European integration allow the new member countries to keep on waiting for several years in order to start the catching-up process. Just the opposite, it is widely expected that membership will accelerate this process within a very short time (otherwise negative impacts deriving from disappointment and "second-class membership" may quickly emerge).

Sixth, trade and capital integration with the EU-15 reached high and in some cases higher levels before accession than that of several of the old member countries. The Central European countries became more "dependent" on their trade with the EU than most old members. Not less importantly, within the EU-25, the Czech Republic, Slovakia and Hungary represent the highest intra-EU export shares (above 80 per cent of total exports each of them). Rapid growth of trade relations and gaining market shares in the EU-15 countries was accompanied by structural upgrading of exports. Today, about two-thirds of Hungarian exports to the EU consist of high- and medium-level technology products. This share reaches 45 to 55 per cent in the exports of the other Central European countries (excepting Poland). International capital originating in the EU-15 has gained strategic positions in most new member countries (unlike in the Mediterranean even today). For various reasons and as a result of fortunate production factor mix, Central Europe became a favourite location of transnational corporations. The transitional

measures imposed on the free flow of labour have further accelerated this process. Restrictions on labour flows have necessarily led to a sustained flow of capital towards the new member countries and created new job opportunities, export facilities and increased competitiveness.

Seventh, the economic geography of the European integration already shows clear signs of important changes. It is not only the higher growth rates, rapid increase of productivity or unique structural change supported by large inflows of foreign capital that have to be observed. The map of European trade relations started to change already a decade ago. As a consequence, in 2003 Germany already imported 10 per cent more commodities from the five Central European countries (Poland, Czech Republic, Slovakia, Hungary, Slovenia) than from France, its main partner. Taking the manufactured goods alone, the difference reached not less than 50 per cent in favour of the new members. This process is developing at a lower speed in international capital flows, however the trend is obvious even in this area. As a result of accession, new dynamic factors are likely to emerge, as trade in services, the enhanced involvement of small- and medium-sized companies into intra-EU trade and capital flows, the emergence of regional multinational firms in the new member countries and the dramatic increase of trade relations among the new members.

Eighth, all new members wanted to enter a competitive, rapidly growing and solidaristic European Union. This expectation was so unanimous and unquestionable that not even the issue was raised during the public debates and the referenda on membership. It was taken for granted that everybody was interested in a Europe that functions as a global player both in the international economy and, increasingly, in world politics. Thus, everybody hoped for a future-oriented integration. Unfortunately, in the last months various factors, partly and wrongly attributed to the enlargement, have strengthened the status-quo behaviour in several old and key member countries. One can only wish that this wave will not last for long and will not catch and capture some of the new members or part of their economic lobbies or public opinion.

5. Changing balance of power in the enlarged Union

One of the biggest and most lasting impacts of the current enlargement is the dramatically changing balance of power in several aspects.

On the one hand, the sheer size of the new EU consisting of 25 members has to be coped with. To be sure, the most important conditions have been elaborated and enforced well before the big-bang enlargement took place. Even without the European Constitution, the integration can keep on functioning in the next years (however, the entry of Bulgaria and Romania would already raise new questions if the institutional framework remains as it is today, *e.g.* the redistribution of seats in the European Parliament). Interestingly, the decision-making process in the enlarged Union did not slow down as a result of 25 members in the last year. Just the opposite, the new members could become involved in EU structures without substantial frictions (but certainly with a lot of new lessons, not all of them favourable). In some instances, as in the European Parliament, their active presence was considered to be a relevant input into the future work of this institution.

On the other hand, the balance between large and small member states, always in the focus of careful consideration of the integration, has been fundamentally changed. As compared with the construction of the EU-15 consisting of 5 large and 10 "small" countries, the enlargement brought into the integration just one large and 9 "small" countries. Therefore, the balance shifted from 5 to 10 to 6 to 19. Further enlargement will definitely add to the number of small countries (being Romania and, much later, Turkey of a different magnitude). In principle, it could support the federative efforts in the enlarged EU, since the small countries generally feel more secure in a federal structure than in an intergovernmental one dominated by some large members.

Moreover, traditional strategic and temporary alliances have to be reconsidered. As already mentioned, the French-German "locomotive of the integration" does not seem to function both due to the new structure of the integration and the new realities in the two key countries of the EU. Britain would certainly play a more important role in the shaping of the future of the EU. However, a free-market approach will hardly satisfy the new and "small" members who want to have a real political community without great-power-domination.

Therefore, a much more flexible structure of alliance (or alliances) can be imagined. The most probable outcome is a formation of one or two large countries cooperating with a larger number of "smaller" countries. This, however, needs a "21st century leadership culture" that could be carried out by one or two large country and accepted and supported by the "smaller" ones. Such a leadership should observe three preconditions. First, no country must be given a leadership position automatically in any area of integration. Second, all issues of enhanced integration have to remain open for accession to any other member country at a later stage. Third, the number of strategic issues of European integration has to remain limited in order to avoid any kind of atomization or fragmentation of the enlarging community.

6. Requirements and consequences of the "geographic cohesion"

The outstanding features of "Eastern" enlargement are geographic location and the implications that boost European growth, development and cohesion policies. Two basic differences can be identified just by looking at the map of enlargement.

First, with the exception of the two islands, none of the new members represents the geographic periphery of Europe. In contrast to all previous and current net beneficiaries (Ireland, Greece, Portugal and Spain), that formed the Northwestern, the Southeastern and the Southwestern geographic periphery of Europe, the eight Central and Northeastern European countries clearly belong to the geographic core of Europe. The same holds for Bulgaria and Romania as well as for the Western Balkan countries, particularly if Turkey, *i.e.* Turkish membership is considered as a future option of enlargement of the European integration. To put it in the clearest form: none of the new members represents the geographic border of Europe, either to the North, to the South, and particularly not to the East; Europe, as a continent continues farther to the East, even if, just in this direction, its geographic borderline is a debated issue between geographers, historians, politicians and social scientists.

Second, all new and future member states have common continental borders. While Ireland is an island, Greece can be considered also as such, since it has no continental

border to any other EU member, and Spain and Portugal can be characterized as countries surrounded mainly by seas, the new (and future) member states share several common continental borders. As a result, the EU's structural and cohesion policy should be fundamentally changed and focused on large cross-border projects aiming at improving the physical infrastructure and the environmental protection of the new and future member countries. All large net beneficiaries of the EU-15 could design and implement national development projects essentially financed from EU resources and should not take into account the needs of neighbouring countries or the development perspectives of larger (cross-border) regions. It is more than interesting that over twenty years it was not a priority of Greece to strengthen cross-border cooperation with the bordering Balkan countries or Turkey. Spanish-Portuguese cooperation experienced a lot of troubles from both sides, deriving from historical rivalry and economic and political differences. It took a more positive way when money available for large transeuropean networks seemed to be jeopardized as a result of the ongoing "Eastern" enlargement.

There are plenty of justified arguments why the EU should establish a new objective in the financial perspective covering the period between 2007 and 2013 that would definitely support the development of Central and Eastern European infrastructure and environmental protection. This objective could be partly financed from the national entitlements of the respective countries, plus from additional EU resources to be rechannelled from the old toward the new beneficiaries of the community budget.

The political importance of such a priority is more than clear not only for the new member countries but for those on the waiting list, for it is an evident expression of keeping the door open to them and to let them benefit from the positive impact of integration well before their accession to the EU.

In addition, this objective would improve the efficiency of the resources to be invested in several ways. First, there is widespread experience that common projects used to be more efficient and less expensive than individual national ones. Second, their multiplier effects could create clusters overarching national borders and develop new growth centres in the enlarged and enlarging Union. Third, and not less importantly, national prestige projects, a general phenomenon of large-scale developments, could be prevented.

The economic importance of a cross-border infrastructure fund within the framework of the new financial perspective can hardly be doubted. As the experience of several new member countries indicates, the development of the physical infrastructure, particularly that of the highway networks has a strong and positive impact on the attitude of foreign (and domestic) capital to choose the most competitive locations for production and service activities. Both in the Czech Republic and Hungary, the map of highways (built and in the process of building) and that of the geographic position of transnational companies show a surprisingly high level of overlapping. The sustainability of economic growth, the catching-up in the new member states and the emergence of new and competitive growth centres in the European integration require not only the West-East extension of the highway (and railway) networks, but, first of all, the creation of appropriate North-South connections linking the Baltic countries with the Balkans through Poland, Slovakia and Hungary.

Last but not least, such an objective could substantially restructure the current pattern of the EU budget and redirect larger amounts of money towards the new and "poorer"

member countries. Considering the changed and further changing economic map of the European integration (new trade and capital networks), this goal could be easily shared by several developed and net contributing member states of the EU. In addition, this seems to be the way how to unlock the stalemate that is accompanying each discussion about the distribution of community-level financial resources.

7. The new neighbourhood of the enlarging EU

Excepting the two Mediterranean islands and the Czech Republic, one or more border sections of all new member countries represent the common external border of the enlarged EU. These borders, however, can be classified in two groups. We call "soft" borders those that are shared between one new member country and another European country with clear or general promise of membership. In turn, "hard" borders are considered those that are shared with another European country without having the promise or perspective of full-fledged membership in the EU. Thus, the borders of the Baltic countries with Russia and Belarus, the Polish borders with Belarus, Russia and the Ukraine, as well as the Slovak-Ukrainian and the Hungarian-Ukrainian borders belong to the "hard border" category. In contrast, the Slovenian border to Croatia or the Hungarian ones to Croatia, Serbia and Romania can be characterized as "soft" borders that, sooner or later, will become internal borders of the enlarging EU.

The changing neighbourhood map of the continent is obviously increasing the importance of the member countries representing the external borders of the EU. On the one hand, and mostly in cooperation with other member states, they are responsible for the internal security of the entire integration. According to the current plans, the Schengen border can *de facto* be shifted to the Eastern (and Southern) borders of the new member countries by 2007. On the other hand, the new member countries have a special task of and interest in developing comprehensive political, economic and civilian contacts with their non-EU neighbours. Borders should not separate but unite Europe, even outside the institutional framework of integration. National minorities living either in the territory of new members (mainly Russians in Estonia and Latvia), in not-yet EU members {*e.g.* Hungarians in Serbia, Romania and Croatia) or on the other side of the "hard borderline" (Poles, Slovaks and Hungarians in the Ukraine) are just one reason for enhanced cross-border cooperation and regional stability. Another and at least as important factor is the dynamic role such a neighbourhood policy is expected to develop in the interest of a competitive Europe. The continent's political and economic position in the unfolding global framework to a large extent depends not only on successful community-level and domestic adjustments but also on the stabilization of its geographic environment and the deepening of cooperation with the new neighbours. In this context, the new member countries will certainly enrich politics, social attitudes and public opinion in all member countries, and on the community level, future-oriented decision-making.

THE ENLARGEMENT OF EUROPEAN UNION AND THE ROMANIAN CAPITAL MARKET

George Ionescu*

I. Introduction

At this relatively early stage in the development of financial markets in the accession countries, it seems more appropriate to refer to the financial sector rather than the capital market, since the latter is not yet very well developed. It is the same problem with the Bucharest Stock Exchange, re-opened after 50 years of socialism, which is totally engaged on fulfilling its mission to serve as an efficient, fair rule-based market which should be attractive and match European standards.

The functional culmination of European Economic and Monetary Union (EMU) came on 1 January 2002, when euro banknotes and coins entered circulation. Now all that remains is the geographical completion of the Monetary Union. The process of enlargement is the most decisive step towards finalizing this as a whole, not forgetting those countries that are already members of the European Union but are outside the euro area.

Enlargement will benefit all the sides involved. Economic integration is not a zero-sum game in which for there to be winners, there have to be losers. As economic theory has shown, surpluses can be generated from economic and financial exchange. Consumers, savers, business people, workers, investors, each and every economic agent can benefit from the accession process. The European Union itself, its institutions and its currency, will emerge stronger as a result of welcoming new Member States, as long as the integration process is handled well and is completed successfully.

It should be made clear from the outset that EU enlargement is a political process. Indeed, it is such a large undertaking that I think it is difficult to grasp its full impact. We lack the necessary time perspective in the same way that we still lack the historical distance needed to understand the full implications of having more than 300 million people using the euro for their accounts and payments.

II. The key areas of monetary and financial integration

In the process of EU monetary and financial integration, there are three key areas: legal/institutional, logistical/technical and economic. Considering the together first two key areas of financial integration, there can be no enlargement of the European Union or the Economic and Monetary Union without the prior legal and institutional convergence that allows the accession countries to adopt the Community acquis and without an appropriate technical supporting system. It is important that the acquis must be applied in the financial sector in general, and to central banking activities in particular, in order to ensure a solid legal context. For its part, the Eurosystem has focused on: the financial

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legislation of the accession countries (especially with regard to the free movement of capital and payments); regulation of the financial markets with regard to the provision of banking, securities and investment services; rules governing eligible assets; and legislation paving the way for an internal financial services market.

At the economic level we can identify four main action areas: the accomplishment of the convergence criteria; exchange rate policy; the instruments and processes of monetary policy; and statistics. Most of these aspects provide the basis for understanding the functioning of capital markets in the accession countries and its interplay with the euro-area capital markets.

The most important economic aspect with regard to acceding Romania's membership of Monetary Union is the accomplishment of the nominal "Maastricht" convergence criteria. As was the case for the 25 current members, this is the economic key to the door. It is important to understand that the accomplishment of the convergence criteria by the acceding countries must be sustainable, as was set out clearly in Article 109J(1) of the Treaty of Maastricht and in Article 1 of Protocol no.6.

III. The impact EU integration for Romanian financial sector

For a better understanding of the impact of EU integration for Romanian financial sector, we have to look at what happened with the ten new joined EU states. At the time of their accession, in May 2004, there was a great diversity between the accession countries, talking about the economic situation also extends to their exchange rate strategies. Between them, the ten states had a wide variety of exchange rate regimes, ranging from independent floating (Poland and the Czech Republic), to currency boards (Estonia and Lithuania), managed floating, informally using the euro as the reference currency (Slovakia and Slovenia), pegging to a basket of currencies with a greater (Malta) or lesser (Latvia) weighting for the euro and, finally, pegging to the euro within fluctuation bands of $\pm 15\%$ (Cyprus and Hungary), a practice reminiscent of that used by the Exchange Rate Mechanism II (ERM II).

Over the last decade, these countries have experienced remarkable transformations in their financial sectors. This was primarily driven by the transition process in Central and Eastern Europe and by the prospect of EU membership. In particular, considerable progress has been made in restructuring and consolidating the banking sector, thanks to the large-scale privatization of state-owned banks, the liberalization of markets and the extensive opening-up of the banking sector to foreign ownership.

In parallel, the accession countries' economies have been fundamentally transformed by the establishment of macroeconomic stability and the privatization of assets. Moreover, structural reforms have been made in many areas, and public institutions have been reformed and improved.

This restructuring process in both the financial sector and the real economy is well advanced and a new phase of financial and economic development is now under way in all the accession countries. EU enlargement and the prospect of the eventual adoption of the euro implies the need for the countries concerned to consolidate economic practices and enforce financial regulations and operational procedures in the euro area. This calls for the further refinement of the concept of a "functioning market economy and the ability to cope with competitive pressures", one of the so-called Copenhagen economic criterion

for EU accession. Actual compliance with this criterion requires the accession countries to further strengthen their financial sectors as the linchpin for balanced and sustainable economic growth.

The traditional role of the financial sector in underpinning investment and realizing growth potential through its intermediation and governance functions is still very limited in most accession countries. For example, with the exception of Cyprus and Malta, which display a ratio comparable with that of the euro area, the level of financial intermediation in central and eastern European countries is relatively low and the provision of bank financing represents a much smaller share of GDP than in the euro area. To give you some figures, bank assets in the euro area amount to about 265% of GDP, whereas the bulk of accession countries' banking systems have asset volumes amounting to between 30% and 100% of GDP. At the mid-year 2004, the level of financial intermediation in Romania was approximately 50%, compared with the 75% in central European countries in the same period. The forecast for the next three years is that financial intermediation will reach 100% of GDP.

Due to the relatively prominent role of the banking industry in accession countries' financial sectors – or the correspondingly limited development of capital markets – the low level of financial intermediation has become an obstacle for credit institutions to channel financial savings into investment.

In some countries, specific features of the corporate sector alleviate this constraint through extensive recourse to the international financing provided by multinationals. By contrast, the role of capital markets as a source of financing is not sufficient to offset the activity of the banking sector. As regards stock markets, the total market capitalization of acceding countries combined stood at around 52% of GDP in the euro area. Turning to bond markets, unlike in the EU, their role has traditionally been limited in terms of accession country financing, mainly as a result of low levels of outstanding government securities. Even though the levels of fiscal deficit have been high in some countries, the average general government debt outstanding at end-2002 amounted to only around 40% of GDP, compared with an average of 70% of GDP in the euro area.

Although the banking industry in accession countries is widely considered as stable and sound, it has its structural weaknesses and inefficiencies – for example, those reflected in the continued high spreads between lending and deposit rates or the relatively large proportion of bad loans in some countries. These weaknesses require that an extra effort be made to consolidate the financial sector and to avoid adverse future implications.

IV. Romanian capital market and European Union membership

Overall, enhancing the efficiency of the financial sector in accession countries is relevant in order to achieve full integration in the euro area's financial sector. Important steps towards this integration have already been taken and are clearly visible. In the banking sector, for example, the strong presence of foreign banks has already had significant implications, accelerating concentration, increasing competition and enhancing efficiency.

However, the adjustments still to be made in order for the financial sector in accession countries to reach euro area standards remain significant. In this context, the

changes occurring in the euro area's financial sectors imply that the accession countries have a moving target to catch up with. Some euro area indicators, such as degrees of efficiency in financial intermediation, are relevant for the accession countries' financial development, while other elements are not necessarily meaningful benchmarks because the euro area is highly heterogeneous and its financial markets are still subject to profound changes.

This means that further integration with the euro area – which will be mainly market-driven – will also need to be supported by considerable action on the part of the authorities. The adoption of the EU's legal framework, a greater integration of the financial infrastructure with that of the euro area and strong cross-border collaboration between supervisors are the main elements of this process.

For example, in the specific case of covered bond legislation, this entered into force in a number of accession countries some years ago, for instance in the Czech Republic (1995), Slovakia (1996), Hungary (1997), Poland and Latvia (both in 1998), Romania (1999) and Bulgaria (2000).

However, the development of this particular segment of the capital market is still at an early stage, reflecting the above discussion on the dominance of the financial system by the banking sector. To illustrate this in figures, at the end of 2002, the outstanding amount of euro-denominated covered bonds was EUR 1,497 billion – around 20% of the total amount of the euro bond market. This compares with roughly EUR 3 billion in accession countries. Moreover, this relatively low volume is concentrated in only two countries, Hungary and the Czech Republic. However, although these differences are significant, they should not be overstressed. In fact, in the rest of Europe, the German covered bond market is by far the dominant one, since it accounts for 73% of the total euro-denominated covered bond. In the light of the substantial differences remaining in the structure of the national European financial systems, we should not prematurely judge the current status of convergence of capital markets in accession countries, particularly at this early stage.

In Romania, the positive performance of the real economy also entailed favorable changes in the financial sectors, the capital market included, which did not go unnoticed by investors, the outcome being a more intense trading in the last few years. There was a combination of factors that exerted a favorable impact on the capital market, such as sustained GDP growth, declining inflation, the appreciation of the national currency and the fall in banking interest rates. It is important to mention the end of the demutualization process of Bucharest Stock Exchange (BSE), with financial intermediaries becoming shareholders of the commercial company Bucharest Stock Exchange SA.

The demutualization of BSE, the merger with the RASDAQ electronic exchange and with the Sibiu Financial Monetary and Commodities Exchange, opens the possibility of creating a powerful exchange in this region. These mergers were planned with a view to creating, which in 2007 to be able to cope with international competition. This development strategy means that BSE has to reposition itself regionally and look equally attractive to Romanian and European investors.

The indices of the Bucharest Stock Exchange posted remarkable growth rates in 2004, this placing the BSE in the category of European stock markets that offered investors the highest returns on their financial placements. In 2004 the BET-C composite index grew by 114.13%. The CESI index of the Central European stock exchanges grew

by 65.40% in 2004, while EUROSTOXX50 grew by 5.49%. Such rises in stock exchange indices occurred against the background of intensified trading, the total value (shares and bonds) traded in 2004 on the Bucharest Stock Exchange standing at EUR 667.81 million. The favorable market tendencies also showed in the greater market capitalization by over 194.84% as expressed in EUR which by end 2004 stood at EUR 8.82 billion.

The same positive evolution of BSE was observed in 2005. The composite index of BSE (BET-C) grew by 46.16%, compared with EUROSTOXX50 which grew only by 20.50%. Total value (shares and bonds) traded on the BSE standing at EUR 2.15 billion, a remarkable 360% growth from the total value traded in 2004, sustained by a market capitalization of EUR 15.3 billion.

V. Conclusions

Looking back to the early years of the BSE, the progress is obvious and substantial. In the context of a comparison to neighboring countries, we will realize that while in 2002 BSE ranked sixth, with a market capitalization of EUR 2.6 billion, in 2004 it ranked fourth with EUR 8.8 billion. At the end of 2005 the market capitalization was over EUR 15 billion, approximately 20% of GDP.

In transition economies, stock market evolution gives very clear signals determining the way investors perceive the economic environment of a country, and also as major signals for economic policymakers. Thus, a stock exchange that holds a good regional position can serve the country's image, especially in view of the European Union membership looming ahead. It is very important for BSE to participate, and become the promoter of a regional virtual market which to serve the important Romanian listed companies as the necessary channel to regional capital in flows without losing the domestic one.

It is essential that Romania create a modern financial market infrastructure. Preparatory work in this field is subject to very long lead times and, therefore, needs to be implemented years before the adoption of the euro. Moreover, the target of this preparatory work is a moving one, and it may be moving faster than other targets. Certain components of the euro area financial infrastructure may need to be dynamically adapted before Romania can be integrated into the euro area.

In any case, development of the financial systems in Romania needs to be consistent with economic convergence. In this respect we can mention the case of fixed-rate bond markets: without convergence of inflation towards euro-area levels, it will be difficult, if at all possible, to promote the bond market. This also applies to the covered bond market in particular. The relevance of such development is based on the fact that the financial sector plays a key role in strengthening and broadening economic growth, as well as fostering stability. In order to promote financial development, without compromising hard-won financial stability, it seems crucial at this stage to complete a number of structural reforms. Moreover, a fully integrated capital market in Europe, including the accession countries, may be considered an aim in itself and an ultimate hard test for a truly successful enlargement.

In conclusion, although a new era of financial development in Romania is now in full swing, the challenges ahead are still considerable. Despite the remarkable progress made in recent years and the ongoing adjustment to euro area standards, the Romanian financial sectors need to undertake further significant changes in the future.

REFLECTIONS ON EUROPEAN UNION'S OPENING PROCESS TO THE REGIONAL AND GLOBAL SCALE

Marcel Moldoveanu*

The opportunity and understanding of the deep philosophy of world evolution at the crossroads of centuries and milleniums, that allows the interpretation of great ideas of universal economic and socio-political thinking on the international relations evolution, undoubtedly implies a vast multidisciplinary activity, mixed efforts in scientific, academic and universitary research.

In the context of deep interdependence between globalization and regionalization, the European Union is objectively determined to promote an offensive strategy, through viable ways of intensification of cooperation with the other geoeconomic and strategic areas of the world: American (from the North-American Free Trade Agreement to Latin America), Asia-Pacific, former Soviet, Africa and Middle East.

In a multipolar world, that will bring into the first line of international relations new big actors of regional and universal vocation (China, Rusia, Brasil, India), the European Union will play an extensive role in participating at the geostrategic, regional and global equilibrium, through promotion of an „open diplomacy" that will allow - by dialogue and cooperation - the resolving more rapidly and efficiently the great challenges of the beginning of the century and millenium: the reduction of the great development gaps, the regional and global security, in a very solid economic background.

I believe that the European Union has also major responsibilities in revitalizing the activity of international organisms and institutions, in giving the United Nations Organization the vocation of universality.

- An objective priority of the European Union is and will be to maintain peace and stability in the Balkans, by an increase of the technical and financial assistance, and by intensification of the collaboration projects in the fields of justice and the adoption of the *acquis communautaire*.

- Through the partnership and cooperation agreements, the European Union grants financial assistance to the members of the Community of Independent (CIS), in order to support the reform and privatisation process, the modernization of the environment infrastructure and the development of the rural economy. The assistance programme takes into consideration the promotion of the bilateral and interregional cooperation, including the disarmament and observing human rights.

Part of the EU's opening strategy towards the former Soviet area is represented by the Partnership and Cooperation Agreements with two economic and strategic powers, Russia and Ukraine.

The democracy, rule of law, the public institutions represent goals as well as exigencies of the European Community towards the new independent states in the perspective of the acceleration of the integration process into the common European economic and social area.

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It should be emphasized the role of the European Union in maintaining peace and security in the Middle East, that, undoubtedly, implies a fair and long lasting solution, on the basis of pertinent resolutions adopted by the United Nations Organization.

The cooperation relations with Africa (in the context of geographic proximity), Asia and Latin America will continue to present, in my opinion, an important component in the foreign policy of the European Union.

The European Union will promote actively the development of economic relations with Asia - region represented by the main economic powers - Japan, China and the „four dragons group" (South Korea, Hong Kong, Taiwan and Singapore) - region that will become a powerful area with sustainable economic growth in the perspective of the years 2010-2020.

The strategic options of the European Union will have to be defined to a greater extent taking into account the architecture of the Asia-Pacific area, that constitutes the greatest world economic cooperation and integration project.

I would like to emphasize, at the same time, the philosophy of the process of rethinking the economic and political-diplomatic strategy of the European Union towards the Mediterranean region, with an opening to the African and the Middle East world. The Euro-Mediterranean Conference in Barcelona (November 1995) introduced a new concept of the Euro-Mediterranean policy, namely The North-South partnership, with mutual rights and obligations: "The Barcelona Declaration" represents, indeed, an outstanding point in defining an Euro-Mediterranean policy, that, in my opinion, must know a pragmatic approach in promoting the economic reforms in the South-Mediterranean region, relaunching the peace process in the Middle East and opening towards the global economy. I believe that achieving regional stability and security will represent the main pillar of the future regional free trade area. The development and modernization of the economies of the South-Mediterranean countries is, nevertheless, influenced by an increased domestic and foreign investment effort. Despite any endogenous or exogenous difficulties, the setting up of the Euro-Mediterranean economic area -through progressive stimulation of industrial cooperation, trade and investment - is in deep connection with the objective process of integration of developing countries in the world economy.

A new dimension of the EU enlargement policy at regional scale is represented by the cooperation relations and the attraction into the European circuit of material and spiritual values of the countries in the Central and Eastern Europe, strategy put into place through the accession, on 1st May 2004, of a number of 10 states, that will be followed, at the beginning of 2007, by Romania and Bulgaria, leading to a European union of 27 and not only. The opening of the European Union towards the Central and Eastern European area reflects the realistic character of the strategy of the European integration process, through the recognition of a common Europe, of the same civilization.

In my opinion, in the context of deepening the interdependence and complementarities at regional and global level, more focus should be put on the viable ways and modalities to intensify the cooperation in the Danube-Black Sea and Euro-Mediterranean geo-economic and strategic areas. The analysis and reflections should be focused on the development of a long and efficient relationship that would evolve from concept to pragmatic approaches, taking into account: the geographic proximity, the cultural-human potential, the trade, investment and technological flows, the necessity to

connect the national entities to the new European and global architecture, the increase of the negotiation power at the interregional level in the international relations field. The two big geo-strategic regions of the world belong to the same civilization and are subject to similar changes as the other regions of the world, despite some specific features of history and culture.

The intensification and diversification of the cooperation at the Central and South-Eastern European level, as well as the Euro-Mediterranean and Danube-Black Sea region, does not represent an alternative to the general objective process of integration into the Euro-Atlantic structures, but a complementarity meant to support the material and human efforts of the participants to the cooperation agreements, to a more rapid development and modernization of the economic-social structures.

It is my belief that, despite some contradictory approaches on the globalization and regional stability processes, only a consolidated cooperation between the European Union and the USA will reorient the world economy towards a sustainable growth.

The Euro-Atlantic unity undoubtedly reflects the new dimensions of the interdependence process between globalization and regionalization and it is compulsory that this should be transformed into viable poles of stability in the world. The consolidation of the Euro-Atlantic unity, on the basis of democratic ideals and a common vision on the world evolution, at the beginning of the millennium, will allow the North-Atlantic Alliance to have a decisive role in the regional and global security process.

Next to the world issues - stated the great Romanian diplomat of universal vocation, Nicolae Titulescu, elected twice President of the Society of Nations -there are the regional issues that form its elements, namely the regional interests of what is called Europe.

WILL THE ANTI-GLOBALIZATION MOVEMENT SAVE US FROM THE GLOBALIZATION DEMON?

Adriana Popescu and Sorina Costache*

Today, anybody is free to protest against anything they please: politics, fashion, the latest movie, education, globalization.... Globalization, a relatively new word in our vocabulary, a word so new that the first versions of Microsoft Word do not even recognise, is a world-wide phenomenon many agree with while some strongly criticize.

Some of these protests end up as quite big social issues, like the demonstrations against the 6th WTO Ministerial Conference in December of 2005, others in blood-baths and mass arrests, as many of us witnessed the “Battle of Seattle”.

In this article we aim to underline some of the major aspects of the anti-globalization movement, a social movement sustained by those who, understanding more or less this so-called new world-order, have chosen to fight against it.

At this very moment, an important question must be answered. What is this anti-globalization movement we are hearing about more and more often these days? One may be inclined to think that it simply stands for all that globalization does not. Or vice-versa. Well, it is not that at all.

First of all, it is vital to distinguish between the anti-globalization activists and those who define themselves as globophobes. Both groups believe that globalization is a phenomenon that causes poverty, social polarization, that aids rich countries in exploiting those less developed ones and which also seriously prejudices the environment. If the last group content themselves with expressing their pessimism concerning the international trade, the anti-globalization activists go to extreme measures in protesting against what they usually refer to as “The Enemy”.

Declared enemy of a global economy, we would expect the anti-globalization movement to stand against all those practices that would transform any phenomenon into a global one. Nonetheless, it is important to mention the fact that the movement itself has become global if we take into account its sympathizers or the extent of the demonstrations. Some members explain this by pointing out that in fighting against a global phenomenon there must exist a global residence which, in this case, is called the anti-globalization movement.

The anti-globalization movement has its precursors in such movements as the 1968 movement in Europe, and especially France, and the world-wide protests against the Vietnam War in the United States during the 1970s. The anti-globalization movement as it is known today stems from the convergence of these different political experiences when their members began to demonstrate together at international meetings such as the G7 summit in Bonn.

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In Germany, mass protests against meetings of the international elite date back to 1985, when the G7 was held in Bonn, West Germany's capital. The forms of protest used there were remarkably similar to those used 15 years later: the radical left organised „action days”, there was a counter-conference, and a big demonstration with 30,000 participants. For the autonomists, however, the campaign against the International Monetary Fund (IMF) and World Bank meeting in West Berlin in September of 1988 was to have far greater meaning. The mobilisation lasted three years and attempted to combine mass militancy with clandestine actions, to formulate and express radical analyses, to bring different tendencies within the radical left together, to interact with the broader left and to publicly oppose all that the Conference stood for.

One of the first international anti-globalization protests was organized in dozens of cities around the world on June 18, 1999, especially London, U.K. and Eugene, Oregon. The anti-globalization demonstrations continued on over the years, but none was to have such a spectacular outcome as that of the „Battle of Seattle”.

The second major mobilization of the movement, known as N30, occurred on November 30, 1999, when protesters blocked delegates' entrance to WTO meetings in Seattle, USA. The protests forced the cancellation of the opening ceremonies and lasted the length of the meeting until December 3. The protesters and Seattle riot police clashed in the streets. Over 600 protesters were arrested and dozens were injured. One demonstrator miscarried her baby after being exposed to CS and OC gas. Black Bloc Anarchists and primitivists destroyed the windows of storefronts of businesses owned or franchised by targeted corporations such as a large Nike shop and many Starbucks windows. The mayor put the city under the municipal equivalent of martial law and declared a curfew. As of 2002, the city of Seattle had paid over \$200,000 in settlements of lawsuits filed against the Seattle Police Department for assault and wrongful arrest, with a class action lawsuit still pending.

In 2000, ample demonstrations in Prague took the world by storm. Various anti-capitalist protesters were blaming these institutions for being one of the reasons for the economic problems faced by the third world. Thousand of activists who travelled from all over the world protested and some even clashed with the police in the streets of Prague for several days. Police estimated more than 15,000 protesters were involved. Anger was directed against the way IMF and World Bank pushed for a policy of directing power to the market and the multinational companies. Tear gas and water cannon was used to force back a breakaway group of activists that attempted to reach the summit venue to shut down the meetings of the global financial institutions. In spite of the massive turn up of police, the protesters succeeded in breaking up the last day of the summit.

Next came the G8 demonstrations in Genoa in 2001 and the 5th WTO Ministerial Conference of Cancun in 2003. Genoa Group of Eight Summit protest from July 18 to July 22, 2001 was one of the bloodiest protests in Western Europe's recent history. Police have subsequently been accused of brutality, torture and interference with non-violent protests. Several hundred demonstrators and police were injured and hundreds were arrested during the days surrounding the G8 meeting. During the MC5, protesters were kept behind fences far away from the 5 Star Hotels where the delegates were meeting. This provoked confrontations with security forces and a KPL (Korean Peasants league) member stabbed himself to death in protest.

The 6th Ministerial Conference of the WTO, which was held in Hong Kong, in December of 2005, was to witness peaceful protests. The demonstrations started with around one hundred Koreans jumping into the Victoria Harbor to try to swim to the Conference and Exhibition Centre where the talks were being held. Police in boats prevented the Koreans from swimming to the Convention Centre, pulled them out of the water and brought them back to the central area. Then the activists approached the police force with a burning coffin, and conflicts broke out. In less than five minutes, the police began to use pepper spray liberally to dispel the activists despite that the police outnumbered the protestors. The majority of protestors were peaceful, though, chanting slogans and playing instruments.

Who are they, these anti-globalization activists? The anti-globalization movement reunites under the umbrella of a broad coalition human rights activists, Third World-oriented groups who defend these countries' chance to development, protectionists, ecologists, but also nationalist and anarchist groups and even Marxists-Leninists. All these groups wish to be regarded as a civil society who opposes the global capitalist economic and political infrastructure.

We cannot understand the actual implication of the "Movement of Movements" unless we venture into an analysis of this process. Some believe that the anti-globalization movement can be analysed from two different perspectives, on one hand, from the point of view of its organization and on the other hand, from a ideological point of view.

From the organizational perspective, one must mention that this movement does not comprise of a single organization or of a single discourse. The link between its members is the Internet, undoubtedly a product of the very essence of globalization. It cannot be stated that without the Internet this movement would not have been able to develop, but it is certain that the Windows era had a crucial role to play in its existence. How else would all these activists have been able to meet, to exchange opinions, would have printed out manifests or would have participated in boycotts or other forms of protests?

Many a time devoid of economic means, the anti-globalization activists use the Internet as the cheapest and the fastest way of communication, which the process of globalization brought to us all. The Internet is the perfect answer for those meager budget groups which wish to organize extended demonstrations. The movement's sympathisers are reunited through the Internet, on special web-sites constructed namely for the sole purpose of announcing due demonstrations or on those that host fan clubs for anti-globalization books and forums.

From an ideological perspective, the anti-globalization movement is reunited in the fight against the "Enemy", identified as the global capitalism. Until now everything is crystal clear, the problem only arises when we approach the organization of the discourse. Because, thanks to the Internet, the goal of the different anti-globalization sympathizer groups was widely popularised, but due to the lack of an unique and coherent discourse, the public opinion is confronted with a series of ideas and demands which may not be linked to one another.

Nevertheless, the anti-globalization movement can boast a certain number of best-sellers, in which one may find some fundamental ideas of "The Global Justice Movement". Upon reading "Globalization from Below", written by Jeremy Brecher, Tim Costelano and Brendam Smith, we may be surprised to find out that not all of the sympathisers of this movement are against every aspect of globalization. Basically, these

authors state that the interconnectedness signified by globalization, though irreversible, may actually be a good thing. Only, the dominant values must be changed. The problem is that this book forgot to mention with what values the old ones should be replaced.

Amory Starr's "Naming the Enemy" proposes different alternatives to the global capitalism, while making an interesting point, namely the fact that "The Movement" should democratize globalization by making governments and corporations accountable to people instead of elites. For once, we are faced with a practical scenario? It is indeed very hard to imagine how this democratization can be achieved at a global level.

"No Logo", written by Naomi Klein, is by far the best known book that discusses this subject. In short, Naomi Klein advises the potential consumers world-wide to boycott the products of some (not all) multinationals, over which hangs the suspicion of exploiting their workers, while disregarding the environment. This book was tremendously well acclaimed, conquering a great many supporters for the movement. It even has its own web-site and it is extremely well branded. This book could very well have been a proper anti-globalization manifest if it was not so globalized. "No Logo" is a logo!

In "The Silent Take-over" Noreena Hertz argues that the public space, namely democracy, has become private (capitalism). This state of things can eventually bring about the death of the nation-state since "Economics is the new politics, and business is in the driving seat" (Noreena Hertz, *The Silent Take-over*). For all the problems that our society faces she points an accusing finger towards capitalism.

These mile-stones of anti-globalization literature propose different solutions to different problems and thus fail to achieve a strongly-bounded community of supporters.

Amongst many discourses lacking in consistency due to their impossibility to name the adversary or to come up with new, revolutionary ideas, the ATTAC association has a solution that the globalization process itself offered. This solution, the Tobin tax, was met by the greatest understanding and support ever to be generated by an anti-globalization proposal. The Tobin tax, an adaptation of the solution proposed by James Tobin some time ago in the 1970s, is a modest tax (between 0.05 and 0.25%) that is to be applied to every currency trade across borders. The purpose of this tax is a double one. On one hand, this tax will help regularize capital movements across borders, on the other, it will bring important yields to third-world countries. This proposal echoed all the way to the European Parliament, where such a measure was nevertheless rejected because of the lack of international regulations. Taxes are collected by the state and not by international institutions, thus levying this tax will be practically impossible in the absence of an authority which, in the end, could redistribute it to those countries in need of help. Also, ATTAC does not come forward with any basic requirements regarding the grant of the help, a grant ceiling or programs through which this tax could be redistributed.

What means do these activists use in their fight against globalization? Leaving aside such demonstrations as that of Seattle or Prague, where more and more protesters seem to get involved, one must first mention their discourses that urge their supporters to adopt different forms of protest. Most of these discourses are posted on different web-sites, web-sites that are made by and for these supporters. One must not forget the different manifests, articles and books through which the movement tries to recruit more activists. Many of these articles actually see the print in publications supported by different

associations, sympathizers of the movement. Also, many journalists, themselves supporters of the movement, who work for prestigious publications, disguise anti-globalization messages in their daily articles.

Commercial boycotts are also a form of active protesting against globalization. Activists are incited not to buy the products of those companies that fringe the human rights of their workers. Unfortunately, by not buying the products of those companies that have moved their production system to third-world countries, who pay low wages and use the work of children, a diminution of their returns is thus triggered. In the rare case in which such multinationals would yield up to the international pressure, an increase of the unit price, due to the readjustment of the level of wages, would be unavoidable. In this case, the multinational company would sell less or not at all its non-competitive products. The second scenario would imply a readjustment of their number of workers. On the other hand, if these companies would stop using the work of children, who can guarantee that these youngsters would have a better life? Statistically speaking, many of those children would end up on the streets. But there is another solution. These multinationals could simply pay better wages and thus agree to lesser returns. Or maybe not.

Who supports this movement? The great majority of the anti-globalization supporters are members of organizations that have not necessarily been formed with an anti-globalization purpose, but do actually embrace some of the movement's goals. The question is, how can they finance such forms of protest as demonstrations and the different publications? The peculiar thing is that some NGOs receive funding without checking up on their source, and thus end up being financed by some multinational companies, activists and even organizations sustained by terrorist's movements.

It is important to underline the fact that the majority of anti-globalization activists agree with one form of globalization, defined as global institutions (or global governance). These activists call themselves reformers and while they reject such international institutions as WTO or IMF, seen as mere products of the globalization process, they strongly support a global governance where NGOs sustained by anti-globalization activists would have a major role. It is indeed quite strange, but the two concepts, that of new global institutions and a global governance became known especially thanks to the anti-globalization discourse.

The anti-globalization movement is widely and openly criticized. One of the most common criticisms of the movement, which does not necessarily come from its enemies, is simply that the anti-globalization movement lacks coherent goals, and that the views of different protesters are often in opposition to each other. Many members of the movement are also aware of this, and argue that, as long as they have a common enemy, they should march together - even if they don't share exactly the same political vision.

Another important argument, made by The Economist, is that trade barriers, the very thing against which WTO fights, are the major reason for third-world countries' poverty. If the anti-globalization movement cares so much about these countries, then why not support the WTO activities instead of combating them? Maybe they just want to protect their workers, and not all workers everywhere?

Another criticism against the movement is that, although it protests about things that are widely recognized as serious problems, such as human rights violations, genocide and global warming, it rarely proposes detailed solutions.

Some have also criticized the movement for engaging in violent protest. Aside from the indisputably violent tactics used by a minority of protesters (possibly aggravated by the police), some see an enforced blockade of events and public thoroughways as a violent action, in and of itself. Many protesters counter that blockades are a time-honored technique of civil disobedience, and that the organizations they are protesting against are themselves guilty of crimes.

The motivations of the organizers of the protests are often questioned. Some critics point to pervasive anti-Americanism in the anti-globalist movement. They argue that anti-globalisation protesters in fact object to many people around the world voluntarily choosing American (or American-style) cultural products. Attempts to prevent the “Americanization” of French culture would be an example of this. In this sense, anti-globalisation is perceived as cultural chauvinism directed against American products, corporations and individuals, whereas their close European equivalents are ignored or even celebrated.

Finally, critics assert that members of the anti-globalization movement use anecdotal evidence to support their views, which are not supported by worldwide economic and social statistics. These critics point to statistical trends which suggest beneficial effects of globalization, capitalism, and the economic growth they encourage.

Many supporters of capitalism do think that different policies than today should be pursued, although not necessarily those advocated by the anti-globalization movement. For example, some see the World Bank and the IMF as corrupt bureaucracies which have given repeated loans to dictators who never do any reforms. Some argue that free trade may be harmful in certain instances or that spending on education and basic health care may be very important. Some, like Hernando de Soto, a Peruvian economist, argue that the most important thing for the developing world may be to develop the institutions of capitalism, like protecting the property rights and access to credit for the poor.

In short, the anti-globalization movement protests against the present world-order... without being able to come up with a viable replacement scenario. They have too many different ideas, promoted by too many different people, none which will be able to answer the demands of all the protesters. Supposing that the globalization process is so bad for our society, it is hard to see how much good can the anti-globalization movement bring to us all.

CLUSTERS, INDUSTRIAL POLICY AND ENTREPRENEURSHIP: A CRITICAL VIEW

Bogdan Glăvan*

Market failure and cluster theory

In the last decades, more and more economists have advanced the idea that significant obstacles impeding economic growth (especially in less developed regions) consist in different market failures, which prevent entrepreneurs from taking the necessary actions to exploit profit opportunities.

Recently, a number of economists have pointed out an interesting market failure that may jeopardize development: coordination failure of different entrepreneurs to act upon perceived profit opportunities.¹ Economists like Rodrik (2004) and Rodriguez-Clare (2005) have used this particular market failure argument as justification for a “new industrial policy”, the goal of which is to induce entrepreneurs to invest in those projects with the highest social return.

As the coordination externality argument goes, exploiting new business opportunities has considerable positive externalities for other entrepreneurs, who can learn about the profitability of certain ventures and can act accordingly. Firms can improve their performance if entrepreneurs realize that their individual success is dependent on the actions of other market participants. They can, for example, get organized to identify common challenges, for example that all companies would profit from a specific training program at the local university, from an investment in improving transport facilities, or from a joint effort to upgrade the local power or water supply. For an individual company it would not make sense to address such issues but for the group as a whole they become hugely beneficial efforts. Put it differently, the social rate of return on investments in key projects is higher than the pure private return. This means that coordination will be under-supplied and that government should correct market failure, providing proper incentives in order to reach the optimal level of coordination.

These writers’ argument can be associated with Porter’s idea that clusters, that is, regionally coordinated industries, are critical for overall economic growth.² Clusters develop when coordination failures are overcome. “As the cluster develops it becomes a mutually reinforcing system where benefits flow backwards and forwards throughout the industries in the cluster.” (LeVeen, 1998) Cluster-based policy aims at removing imperfections of the free market by facilitating the coordination of economic agents.

At the present, the opinion that clusters can play an important role in fostering industrial development is widely held among development economists.³ In Porter’s view,

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¹ Ferris and Gawande (1998) attempt to provide evidence for this argument, referring to the case of developing countries.

² As Rodrik (2004, p. 13) put it, “the cluster approach to development represents a narrower version of the same idea.” See also Rodriguez-Clare (2005).

³ See, for example, Nadvi and Barrientos (2004).

“clusters should represent an important component of state and local economic policy.” (Porter 2000, p. 29.) This new ground for industrial policy has found an increasing number of supporters among policymakers throughout the world. “Many areas around the developed world are adopting the clusters approach to regional economic regeneration, with the United Kingdom-wide government Department of Trade and Industry suggesting that this could be a key element in re-establishing the competitiveness of national businesses in the future.” (Danson and Whittam)

This paper intends to provide a refutation of the idea that coordination failures as manifested in the inability of clusters to emerge can serve as a ground for government intervention. Porter’s theory of clusters is shown to be irrelevant and inconsistent on its own terms.

Definitional problems

According to Porter (1998, p. 226), “a cluster is a form of network that occurs within a geographical location, in which the proximity of firms and institutions ensures certain forms of commonality and increases the frequency and impact of interactions”. From the very beginning, it is important to note the vagueness of this definition. As Martin and Sunley (2003, p. 10) emphasize, “the obvious problem raised by these cluster definitions is the lack of clear boundaries, both industrial and geographical. At what level of industrial aggregation should a cluster be defined, and what range of related or associated industries and activities should be included? How strong do the linkages between firms have to be? How economically specialized does a local concentration of firms have to be to constitute a cluster? [...] At what spatial scale, and over what geographical range, do clustering processes (inter-firm linkages, knowledge spillovers, rivalry, business and social networks, and so on) operate? What spatial density of such firms and their interactions defines a cluster?”

Another point is that clusters do not necessarily increase the competitiveness of member firms – a fact acknowledged by Porter himself. When a cluster shares a uniform approach to competing, a sort of groupthink often reinforces old behaviors, suppresses new ideas, and creates rigidities that prevent adoption of improvements. Clusters also might not support truly *radical innovation*, which *tends to invalidate the existing pools of talent, information, suppliers, and infrastructure*. In these circumstances, a cluster participant...might suffer from greater barriers to perceiving the need to change.... (Porter 2000, p. 24, emphasis added.)¹

The lack of conceptual precision has been referred to by various analysts as part of the intentional style of Porter, who seeks to provide policymakers with an argument for exercising interventionism. Porter’s idea serves as basis for a redefinition of interventionist policy, following the obvious intellectual bankruptcy of the old (rude keynesian) macroeconomic policy and price interventionism. It provides the ground for a more refined, intellectual-appealing interventionism.² The definitional elasticity of the

¹ See Industrial Districts, www.rrl.wvu.edu/WebBook/Norton/nortonupdate/neoflows1.htm

² As Martin and Sunley (2003, p. 12) observe, the notion of cluster can be used in a variety of situations, “depending on what the aim of the exercise is, or the client or policymaker for whom the analysis is intended.”

cluster concept undermines the operationality of the theory while simultaneously making it an ideal tool for politicians. In the words of Porter (1998, p. 102), “drawing cluster boundaries is often a matter of degree, and involves a creative process informed by understanding the most important linkages and complementarities across industries and institutions to competition.” This can only mean that the exact shape of clusters is related to the discretionary choice of policymakers. Any attempt to circumscribe a group of related companies based upon a certain criterion runs the danger of overlooking important clusters; at the same time, too many firms might be selected and clusters can be loosely defined.

Coordination and the development of clusters

According to Porter (1998), “being part of a cluster allows companies to operate more productively in sourcing inputs; accessing information, technology, and needed institutions; coordinating with related companies; and measuring and motivating improvement.” This characterization is supported by Rodriguez-Clare (2005, p. 3), who argued that government should promote the development of clusters by inducing entrepreneurs to invest in those projects that offer high clustering opportunities. However, this characterization, as well as the policy recommendation based on it, should be considered carefully.

It is essential to note that the formation of clusters enhances the productivity of individuals only if it springs naturally from the voluntary actions of the producers. To say that a higher agglomeration of firms (at the extreme, a single cluster) encourages unconditionally the deepening of specialization, development of trade, promotes innovation and supports an increasing of economic growth, is to treat mechanistically human actions. It is true that cluster formation decreases some economic costs, because businessmen do not have to incur the same expenditures with transportation and search costs. But following similar reasoning, an extension of the number of producers on the market – that is, a deepening of the division of labor – increases search costs. Yet, as it is absurd to consider that agglomeration promotes society’s welfare just because, by decreasing transportation and search costs, it simplifies trade and production, it is no more reasonable to assume that industrial clusters bring an increasing of welfare. Individuals do not wish unconditionally to avoid transaction costs by eliminating the distance among them. Beyond a certain level, increased agglomeration does not result in net positive external benefits, but in negative externalities. An important question for the entrepreneur deciding the location of its venture is whether agglomeration benefits are higher than congestion costs. The issue cannot be settled by an independent observer, because respective benefits and costs cannot be determined objectively.

It is difficult to prove empirically that clustering is by necessity beneficial. Rather, as history illustrates, people prefer to spread even if, as a consequence of their choice, the transportation expenses increase. On a free market, entrepreneurs will try to respond properly to the demands of their customers, providing goods in the locations preferred by the public. Therefore, only on a free market would it be possible to discover what is the optimal size of a firm or cluster. Since political action is not a substitute for voluntary cooperation, a discretionary intervention on the organization of production cannot bring any benefits to the community.

The characteristics of a cluster are the outcome of speculative actions. Consequently, not all clusters spur the competitiveness of their members. There are examples of cluster failures.¹ Territorial industrial agglomerations spring from entrepreneurs' actions. Businesses cluster together because it is more efficient. "Clusters dissolve when costs become too high for industries to remain competitive."²

Clusters represent a form of industrial organization. It results from the incessant attempt of entrepreneurs to arrange the structure of production so as to fulfill to the best extent possible the consumers' demands. Therefore, clusters are specific consequences of entrepreneurial ventures.³ Government meddling with clusters is tantamount to interference in the entrepreneurial process by which resources are directed toward the fulfillment of the market participants' most urgent needs. It introduces artificial incentives that weaken the inherent coordinative quality of market incentives.⁴

Instead of reasoning in terms of "externalities" and "market failure", it is time for the mainstream economists to realize that government is the only source of entrepreneurial discoordination. Through its trade policy – imposing different regulations and technical specifications, customs duties, quotas, voluntary export adjustments – immigration laws, regulations concerning capital movement etc., the state is the only source of barriers for trade and economic (inter-regional) integration. In addition, the localization process is also indirectly influenced by the government policy. State intervention is the object of individuals' anticipations, and it consequently changes the behavior of economic agents. If market participants expect a change in government policy, they will act in order to capture all the benefits and minimize the losses arising from that policy. For example, apparent lack of delocalization to improve the coordination of production is due to the expected shift of industrial policy. Therefore, far from being an exogenous variable, the disparities in the production structure should be considered as dependent on the political institutions governing the market process.

Coordination and government intervention

How is government supposed to improve the coordination of market participants? As Rodriguez-Clare (2005, p. 30) argues "One interesting approach would be for the government to create a mechanism whereby business associations representing different clusters would submit proposals that identifying areas for collective action and public support. The different proposals would be reviewed by a "panel of experts," who would

¹ The reluctance to accept this perspective has serious practical consequences. As Bresnahan, Gambardella and Saxenian (2001, p. 7) note, "Many governments have made the analytical error of focusing far too much on the second aspect of external effects, and have viewed clusters of innovative activity as no more than a ticket to producer rents. This has provided the intellectual foundation for largely failed policies that attempt to jump-start growth in clusters by directive policy."

² See Buss (1999, p. 368).

³ "Clustering is the result of entrepreneurial activity and is driven by the production of valued goods to seize profits. Governments cannot therefore supersede the market in the creation of clusters." (Desrocher and Sautet 2004, p. 238-239).

⁴ Besides this, Barkley and Henry (1997) discusses several shortcomings of cluster development strategies.

rank them according to the estimated social return for the public investment. Finally, the best projects would be selected for support.” Since the author is optimistic about the quality of such an institutional invention, the natural question that arises is, why not extend the “mechanism” to all businesses and investment projects? The government could tax away individuals’ income and then redistribute it according to the authoritative views of the “panel of experts”. Rodriguez-Clare seems not to notice how much his argument can prove.

The proponents of the new industrial policy are aware that past interventionism has failed miserably to promote growth and prosperity all over the world, and they are very cautious to differentiate their opinions about market failure from the older view of government’s superiority.¹ As Rodriguez-Clare (2005, p. 29-30) maintains, “if one wanted to call the current proposal a sort of industrial policy, it would be a “soft” industrial policy, rather than the “hard” industrial policy implemented in previous decades, which entailed distorting prices so as to reallocate resources to certain sectors as a way to generate a new pattern of comparative advantage [...] This is important because soft policies are likely to be more transparent and less costly.” Porter (2000, p. 27) holds a similar opinion, arguing that “a role for government cluster development and upgrading should not be confused with the notion of industrial policy” and that “the intellectual foundations of cluster theory and industrial policy are fundamentally different, as are their implications for government policy.”

But why is transparency so important about government policy? Freezing commodities’ prices or wages is a very transparent political measure. Yet at the present, it is far from being advocated by policymakers, because its harmful effects have become widely understood.² This example shows that transparency is not a proper criterion to evaluate policy initiatives.

According to the proponents of the new industrial policy, the government should shift the attention from individual firms and industries to clusters. Rodriguez-Clare (2005, p. 28) points out that unlike the old strategy, which attempted to pick winners (that is, individual companies), “policy should pick clusters”, and Porter complements this arguing that instead of targeting specific clusters, all existing and emerging clusters deserve attention.

Despite these authors’ efforts to differentiate their proposal from the older industrial policy, the distinctions they introduce are nothing more than rhetorical innovations. As a number of writers have aptly noted, the new sort of interventionism amounts to nothing more than picking winners. In a sense, this new political activism can incur even higher costs on society than previous attempts to engineer development. Since picking clusters means that policymakers should target groups of companies or industries, rather than specific businesses, the magnitude of potential failures increases considerably. If

¹ As Rodriguez-Clare (2005, p. 29) mentions, “there is no need for the Government to distort prices so as to reallocate resources towards certain sectors.”

² One could argue that government is always tempted to choose the least transparent measures available at the moment.

government's privileges fail to promote growth, than the outcome will be not punctual bankruptcies as in the past, but the occurrence of clusters of losses.¹

According to Rodrik, the policy of correcting coordination failures need not consist in subsidization. As he explains, "it is the logic of coordination failures that once the simultaneous investments are made all of them end up profitable. Therefore none of the investors needs to be subsidized *ex post*, unless there is an additional reason (i.e., a non-pecuniary externality) that such subsidization is required." What is needed in order to induce entrepreneurs to start complementary investments is an "ex-ante subsidy", consisting for example in a implicit bail-out or an investment guarantee. Put it this way, the "new" industrial policy seems to be apparently immune against much of the virus of corruption, rent seeking and malinvestment usually associated with government activity.

In spite of its new clothes, government interventionism has no more solid foundation that it ever had. The problem with industrial policy is deeper than most of its critics admit. Promises to bail-out entrepreneurs in case they fail to operate profitably amount in a *de facto* socialization of private investments. The experience of former communist economies and the "crony capitalism" developed in some East Asian countries illustrates the failure of such political schemes.

The advocates of industrial policy thinks government can act as private business do, using profit and loss criterion to decide between different investment projects. Rodriguez-Clare (2005, p. 28) thinks that, "at least in principle, one could calculate a social return for such an investment. With limited resources, the obvious approach would be to invest in the proposals that entail the highest social returns. The problem, of course, is that calculating such social returns is very difficult. One (perhaps limited) way to interpret prospective studies is as a way to facilitate this calculation." Here, the author (to his own merit) touches the real problem of industrial policy. The state is not an entrepreneur, so it is not in position to "interpret" prospective studies the same way private individuals do. As Buss (1999b, p. 367) says, "there are only individual or group interests that use public authority to their benefit, often at the expense of others."

Conclusion

In this paper I have tried to prove that the coordination failure argument does not provide a solid ground for a reshaping of the industrial policy both because of its lack of sound theoretical foundation, and because of its empirical irrelevance. We have seen that the vagueness of the notion of cluster makes the case for industrial policy appealing. There is no recipe for clusters. The "new" industrial policy should therefore be eliminated from the field of development economics.

Why are cluster-based targeting, so widely practiced? Not because of their scientific merit, but for political reasons. Impressive analytics can be drummed up on demand to

¹ Desrochers (2004, p. 239) notes that it is not clear whether cluster-based regional development policy is beneficial for the future of these regions, given that "diversified local economies are more stable than highly specialized regions that are more prone to abrupt decline if their main line of business is supplanted by competitors located elsewhere or if new and better substitute products are manufactured elsewhere."

justify inherently political proposals. And why, when so many targeted industry strategies have failed, do states and localities continue to rely on them? Partly because they have the appearance of scientific backing, but mainly because of a herd effect. Once some states and localities develop targeting strategies, others feel compelled to follow suit.

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THE SPREAD OF ECONOMIC THEOLOGY: THE FLAT TAX IN ROMANIA

Anthony J. Evans*

1. Introduction

The fall of the Berlin wall signalled an end to the Soviet footprint across Eastern Europe and the prospect of a new vision and direction for those countries affected. If ideas matter, it seems likely that they'd be most visible following such a sudden collapse of an ideological system.

This paper is a case study that traces the spread of the flat tax, and analyzes the conditions that are necessary for its adoption. Of most concern are the early adopters, and since by definition there are only a few, empirical cases must be compared to hypothetical cases. By providing the factual history of the flat tax, with biographical accounts of key players, a conjectural history can thus be formed to establish which of the many variables were especially important. I will argue that faith – an underlying belief somewhat disjointed from certain knowledge – was essential. In other words, ideas are usually adopted for their empirical and operational content, but if this is lacking, due to the novelty of the idea, or the uncertainty of the political environment (for example when following regime change), then their normative content can generate a crucial carrying capacity. The flat tax is a fine example of this phenomenon.

2. Making Ideas Susceptible to Analysis

If rational choice theory can be convinced of taking ideas seriously, a solid definition of what ideas are must be generated to enable their mapping and observation; and an institutional structure must be identified for them to be created and exchanged. I will use *operational codes* to achieve the former, and *epistemic communities* to address the latter.

a. Labelling Ideas: Operational Codes

Whilst political and economic beliefs can be – and usually are – subjectively understood and tacit, so-called *operational codes* can reduce this vast array into manageable and identifiable beliefs. If 'ideas' are the multitude of assorted candy that fills an individual's conscience, operational codes are the colour-coded wrappers that define the particular flavour and enable comparison and exchange¹. George (1980)

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¹ I owe this analogy to Stephen Lai

divides operational codes into two categories: *instrumental* and *philosophical* beliefs. Instrumental beliefs are answers given by subjects on ideas relating to causal chains or the relation of means and ends in a given political context. Philosophical beliefs are more general premises that relate to abstract notions and fundamental values. Interviews and surveys can thus be administered to map individual's beliefs, and this can be compared with other people to accumulate patterns of common ground. Also, analysis of historical records such as books, speeches and biographical accounts can trace the spread of ideas over space and time.

Even though some operational codes will exhibit both of these properties, a detailed case study will be able to uncover the relative importance of each, and the scientific and theological elements can be compared. A set of operational codes will form particular policy issues, and due to their media exposure and historical record they are easy to track and analyse.

b. An Institutional Context: Epistemic Communities

If we view institutions as cognitive constructs that facilitate interaction between individuals (North 19xx), ideas must require a structure that permits their transference.

So called "Epistemic Communities" are a concept created by Ernst Haas and John Gerard Ruggie and trace the influence new actors have on national behaviour and the co-ordination of policy. Operational codes are free floating ideas that are anchored to a social context by epistemic communities. They are social networks of knowledge-based experts, holding an authoritative claim to policy-relevant and shared opinions.

An epistemic community can be defined as a group of actors who share principled beliefs, hold a common set of casual beliefs, shared notions of scientific validity and common policy projects (Haas 1992).

We can view epistemic communities as the channels that circulate ideas from academic institutions to government, as well as those who spread ideas from country to country. They are the institutional pre-requisite for inter-personal relationships. They can influence policies by framing alternatives, defining self-interests, shaping public opinion and providing respected advice and scientific data.

This function demonstrates why epistemic communities will be particularly evident amidst uncertainty, since the demand for interpretation and advice will be high. We should therefore expect epistemic communities to have a normative dimension, and for this normative dimension to become especially important at the policy level.

3. The Rise of the Flat Tax

The flat tax is a relevant, contemporary policy issue and therefore provides an excellent opportunity to unpack the forces that explain its adoption. It is also an exemplar example of an operational code that possesses both scientific and theological connotations.

The flat tax (or "proportional tax") bares all the energy and enthusiasm of novelty, but in actual fact is anchored within the deep tradition of taxation. Whereas a head tax levies a certain amount for each individual regardless of income, it's inherent bias against the poor makes it deeply unpopular. By contrast, a flat tax will charge a single rate on all

income, treating all types, and all levels of earnings equally. This was the norm until 1848, and Karl Marx's call for a 'heavy progressive or graduated income tax' to make the wealthy pay a larger share of their income. This progressive system was adopted with ubiquity, mirroring the general rise in the modern welfare state and Fabian thinking that underpins redistributive politics. A progressive income tax is susceptible to manipulation, and not only can this arise in perverse incentives to work (individuals can face widely divergent marginal taxation rates depending on their unique situation), but loopholes that shift income into other classifications. Progressive taxation suffers from its inherent assumption of political benevolence: in reality deductions, credits and exemptions serve mainly to fuel rent-seeking activity and failing to extract dues from those with the resources to circumvent the obfuscatory layers of tax code.

All flat tax proposals include a basic rate of exemption that means income below a certain level (typically higher than the basic exemption under a progressive system) is non-taxable. This step therefore ensures a degree of progressivity in the flat tax, but intends to offer a break for the poor, rather than punish higher earnings.

a. The Theological Foundation of a Flat Tax

While the flat tax story is typically traced back to when it first became challenged, a more thorough analysis will see evidence even farther into the shadow of history. As an example, tithing is a religious doctrine that is a flat tax. "Tithe" means a tenth, and is invoked by many Judo-Christian denominations as the proportion of income that a believer must donate to the church. Regardless of wealth, the tithe is a fixed rate and can be said to be the first flat tax. Abraham gave God a tenth of his spoils following war, establishing the verb "tithe" that appears throughout the Old Testament. During these times the tithe was applicable to agricultural products rather than straight cash, and this is one of many sources of dispute for modern churches. Another issue is the loss of explicit references to tithing in the New Testament, but the existence of references to offerings to God that can be interpreted as following the 10 percent tradition. Although the actual biblical basis for tithing remains contentious, there are two facts we can establish. Firstly, the concept has escaped strictly religious scripture and become part of society. Archaeological records have found the seals and jars known as "LMLK"¹, which originate from circa 700bc and 10% of which bare stamps. And secondly, some churches view the tithe as an integral part of man's relationship with God, and continue to sermon and demand it's levy from congregation.

Regardless of textual analysis, there is a clear theological basis for tithing, and a more modern economical basis for the flat tax. Consequently we should be able to trace some tessellation between the respective proponents – in the religious realm, and in political economy. Casual empiricism suggests that Protestant denominations have a greater propensity to tithe. This might well be down to their more personal relationship with the church, as contrasted to the Catholic position that tithing is divine ordinance rather than command from Christ. Similarly flat tax proponents are typically conservative groups that view the state as a contractual relationship, rather than deity. It is my claim

¹ Translated from Hebrew, this can mean "belonging to King" (whether a person or deity), or "belonging to the Government"

that the tithe and flat tax share similar theological foundations and therefore an understanding of the spread of the flat tax can also shed light onto the diffusion and adoption of religious ideas. However this correlation between the theological basis of a flat tax and Conservatism shouldn't be taken too far. *Every* idea contains a theological element, and a normative commitment to principled values will be evident for every type of policy proposal. Rather than single out the flat tax epistemic community as being particularly driven by shared values, I intend to use it as an example applicable universally. The strength of belief in this instance does not run counter to scientific validity – it's a blunt complement.

Economic ideas have a long history, but it seems wise to return to Adam Smith whose ties to theology have received attention¹. It is true that Smith hints that a proportional tax is not his favoured system², and he even critiques it outright with regard to agriculture³. Whereas his position on tithing is clear, as theology we are more concerned with his general principles of taxation, and the legacy that others have interpreted from him. Indeed Smith provides the defining outline of a taxation system (Smith, A., ([1776]1965) Book Five, Chapter II, Part II). This position highlights fairness, certainty, and ease of payment, expressing the user-friendly relationship with the state that characterises classically liberal beliefs. The citizen is viewed as a holder of inalienable rights, and contracts with the government to protect those rights. This is in contrast to the alternative – that states grant rights and government activity transcends market activity.

b. The Scientific Flat Tax Prescription

It is no surprise that the two great pioneers and practitioners of a c20th science of liberty - Friedrich Hayek and Milton Friedman – viewed the taxation system in essentially the same light, but went beyond Smith to provide scientific basis to a proportional tax. Hayek first advocated a flat tax as early as 1956, and did so again in *Constitution of Liberty*, building upon Adam Smith's emphasis on the effect of tax rates on expectations:

“It is the great merit of proportional taxation that it provides a rule which is likely to be agreed upon by those who will pay absolutely more and those who will pay absolutely less and which, once accepted, raises no problem of a separate rule applying only to a minority.”

Hayek, 1960:314

He continues to offer other advantages for a proportional rule, further echoing Smith: “since almost all economic activity benefits from the basic services of government, these services form a more or less constant ingredient of all we consume and enjoy and that, therefore, a person who commands more of the resources of society will also gain

¹ See Iannaccone (1991); Leathers and Raines (1992); Ekelund, et al. (2005)

² “It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion.” *Wealth of Nations* (Book Five, Chapter II, Article I)

³ The tithe, as it is frequently a very unequal tax upon the rent, so it is always a great discouragement both to the improvements of the landlord and to the cultivation of the farmer. *Wealth of Nations* (Book Five, Chapter II, Article I)

proportionately more from what the government has contributed” (Hayek 1960, p.316). He also stresses the importance for taxation to fall evenly, and thus leaves consumption patterns unchanged. Soon after the first edition of *Constitution of Liberty* was published, Alvin Rabushka visited Hong Kong and became intrigued by their flat tax. Milton Friedman – a colleague of Hayek – encouraged him to pursue research in this field, and it culminated in the 1985 book *The Flat Tax*, co-authored with Robert Hall¹. This book would provide the policy proposal that subsequent politicians could rally behind and adopt.

Friedman had raised the flat tax in his own work of personal belief, *Free to Choose* (co-authored with Rose Friedman), saying:

“A low flat rate – less than 20 percent – on all income above personal exemptions with no deductions except for strict occupational expenses would yield more revenue than the present unwieldy structure. Taxpayers would be better off – because they would be spared the costs of sheltering income from taxes; the economy would be better off – because tax considerations would play a smaller role in the allocation of resources. The only losers would be lawyers, accountants, civil servants, and legislatures – who would have to turn to more productive activities than filling in tax forms, devising tax loopholes, and trying to close them.”

Friedman & Friedman, 1980:294

Friedman’s impact has been immense, and an appreciation of his works flows through the channels of free market economic thought. Together with Hayek, we can see an articulated science of liberty that serves as useful expositions of the epistemic community that we’re interested in.

c. The Flat Tax epistemic community

We defined an epistemic community as sharing certain principles, beliefs and values. The flat tax epistemic community will have principled values for freedom, liberty, equality before the law, and a general desire for minimal state. In this regard they are individualist in approach, and capitalist by method. They will also have common causal beliefs: for example that lower taxes will stimulate growth, or that simpler taxes creates economic activity. They are bound by the same validation techniques of economic reasoning combined with macro qualitative projections of tax incidence. A crucial element of the epistemic community is attention to the Laffer Curve – the graphical exposition that shows how tax rates can become so high that they reduce overall tax revenues². Finally, the common policy enterprise is the adoption of a flat tax, and the networking scope of the community is evident in the fact that policy proposals will be applied internationally.

As we shall see, successful adoption of a flat tax has been the result of American-based academics unable to counter the vested interests within their own legislature. The Hoover Institute, the Liberty Fund and the Volker Fund provided the finance and networking for the early promoters – Hayek, Rabushka and Friedman – to work within. Since their early influence, prominent western think tanks such as the Heritage

¹ See Hall and Rabushka (1985)

² See Laffer (2004)

Foundation and the Adam Smith Institute provide an institutional incubator and diffuser of flat tax ideas.

The fall of the Iron Curtain provided a perfect constitutional moment to spread free-market economic theology, and to do so effectively.

4. The Adoption of the Flat Tax

a. General Overview

The flat tax – along with school vouchers and privatisation – is one of a key bundle of free market policies that have been propagated by the free market epistemic community, and is therefore an unsurprising choice for countries that are intending to liberalise. Whereas Hong Kong has had a proportional tax on income for over 50 years, and Jersey and Guernsey¹ are other examples of a colonial laissez-faire, Estonia became the first sovereign nation to adopt a flat tax in 1994 setting a rate of 26%, and was soon followed (within a year) by Latvia (25%) and Lithuania (33%)². These Baltic countries responded well to the new taxation scheme, which led a general emergence as competitive economies. Russia adopted a 13% flat tax in 2001, and the large effect this had on tax evasion, creating a remarkable increases in tax revenue³, paved the way for a spate of others in 2003: Serbia (14%), Slovakia (19%), Ukraine (13%), followed by Georgia and Romania in 2005. Other former Soviet countries such as the Czech Republic, Croatia, Hungary, and Slovenia have flat tax proposals, as do similar sized economies such as Greece, Ireland and Malta. Remarkably, the flat tax is also on the radar of larger nations such as Germany, the US and the UK.

b. The Early Adopters: Faith in theory

The Estonian Prime Minister Mart Laar was a young, inspired and idealistic leader willing to make a bold step toward the vision of free markets that the flat tax epistemic community espouses. When he became a change agent – by moving from the epistemic community to the policy level – his statements and biographical accounts suggest two things. Firstly, he was aware of Friedman and Hayek. Secondly, he had faith that they were right. This opinion is derived from an economic theology that manifested within the flat tax.

“Like the idea that, okay, if you cut taxes, you will raise more revenue. That was only written in textbooks. I had faith that this was right, yes. But like with any faith, there’s always the sense that, ‘Gee, I don’t know, maybe this isn’t going to work.’ And it was really a miracle for me to see that things really started to happen just as the text books said they would happen. The same thing with the notion that if you balance the budget, then inflation will begin to fall. Well, this was hard to believe. I wondered to

¹ Two islands just off the Northern Coast of France, enjoying special constitutional status from the Great Britain

² Some debate exists as to whether Lithuania should classify as a Flat Tax country akin to their neighbours, see Rabushka (2005a)

³ see Rabushka (2005b)

myself: 'How will this happen?' But it did happen. So many things that we tried had never really been tried before, like a flat tax. But we did it and it worked. On one hand, you had to have lots of faith that these reforms would work. But I must say that, honestly, I always had my doubts."

Mart Laar, to City Paper¹

The empirical evidence that would follow this decision would confirm the theory, and provide crucial verification for other nations that would go onto adopt a flat tax.

Whereas Mart Laar was the policy entrepreneur that drove the flat tax in Estonia, in Russia it was Andrei Illarionov who would carry the policy goal from the dusty halls of academia to the marble walls of government. Illarionov is an ardent devotee of capitalism and has spoken publicly to make clear his position: "Every tariff and every limit on foreign-exchange transactions is a blow to our consciousness. Every tax acts against our freedom,"². Yegor Gaidar - another member of the flat tax epistemic community - brought him to Moscow. As the following quote suggests, Gaidor shared Laar's thoughts on the chasm between theory and the task of implementing policy.

"Yes, I read Friedman's books with interest, and also Hayek. They were very authoritative for us, but all the same far away from our domestic realities"³

As a member of Vladimir Putin's inner circle Illarionov is widely credited to have been the force behind Russia's adoption of a flat tax in 2001. In 1994 he founded the free market think tank *Institute for Economic Analysis*, and in 1999 he worked for the *Center for Strategic Planning*, securing a position within the Kremlin in 2000.

Estonia and Russia were the watershed, and grandest example of flat tax adoption, and there's no surprise that the epistemic community we've identified was at the heart of each. Operating within the deep uncertainty of regime change the epistemic community provided the baggage handlers of debate, creating a window through which policy entrepreneurs could leap. This leap was grounded in economic theory but also contained a theological element. Common belief that the economy was the "good side" of the infamous Laffer curve guided and prompted the epistemic community to seize the constitutional moment.

These early adopters had ample data regarding the current state of the economy, and projections that could provide an empirical grounding to a decision. However taxation is a complex policy to alter, and by definition you can never know ex-ante whereabouts on the Laffer curve you are. Consequently a radical policy such as a flat tax is a risky strategy, and by no means guarantees the results hoped for. But it appears that the early adopters were driven by something more than just an appetite for risk – they were committed to the principled values that underpinned the policy. Despite the estimations on national income accounting, they thought the policy was good *in itself*, and saw it as part of a broader strategy to make structural changes in the economy.

¹ Transcript available here: <http://www.balticsworldwide.com/larr.htm>

It is important to note that Laar's answer was in response to what could be considered to be a leading question. Personal correspondence is important to therefore establish a more robust answer.

² http://www.businessweek.com/magazine/content/02_24/b3787624.htm

³ cited in Boettke, 2003

Since expectations precede action, the fact that the actors implemented new policy (rather than keep the status quo) – i.e. acted – proves that they had an expectation about what the effects would be. And because the pervading uncertainty meant that the effects of a flat tax lacked a solid empirical basis, the expectation could not have been grounded in objective probability. Rather, the decision to adopt was grounded in a faith generated by the theological aspect of a flat tax.

These theological policies would in turn provide the evidence for other countries, reducing the need for an advanced epistemic community or strong will. To demonstrate this point we will turn to a case study of Romania, who adopted a flat tax in 2005.

c. The Case of Romania: Faith in the epistemic community

“The revolutions in Eastern Europe and the dissolution of the USSR, however, present a golden opportunity – a theorist’s dream – to control better for the independent effect of the different variables”

Checkel 1993:297

Former Soviet nations offer a fertile laboratory for study on account of the prolonged and enforced absence of economic ideas available to academics, policy-makers, media and the general public. Indeed Romania provides an especially conducive situation since (with the possible exception of Albania), free market ideas were more outlawed than any other communist nation. This meant that prior to the revolution there was not a domestic epistemic community and the year 1989 provides a clear event after which market ideas were able to flow. In other countries, there is an immense historical record of economic ideas that generates multiple threads, traditions and sources. The task of distinguishing between different influences and mapping the resulting network would be prohibitively overwhelming. But in Romania, although the epistemic community may be large, it is small enough to explore and trace causal chains of diffusion. The people most responsible for the spread of ideas are still alive and contactable and yet enough time has passed for the effects to be known and tentative assessments to be made.

A case study is most valuable when the “*phenomena under study is not easily distinguishable from the context*” (Yin 1994), or is a particularly unique and extreme situation. Since our purpose is to chart a policy stream, rather than merely document instances of an outcome, we require a method that produces operational links and not mere frequencies. Whilst a historical study can explain the facts behind an event, a case study based on direct observation, informal conversations and systematic interviewing is better adept at generating theory. It is therefore the consummate methodological tool for studying the implementation of the flat tax in Romania.

The case study was conducted over a 5-week period during the summer months of 2005. Over 30 formal interviews took place with representatives from academia, the government, and the press, and anonymous transcripts are available on request. Since the intention was to map the epistemic community, we did not require a random sample to find interviewees – we utilized the interpersonal network via recommendations. Since Anthony Evans and Gavin Ekins conducted interviews jointly (and utilised information for different research projects), there was investigator triangulation that ensured insights weren’t taken out of context, and were subjected to competing explanations. Also,

informal conversation; direct observation; and documentation, archival records and physical artefacts where consulted to corroborate interview data.

During interviews we asked question relating to principled values, causal beliefs, methods of validity testing and policy goals, in order to map the membership of the flat tax epistemic community. Five questions were asked to ascertain principled values (or normative issues), and these were: Should the state be actively involved in the redistribution of income? Do tariffs and customs duties reduce the quality of life of a nation? Should the state actively attempt to stimulate exports? Are state enterprises less efficient than private enterprises?

Causal beliefs (or broadly positive issues) were touched upon with the following: Rent controls lead to a reduction in the quality and quantity of available housing; Minimum wage laws lead to an increase in youth unemployment; Budget deficits lead to inflation; Flat tax leads to an increase in government revenue

Of those who answered over four of the first questions with “Yes”, and over four of the second bunch with “Yes”, the support of the flat tax was virtually unanimous. Although the questionnaire was deliberately designed to see if respondents gave immediate answers to vague and ambiguous questions, they were given ample time to discuss the question and provide a coherent picture of their beliefs.

As expected, those who were familiar with the free market epistemic community fell into two camps – those who refuse to engage in government activity, and those who will. This splintering suggests two things. Firstly, the Romanian epistemic community is still relatively young, and therefore there’s a modest division of labour. The diffusion of principled values (which at the extreme seek to abolish all taxation) thus prohibits the common policy platform. Whereas countries that have a richer tradition in free market ideas can satisfy both aspects, and therefore form a coherent and influential epistemic community, Romania is yet to do so. Although our evidence is essentially static, by comparing the age at which members of the community began forming their beliefs, and the creation of internal networks to generate new members (for example the *Center for Institutional Analysis and Development*, the *Romania Think Tank* have only just been formed), we can anticipate growth in the size of the community, lending further influence on a domestic epistemic community that can operate along more margins than currently.

Like other post-Soviet countries, Romania was burdened by a large informal economy and a massive fiscal burden devoted to tax collection. But even given the obvious need for fiscal simplification, the most striking aspect of Romania’s implementation of a flat tax is the speed of the entire process, from beginning to end. As a policy proposal it first appeared on the political radar in late 2003, and was supported by the Romanian Academic Society. Their proposal for Romania was adopted by the centre-right Alliance between the National Liberal Party and the Democratic Party, and an impact assessment suggested that evasion led to an effective taxation rate of 16%. The Alliance proposed to align nominal rates to real ones, and used the flat tax (together with anti-corruption) as cornerstones of their 2004 election campaign. The decision to fight the election over the flat tax was mainly strategic, since the incumbent Finance Minister (of the Social Democratic Party), had previously endorsed fiscal simplification. The Alliance therefore ensured that their chief proposal was being debated with someone having to succumb to party line, and thus underlying their opponent’s hypocrisy.

Despite this particular strategic incentive, the flat tax was popular with the Romanian people. According to Aligica & Terpe (2005) 82% of respondents to an opinion poll run by the National Agency for Small and Medium Enterprises thought the flat tax was the most positive evolution of the past months. Also, in May 2005 *Capital* reported “more than half of Romanians agreed with the flat tax”.¹

An epistemic community has two strategies to enact action: alter a politician’s objective function directly by convincing them of the soundness of a particular idea, or secondly, to launch a broader campaign that changes public opinion and hence implicitly shifts the politician’s constraints. The civic culture of Romania is fairly infant, and we failed to find influential members of the media who had pushed hard for a flat tax. Rather, politicians such as Traian Basescu – a businessman, the former mayor of Bucharest, and current President - were driving the flat tax idea. Other political leaders from both the National Liberal Party and the Democrat Party sustained the project, but faced opposition. Former Liberal ministers such as Illie Serbacuescu and Daniel Daianu expressed concerns about the impact on the budget deficit, but as one although they objected to the rate (they wanted 20%) they weren’t objecting to the flat tax itself.

This seeming absence of a Romanian epistemic community belies the extent of the wider free-market network. The lack of public debate and relative scarcity of NGO activity was offset by the practical example of previous flat tax countries, especially Russia. Of the 35 interviewees who we asked about the flat tax, only 2 offered systematic explanations of Romania’s adoption. The others referred to the case of Russia, and the expectation that what had occurred there would be replicated on account of the similarity of their economies.

Once the Alliance won the national election on December 28th 2004 a narrow window existed to ensure that the tax code would be altered in time for the start of the next tax year (January 1st 2005). Throughout the night the printers published the new legislation, and it was voted on within 24 hours of the shift in power.

Initial results have been mixed, but it is clear that many of the pessimistic predictions (for example the IMF) have not occurred². More time is needed to provide an accurate judgement on the ultimate success of the policy, but the actual implementation was impressive. Political entrepreneurs – embedded within the flat tax epistemic community – seized upon the domestic situation and used the flat tax as a major electoral platform. This generated unprecedented public attention, exposed the opposition as hypocrites, and ensured delivered election success. Conscious that a mandate requires action, and again reacting to the local conditions the legislation was passed swiftly, yet another former Soviet nation joined the flat tax club, enacting substantial economic reforms.

d. Westward Ho!

The explanation given for Romania’s adoption of the flat tax is tied to the perceived similarities between the Romanian and Russian economies. The flat tax epistemic community could economise on performing detailed studies by relying on the emerging data from other nations, due to the underlying faith that the economies were sufficiently

¹ By Mercury Research, in Aligica & Terpe (2005)

² See Aligica & Terpe (2005)

similar. This method of diffusion will therefore cease if a country has different conditions. Western European countries have a lower appetite for reforms more generally, but also have different domestic realities (e.g. less concern over tax evasion). Consequently the theological component of the flat tax idea will become less relevant, and the scientific component will be the more important determinant of the future path. This will involve the production of projections to forecast the likely effects on macroeconomic statistics, as well as the impact on specific individuals. In other words, unless a constitutional moment can be created to steer hearts and minds toward the theological foundation of a flat tax, a more sceptical public (operating within a more sophisticated civic culture) will demand to know how a flat tax will affect the economy, and how it will affect their personal tax incidence. Using Great Britain as an example, epistemic communities such as the Adam Smith Institute, The TaxPayer's Alliance and Reform are all contributing to such simulations (Grecu 2005, Teather 2005, Heath 2006¹).

5. Conclusion

In this essay I have retained the assumptions of goal-seeking man, sensitive to material rewards and bounded by interests. But operational codes offer a means to flag and analyse ideas, which exist at a deeper level to bound and define interests themselves. Although interests matter, if opposing interests are cancelling each other out, or regime change alters the underlying structure of government, a constitutional moment exists in which ideas can also have an effect.²

Epistemic communities – or networks of knowledge-based experts – specialize in the creation and dissemination of ideas, and will emerge during uncertainty to promote their policy proposal. In this essay we have seen how the flat tax idea was formed, and has since spread shedding light on the institutional structures that are prerequisite for ideas to matter.

This approach, and the techniques and methodology employed, is by no means tied to the study of economic phenomena. As pursued throughout economics is itself a type of theology, since any treatment of ideas must stem from a subjectivist approach, and subjectivism demands treatment of belief systems, and epistemic choice. We can view the flat tax as an example of economic theology, and extend our approach to other (non-economic) beliefs and ideas. Any study of the spread of economic ideas must stand back in awe at the more professional and ubiquitous spread of religious ideas. As Mormon missionaries explore the Transylvanian forests of Romania, so too do free-market ones. Indeed both can sit in the moonlit carriage, hurtling through a Soviet wasteland, sharing thoughts (but not beers) and wondering just what is so different about their endeavours.

¹ Aside from presenting his own model, Heath (2006) provides a thorough overview of alternative flat tax proposals throughout Europe, as well as a survey of academic evidence. For an earlier suggestion see Forman, N (1996). Also Heath quotes an unpublished contribution from Howard Scott: "People in the UK have been talking about a flat income tax rate of 25% with a large personal allowance, say £10,000. This would not work. The psychologically crucial figure is 10% and if the pass is sold on this, all is lost" (Heath 2006:107). Note the attachment of psychological importance to the amount of a tithe, furthering the theological foundation of a flat tax.

² See Evans (2006)

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THE CHALLENGES OF THE WORLD ECONOMY COHESION FACTOR – THE INTERNET: WORLD REORGANIZATION, VULNERABILITIES, DISCREPANCIES AND POWER DISCERNMENT

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Times are changing continuously. The changes are in continues acceleration, and the way in which we are able to greet them and to adapt will become an important issue for any organizational structure. No organizations, economical or not, can afford not to be interested for the challenges of *new economy*.

Philip Kotler said the *future will not come fast; future has already happened; unfortunately, it is not same for all firms, companies, economical sections or nations*. The answers that we are looking for is actually the future of our organization is in the present time. For having acknowledgments of the realities can be the same thing with knowing the *future realities*.

Nothing can prevent us from collecting information. In a global economy, everything is faster and in continuing change. The digital revolution has imposed new market ideas of economical organization side. Competition is stronger day by day, and the consumer has metamorphosed into an omniscient person whose main purpose is how to gain these E-evolutions.

There is nothing new in the fact that Internet has achieved a big advance and that, for this reason, there are implications in any country and any (regional or global) economic activity. The Internet is the binder of the actual economy, it is the only process able to transform, invent or reinvent communications of all entities. The Internet and E-commerce are fundamentally changing all aspects of the global economy.

The global population has reached 6, 5 billions, and around 1 billion of the total have already Internet access (*Internet World Stats*, in 31 December 2005). The distance between different regions or countries is no longer a problem because with only one mouse click they become the same entity, being able to use and receive equally the same information at the same time. Internet is changing the way of socialization; the way we gather education, the way in which we are able to individualize each aspect of life.

In our day's business are done in a much-accelerated rhythm, the period given for taking a decision is becoming smaller and smaller. New technologies are making possible the connection of two different persons from different countries in any moment and at the same time. The permanent connection 24 hours per day, 7 days of week to the global market determines the undertaking of decisions in a short period of time, frequent changes of priorities, thus forcing the human limits. Overstressing may have as effect the impossibility of isolating things, which are very important for taking any decision from the information mixture, which are at our disposals (*isolations of the noise from the signal of what is important to know in order to make good decisions*). In addition, we have to consider the vulnerability increasing of e-civilization at cyber terrorism,

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informational pollution (information omissions, pornography, spam, aggressive media activities) and attracts with different informational viruses.

It is estimated that the human being created so much information in the last 30 years as our ancestors did in 3000 years. The Internet makes the information to be available to everybody, at any moment. The difference is in the way of receiving and using the information. Our life is transformed day by day because of the Internet changes the way we are acting in personal life and business. If in the virtual shop which you have accessed the price or the characteristics of the product are not convenient for you, you have the possibility to type the name of the product on all web search engines and in a few moments you will discover and access a lot of other addresses which can bring you what you are looking for. *Clearly the Internet has changed and continues to change the way we do business*, said Scott F. Geld, Marketing Director for MarketingBlaster.com.

The Internet continues an amazing development from one day to another, being able to transform the whole world in the global village of Marshall McLuhan or Alvin Toffler, where there are no frontiers for business, communication and commerce. According to Internet World Stats, in the last 10 years Internet had a spectacular development, from 16 millions of users in December 1995 (0.4% of global population) to 1 027 millions users in 31 December 2005 (15,8% of global population).

The way in which Internet is used at global level is not equally and creates big discrepancies between the regions. Asia is leading in terms of the number of users, with 332,5 millions users (34,2% of the total Internet users), being followed by Europe with 285,4 millions users (29,3% of the total Internet users) and North America with 224,1 millions users (23% of the total Internet users) This situation is generated by the unequal distribution of the population on continents, the leading region having almost over half of the global population (56,4%), much more than the other regions.

Within Asia, from the total of 332, 5 millions users, China has almost a third – 111 millions users (30, 5% from the total of Asia users), being followed by Japan with 86, 05 millions (23, 7% from the total of Asia users), and India with 13, 9 millions users (50,6% from the total of Asia users). Within Europe, from 285.4 millions of users 79.8% are in UE, the first 3 places are occupied by Germany, England and Italy. In North America, from 224,1 millions of users 90.3 % are in United States.

In terms of the share of Internet users in the total population, Asia with a 9,2% percent is not ranked in the first 3 places, occupied by North America (68.2%), Australia (52,9%) and Europe (35,5%).

From 2000 to 2005 the biggest growth of the users number was registered in Africa, followed by Middle East and Latin America/Caraibe. The growth can be explained because of the major existent deviation in different regions from a period to another, and because of the fact that, at the beginning of the period, Internet access was restricted by the costs related to connection. Today, even they are remaining with a user rate quite reduced, the underdeveloped or developing regions present significant growth from a period to another, because of the facility course of Internet access through the reduction of costs at global level.

Internet offers to the underdeveloped regions a number of growth possibilities. Used in the adequate way, the existent development gaps may be reduced, significantly easier than in the case of using traditional methods. The advantages must be judged in the context of a global competitively structure. In comparison with these, the developed areas

register less growth in the new users number, one of the explications being the trend of growth areas of connection quality (broadband). Practically, in these areas, from the Internet access point of view of, thru any type of connection, being actually in the situation in which only who is not interested is not present on Internet (the determinant criteria being the age, social status, and so on).

World Internet Usage				
World Regions	Internet Usage	% Population (Penetration)	Usage % of World	Usage Growth 2000-2005
<u>Africa</u>	23,917,500	2.7 %	2.5 %	429.8 %
<u>Asia</u>	332,590,713	9.2 %	34.2 %	191.0 %
<u>Europe</u>	285,408,118	35.5 %	29.3 %	171.6 %
<u>Middle East</u>	16,163,500	8.6 %	1.7 %	392.1 %
<u>North America</u>	224,103,811	68.2 %	23.0 %	107.3 %
<u>Latin America/Caribbean</u>	72,953,597	13.3 %	7.5 %	303.8 %
<u>Oceania / Australia</u>	17,690,762	52.9 %	1.8 %	132.2 %
World Total	972,828,001	15.2 %	100.0 %	169.5 %

NOTES: Internet usage information comes from data published by Nielsen/NetRatings, by the International Telecommunications Union, by local NICs, and by other other reliable sources.

Source: www.internetworldstats.com. November 21, 2005

Population access from development areas at Internet is facilitated by investments of those countries in infrastructure and by the quite reduced costs that are generated by the connection. The low costs are determined by the existent competition on these markets for offering these services, by existent infrastructure, by various ways on which the connection can be accomplished. When we are discussing about the accessibility of costs, we will have to consider also the incomes, which every country has for each citizen and by the weight of the expenses generated by connection.

Using the Internet with high speed usually in development countries was and it is generated by evolutions which businesses registered and will register, representing one of the new way of doing business at the global level. On the other hand, in development countries the usage of the Internet became usual, being transformed in a contemporary life necessity. The arguments are various and can be individualized from one person to another. Maybe this feature – adapting to everybody needs – fuels the development of this global phenomenon – the Internet.

According to the categories drawn up by Internet World Stats at the end of year 2005, on the first 5 places at global level, from the point of view of access to the Internet (Internet users % from the total population) were Malta (with 78,3% users from the total

population), New Zealand (77,6%, Iceland (76), Sweden (75,5%) and Hong Kong (70,7%). United States is placed on the 7th place with 68,7% users from total population, United Kingdom on 15th place with 63,1%, Japan on 20th placed with 60,9% and Germany on 25th place with 57%. On the first five places are in general countries with a reduced number of people, where the income distribution and the education are equally.

TOP 10 COUNTRIES WITH THE HIGHEST NUMBER OF INTERNET DSL BROADBAND SUBSCRIBERS				
	Country or Region	DSL Broadband Subscribers	Internet Users Latest Data	Source and Date of Usage Data
1	<u>United States</u>	33,900,000	199,861,345	Nielsen//NR Feb./05
2	<u>China</u>	25,800,000	94,000,000	CNNIC - June/04
3	<u>Japan</u>	12,739,564	66,586,234	Nielsen//NR Nov./04
4	<u>Korea, (South)</u>	11,900,000	30,670,000	KRNIC - June/04
5	<u>Germany</u>	5,950,000	46,455,814	Nielsen//NR Oct./04
6	<u>France</u>	5,253,000	24,803,250	Nielsen//NR Oct./04
7	<u>Italy</u>	3,680,000	28,610,000	C.I.Almanac - Dec/03
8	<u>United Kingdom</u>	3,335,000	34,874,469	Nielsen//NR Oct./04
9	<u>Taiwan</u>	2,900,000	11,602,523	Nielsen//NR June/01
10	<u>Canada</u>	2,568,351	20,450,000	C.I.Almanac - Dec/03
DSL - TOP 10 Countries		108,025,915	640,219,011	IWS - Jan.20/05
Total World - DSL Users		128,870,433	819,931,592	IWS - Jan.20/05

Source: InternetWorldStats.com., March 31, 2005

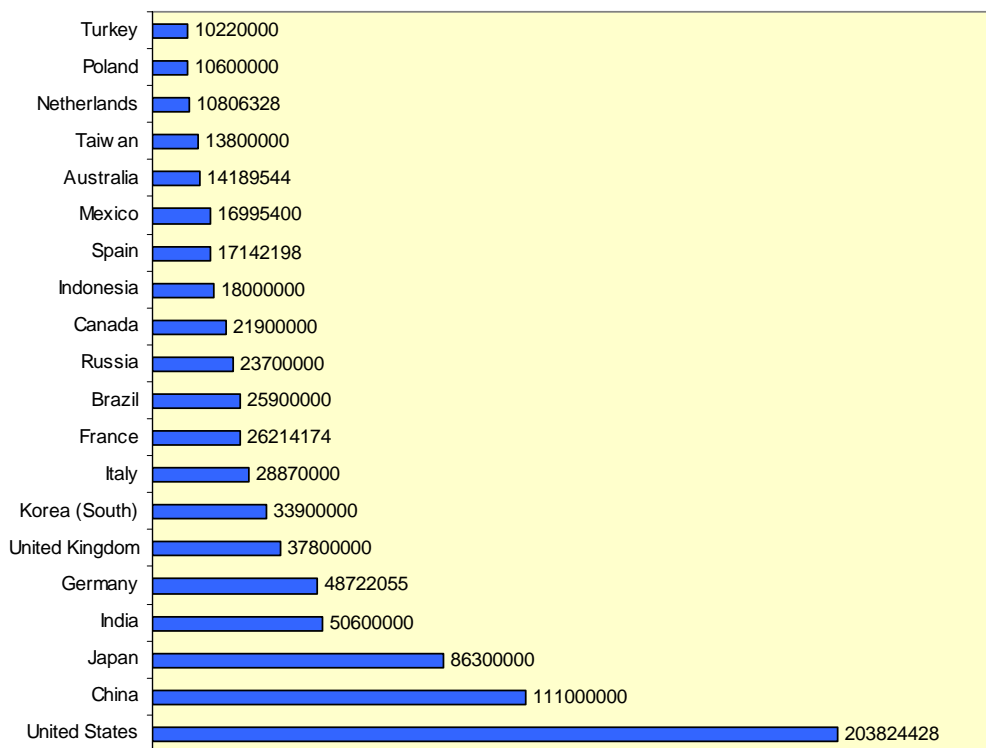
In terms of the number of users, on the first place is United States of America with 203, 8 millions users, followed by China with 111 millions users and Japan with 86, 3 millions users.

As one can notice, there are significant differences among the first fourth countries. United States strongly dominates this ranking, the occupant of second place, China, having approximately half of user numbers registered by these. China and United States are, in fact, two of the most populated countries, being place on the first place and respectively the third place in the world.

An important element, which influences the usage of Internet at global level, is the acknowledgement of a international language. The most used language in the World Wide Web, even if this is not official, is English language.

English is one of the most used languages for global communication because of old colonialist tradition, of economical and political importance of the countries that officially use this language as native language. In general, the knowledge of this language, depending on business environment and the affiliation to different geopolitical influence sphere, is a necessity for integrating local socio-economical life. Therefore, it is increasing substantially the chances for any individual to succeed in any country of the world. In this context there are many countries that have introduced the teaching of this language even from the elementary school, transforming it in fact in the second spoken language.

TOP 20 COUNTRIES WITH THE HIGHEST NUMBER OF INTERNET USERS



Source: www.internetworldstats.com, December 31, 2005

Developing regions with cheap labor, in which English is widely known and used as language, and as a plus have a relatively stable environment, are becoming attractive destinations for international investments. Simultaneously, the social-economic environment will improve and will generate, as a necessity, the technological infrastructure necessary to facilitate the Internet access of the population.

It will be observed how the Internet importance will grow in any kind of activity, being present in any aspect of human life, with bigger implications of what communication and affiliation mean to groups and society. People will become aware of the fact that using

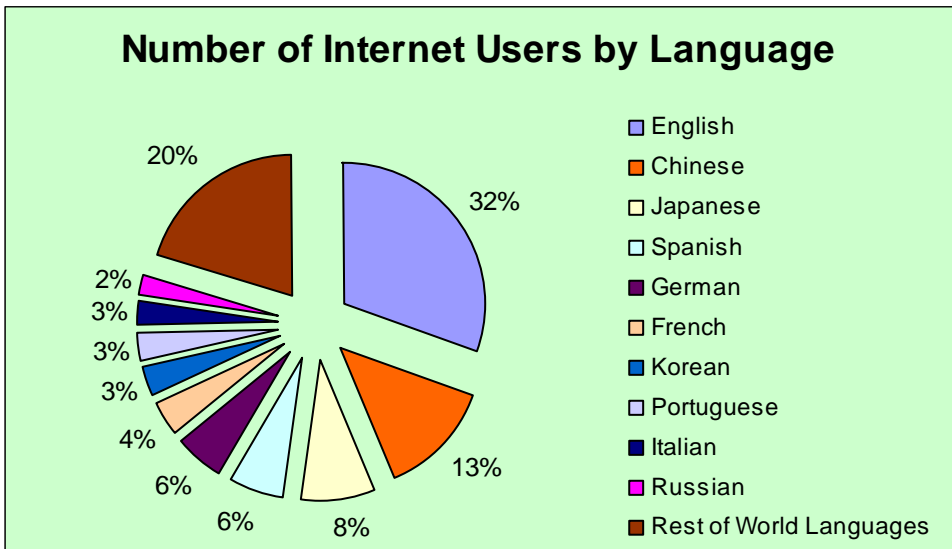
Internet is more and more important day by day and that, therefore, having knowledge of an international language is essential.

Talking the same language is one of the important conditions that not only the international companies take in consideration at the moment they want to get involved in international business, but also two persons being in different countries and different continents and who are trying the discuss about the last preferred musical album. Any frontier is destroyed when the same language is used and the Internet is accessed.

Internet is able to enlarge the discrepancies among people, both in the developing countries and developed countries. Replacing the traditional communication ways will challenge people, and some of them will hardly manage to adapt, or maybe they will never try to. In general, older people have problems with the accommodation to the actual life in this changing world.

Not only using Internet may create damages. For a beginner it can takes several hours and maybe weeks to learn how to use the Internet, depending on his capacities and activity, in comparison with several years necessary to learn any foreign language. This is why one of the reasons to have Internet access is to speak a foreign language. The use of English imposes to the Internet user to known at least a minimum of this language, and using the Internet, in turn, can be an advantage for learning English.

By analyzing the Internet users, which have as native language the English, we will observe that their percent is a small one in comparison with the global level. Consequently, most users (around 69% from the total number estimated by Internet users) need to work harder to improve their written and spoken English.



Source: [Nielsen/NetRatings](#), December 31, 2005

During the years, there were different attempts to build an international communication language, which will not affect or favors any national economy, and

which makes an easiest way of communication. It appears that everything failed because there were no strong ideas for supporting this purpose.

Another solution for the problem of using only the English language on the Internet will be the employment of new technologies (machine translation software) and, in this case, the translation will be done automatically. However, even in this situation problems arise because the translation is not always perfect.

Taking into consideration all these, having knowledge of English became a determinant element in having access to the global information and to turn into profit all the advantages offered by the Internet.

Also, the importance of this language can be explained because of the United States influence over the Internet. There are international debates regarding the way in which the United States influence, in a “unilateral” way, the administration of the Internet. The main source of this conflict is the fact that Internet Corporation for Assigned Names and Numbers (ICANN), which is a non-profit organization, has a contractual relation, which will expire this year, with the USA Commerce Chamber. ICANN may have effects both to the individual Internet users, and the all-organizational users, through the technical requirements about how the computers and networks are working together, and these rules establish the safety and freedom of all information.

Various states, especially developing nations, are opposed to the permanent supremacy that USA has over the Internet, which is in continuous extension on global level. They wish to replace the USA from their position of administrator and to transfer all responsibilities to a multinational authority. The issue of Internet Governance at global level is still under discussions after World Summit on the Information Society from Brussels in 15th of November 2005.

Regardless of the conclusions of these worldwide debates on such a sensible subject, the Internet should be out of any particular influence. The regulation of the Internet so that it may have advantages only to one party, may transform this system into a powerful weapon with strong impact to human rights, endangering the safety and development of the entire global economy.

The actual importance of the Internet is the result of the extraordinary development it had in the last years and of the potential for the future. Practically, we can say that there is no country without Internet access, maybe with one exemption and this is North Korea. Governments especially those of the developing countries have to be aware that liberalization of the Internet provision will enhance growth and will improve the social-economic climate. Governments are, in a way, important beneficiaries of Internet services (G2B - government-to-business and G2C - government- to-citizen).

Information and communication technologies are vital for any country's competitiveness, and for the development of any society. However, without education of different categories of beneficiaries in using Internet, we cannot say that the right effect will result.

Developing countries can reduce the existing development gap through investment in infrastructure. It is well known that the distribution on age's categories in these countries is dipping the balance in the favor of young population. Education of young people is one of the important elements, that needs a special attention, and may have important long term effects on the development of e-business environment and of society at large. Allocating funds for education, assuring the Internet access to all educational institutions,

facilitating the acquisition of personal computers for young people by special programs (as public-private partnerships), represent secure investments in the future of a nation.

Creating a favorable social-economic and legal environment will capture investments in modernization and development of different regions. There are also some regions where this kind of investments would not have any profitability (because of the poverty of rural areas), and the state should have an interest in private sector, having different projects in participation public-private or only public, for a while.

The real opportunities of the Internet economy can be tapped to a large extent in many developing nations, provided the real obstacles get identified and acknowledged. With sufficient dialogue and cooperation between the various public, private, and civil sector players, the Internet market can indeed become quite real for many emerging economies.

With more than 1 billion users in the present and with another billion foreseen for the next 10 years, Internet will represent one of the most important issues of the global economic development, and the main instrument in shaping human relationships and the way of life, being more important day by day. Internet will offer on the one hand, the possibility of diminishing the gap among different countries or regions, and on the other hand, will enlarge this gap because of the lack of investment in IT infrastructure; because of the lack of support by the society and business environment, because of the old educational system, and of the fact that still there are schools where an international language is not yet taught, which is the reason for which not everybody has yet access to the Internet.

The technological development will increase the range of possibilities to get an Internet connection, and will reduce the cost of old technologies and will increase the number of those who can afford them. Internet is and will continue to be a big challenge for all of us.

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THE ROMANIAN REFORM OF EDUCATION – MOMENTS OF THE POST-COMMUNIST TRANSITION

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“The Community shall contribute to the development of quality education by encouraging co-operation between Member States and, if necessary, by supporting and supplementing their action”. (Treaty, Art. 149.1, Chapter 3: Education, vocational training and Youth)

The reform of education, from Romania, began from the first moments of the post-communist transition. It was marked by three limits: the reactive character, the changes in education being the consequence and not one of the driving forces of the political, economical or social reform; the dependence of external financing, especially in investment that led to the precipitated import of institutions, at doubts and discontinuities, at incoherence at the level of educational politics; limitation at formal education, at school and university, ignoring the important fields of permanent education as the adults education, the education of the persons with special needs, early education, education of Gipsy population, etc neglecting the early evolution of the professional field.

In the conditions of these limits, aggravated by the general context of the Romanian society, can be considered the fact that the education reform from '90 was rather a partial reform, a reform limited to certain components and to the priorities that took advantage of external financing.

What was missing was the global perspective; a coherent politic in the field of education, centred on realistic reference points and well defined stages; the agreement of the political class and considering the national education as a domain protected from the political disputes, from unilateral manipulations and steps; a program of the international cooperation, especially as part of the European Union.

The contemporary superior education deals with unprecedented transformations. They are generated by three factors: the first is represented by the technology of information and communications. The second factor is represented by the increase of individual request of superior studies. More and more persons aspire to obtain a superior education degree.

Finally, the third factor takes the form of the superior education market. The institutional diversity on the public – private axis and the increase of the individual request for superior studies generated the competition between universities and the extinction of the tax payers for educational services led to apparition of commerce with such services.

In the Statement from Bologna, adopted in 1999 by ministers of education from member states and associated countries of the European Union, mentioned the necessity of increasing competition of superior education on global plan. This way appeared the so-

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called “Bologna Process” that was expecting to generate, until 2010, the European space of superior education, that is a space more unite and competitive on global plan.

- The superior education is a national value; it contributed along time at the formation of nation, at the preparation of the scientific, engineering and cultural elites.

- Confidence in universities. We have to invest plenty of faith in our universities; either they are old or new, public or private, in the last decade, them insured an important growth (of over three times) of the young persons with university degree.

- European integration. Once was signed, in 1999, the Declaration from Bologna, are universities are expected to show their European vocation.

- Transforming as development. In the past ten years, the Romanian universities passed through a profound changing process. We have to admit that the reform is not concluded yet. The passage to the theory of acknowledgement, the pressure of more and more persons to accede in the superior education faces the new universities with new requests. So, we need to promote changes that generate a new development of the universities.

The options that we should make must be based on the existing reality, and from its messages, the following can not be ignored: there are important differences between the required qualifications on the work market and those offered to the university; the students are selected especially from the urban environment and from the most advantaged social categories, fact that leads to significant talent loss and to the depth of the social inequality.

Comparing to other European states, especially with the states that are candidate to integration in the European Union, Romania invest less in superior education.

Public financing, on each student, began to decrease with about 20% in the period 1990-2000. Universities do not have financial incentives proper to recruit and maintain young people in the universities.

The average age of the university members reaches in some institutions 55 years or even more. The deficit of university personnel on the ensemble of superior education system is of 40%. The quality of teaching, of documents basis from the libraries or the laboratory equipments is precarious in most of the universities, fact that is associated with a chronically status of professional lack of satisfaction of the students and didactic personnel.

Education is much more theoretically oriented, without a focalization in a sufficient measure on the formation of practical professional abilities. Our number of students is yet very small, comparing with that from other European countries, including those in transition.

The participation percent that corresponds to those of 18-30 years is at us less than 30%, while in France reaches 50%, and in Poland arrived at about 35% or more. Top research is less stimulated in our strong universities, and in the others, research is a secondary activity. Sub financing the university research became chronically.

We have plenty of universities, public or private, too small and less competitive, with a traditional management and insufficient development sources. The first 10 great and classical universities are comparable as products and resources with all the other universities, while the administrative and managerial expenses of the last ones are substantial.

The public universities that were recently founded contribute less at the economical and cultural development of the communities where they are situated, and some private universities extended their logistic infrastructure and the students number without realizing didactic and research personnel, based on that of the already existing universities. Several of the actual legal provisions blocks the development, does not offer plenty of space for those with initiative. The subventions and scholarships are still headed after criteria that are insufficiently fundamental to support those who really need help.

The government should propose to gradually eliminate the mentioned status by promoting a coherent set of measures.

The strategy regarding education development in Romania, the sector strategies and any reform program regarding education on the entire complex must respect a series of principles. The general principles that will be taken as a reference in what was called “strategy of transforming as development” that is the development processes of superior education from Romania are the following:

- ✓ The priority granted to major objectives and less to detailed programming of superior education;
- ✓ Realizing an education system that is equilibrated through decentralizing;
- ✓ Promoting the variety of application options of some central ideas in solving some punctual solutions;
- ✓ The development of the relations between superior education institutions and the economical, cultural agents and those of the civil society;
- ✓ Planning changes and granting a response time that should be sufficiently enough, for the superior education system to be able to take reaction at the interventions determined by the implementation of new politics;
- ✓ Finding amplification points from the superior education system.

It is necessary a clear conception about the role of education in society, about the role of students in each stage of the system of work market. Among others, will be imposed: the renouncing at the actual system that is practiced in the state superior education of registration of two student’s category: subvention and tax payers, the introduction of a new system of study taxes and subventions that should encourage those with performances and to ensure real social protection of poor students and those with difficulties. Granting scholarships and social aids must be correlated with a minimum of performances obtained by beneficiary students. The renunciation at state monopoly in education must be encouraged, by encouraging the non-public education (particular and alternative education), the implication of local communities, decentralization and extra – budget financing.

Quality of education is a indispensable condition to ameliorate professional occupation, the social cohesion and economical competitively. For this we will follow objectives as:

- ✓ The instruction of an internal and external evaluation system of the universities;
- ✓ Amelioration of the advising and orientation system for students;
- ✓ The development of the advising and orientation system for students;
- ✓ Accentuating the long term results and not strictly academic performances;

✓ Re elaboration of criteria and standards of institutional performances, the evaluation of university specialization and study programs and their stages, the introduction of a differential financing system in comparison with the quality of performances at the level of programs and institutions;

✓ Elimination from the system of the non- performing education institutions;

✓ The differentiation of superior education units in comparison with the levels of the study cycles that can be organised (national universities – that organises licence, master and doctorate; regional universities – that organises licence and master decided as part of the consortium; area universities – that organizes licence

✓ The essential role of the institutions in ensuring quality;

✓ Adopting a special law regarding ensuring quality in education.

The programs of educational reform, realized after 1990 has a pronounced repairing character, of remediation of some grave dysfunctions. Considered separately, the sector programs of educational reform in their ensemble emphasises a series of disarticulations between components. That is why it is imposed the passage as systemic transformations through which: reanalyse of state education structure to obtain its optimisation; evident formulation of the educational politic option for mass superior education; the definition of the mass superior education concept with its different forms; reviewing the admitting system; changes in teaching methodology and in contexts of facilitating education; introduction of a new system of selection during the study years, adopting a new Law for social service that should oblige the graduates of some study programs to realise a practical stage, with a period of up to one year, in the rural areas or in the de favourite areas, before graduation. Doctoral schools will be realised and 10 centres of scientific excellence, whose financing will be adequate will be selected.

In conformity with the commitments realized by signing the Declaration from Bologna and the Declaration from Berlin, Romania will take action on this side. Among others, will be imposed: the internationalization of the superior education system from Romania by opening for recruiting talented teenagers from other countries, selected on value criteria that can be proved with documents; offering facilities for young teenagers that wish to study in our country, by simplifying the visa formalities, especially for the post university level, the introduction of some study visa that does not give the right to work; offering some consultancy programs for superior education in other countries; informing Romanian students about the chances of a career abroad, in the field of technical assistance and consultancy.

It will be requested the realization of a new investment plan for a new academic quality. It will be realized from public and private resources, an Investment Program in Superior Education, as part of the superior education budget, by stimulating the innovation initiatives in university transforming.

The diversification of the financing sources in superior education refers to the growth of the financial contributions brought by private economical agents and by students, besides those allocated from the public budget. Ensuring, in the following 4 years, the study subventions, for an annual flux of 75.000 students in university and post university studies. The students that did not obtain study subvention are tax payers.

The Investment Plan for Superior Education should have three resources:

1. at least 50% from the total of taxes for university studies paid by tax payers students;
2. donations or any other contributions realized by private agents or other donors;
3. loans granted by government accorded to universities for research – development projects that contributes at the regional economical, communitarian or national development. 50% from the increase of the budget allocation for superior education in 2005 will realize, as part of the Investments Program in education and will administrate the complementary financing of investments.

Starting with 2004, the budget funds that are allocated to research must increase in a substantial way. For an efficient use of these funds, will be realized in the following directions:

- a. The distribution of public funds allocated to research depending on the sector potential of research (superior education, Academy, institutional research and enterprise);
- b. Encouraging the realization of powerful and wide research units and granting with priority funds for them;
- c. Allocation of research funds especially to centers that tests and grants the obtaining of competitive results on national and European plan.
- d. Realization in 2004 of 10 excellence centers with priority financing, through national concourse, in the sciences field (mathematics, physics, chemistry, biology) with engineer sciences and socio- human sciences;
- e. The allocation of post doctoral grants to young researchers that should constitute research teams in domains with big changes of applicability;
- f. Radical changing of the formulation method and the priority number of university research;
- g. The introduction of an efficient evaluation system of the research results, with accent on effective results.

The formation of didactic personnel will be done starting from the compulsoriness principles of such activities, of the specific forms that should be taken in the preparation of the university personnel and the integration of didactic research (active research) as a step towards the realization of initiators in teaching process. It will be imposed: the development of the conciliation and orientation system for students; the elaboration of some programs to prevent school abandon and failure; differentiation of universities in rapport with the performance level requested at entrance and during the university studies, the increase of exigency in promoting the didactic personnel.

Even if there were elaborated several projects of preparing the university managers, not even in the present exists an institutionalization system of initial and continuous formations of them. The university manager is still an autodidact that distillates its own empiric experience and sometimes learns by trying and error.

The dominants of the academic managerial evolution will reside in perfecting the mechanisms from inside the managerial structures, in realizing professional the managerial practice and in the construction of formation and development system of own competences for this professional domain. It will be imposed the realization of a climate of responsibility and emulation by mentioning some quadruple statutory obligations of the university didactic team of teaching, research, participation at the administration of the cathedra and research system and diffusion of the culture and science in the society.

The managerial system in universities will be organized in such way to ensure the

growth of the consistency and efficiency of the decision processes. As part of a system that is managerial at the level of the institution and collegial as part of the cathedra and university, will be realized managerial islands under the form of some study programs, initiation centers for some spin-off enterprises.

It will be realized the maintenance and accentuation of differentiation in superior education between the academic management and administrative management, the distinct formation of two managers categories and the growth of their professional performances; varied and gradual usage of a set of material – financial stimulus that should recognize and pay the upper managerial performances.

The participants at the National Conference of Superior education (2005) have analyzed the actual status and the perspectives of the superior education from Romania and observed the acute need of elaboration of some programmatic document that should begin, on a period of 10 years, a series of priorities and action directions. Their application will ensure the minimal guaranties so that the education should respond in a proper manner to the provocation of the present. The participants at the Conference sustain the necessity of taking the obligations assumed by the Romanian Government by signing the Declaration of the Conference from Berlin from 19 September 2003 by all the universities. By this document, the ministers of education from the European countries have reaffirmed the decision of their governments o realize the objectives of the program European Space of the Superior Education.

The Declaration from Berlin establishes the principal action directions for the period 2003-2010. Between them, three objectives have been considered with priority, having as realization horizon year 2005:

1. Ensuring quality by developing new institutional, national and European mechanisms. In the year 2005, the national systems of ensuring quality will include: establishing responsibilities of the organisms and institutions implied: the evaluation of the programs or institutions, an accreditation, certification and comparable procedures system; international participation, cooperation and nets.

2. The adopting of a structure of the study programs, based on cycles: license diploma, master and doctorate. In this sense it is necessary the elaboration of a system comparable and compatible with the university disqualification, in which each qualification should be described in terms of study direction, knowledge, competence and profile. There will be elaborated a nomenclature of the university qualification that is operational in the European Space of Superior Education.

3. Promoting the mobility of students and the academic and administrative personal.

The representatives of all the universities from Romania, the National Council of Rectors, the consultative national councils and the Ministry of Education, Research and Youth expresses its support for the realization of the following principal objectives of the strategy of superior education in Romania, considering education as a real national priority, will be imposed the followings:

- ✓ The state budget will foreseen in 2007, a budget allowance that is equivalent to over 6% from PIB for education,

- ✓ Encouraging educational investments so that is can exceed 10-15% from the education budget,

✓ Including the education and formation as a priority in international and European development programs for Romania,

✓ The elaboration of a new legislative basis of education, of superior education especially.

The organization of study programs on three cycles, in accordance with the scheme promoted by the Process from Bologna, the university studies will be restructured as follows:

✓ The license university studies, with a duration of 34 years (minimum 180 and maximum 240 credits).

The medicine and architecture studies are excluded from this rule. To obtain the license diploma are necessary, for most of the specializations, 180 credits. The license domains with 240 credits will be established by MEC and the Council of Rectors, at the proposal of university senates. The license studies can offer large qualifications, on study domains. The graduates of this cycle can enter on the work market or can continue with master studies. Such a system will permit the rapid solving of the acute qualified work force in the rural area and from the underprivileged area;

✓ The master university studies with a duration of 60-120 credits. The minimal cumulated duration of the cycle I (License) and cycle II (master) will be of 300 transferable credits (ECTS). The thoroughgoing university qualification (specializations) will be situated at the level of master cycle, moving the fragments that exists, in the present, at the license level, in several early, more and short specialization;

✓ The doctoral studies with duration of 3 years. The gradual passage from the actual system that is based on the individual leading of the doctors and the development of European doctoral schools.

The principal scheme of the cycle's duration will be of 3-5-8. Taking into account the fact that specialty will be realized at the level of master, we consider that for universities, for graduate and future users of the graduates, it will be necessary a master period that is equivalent with 120 transferable credits.

The proposals that I have mentioned above, I hope to be assumed by the Government, especially by MEC and promoted so that it can reach a durable development of our superior education. Concomitant, the consolidation of university autonomy in the didactic field, of research, of leading and administration, including financial, will have to be harmonised with the accentuation of public responsibility of public and private university.

Having regard to all these aspects, we must put into practice the best solutions otherwise, we will console ourselves with – the Romanian academic system being source of an ample exodus of the valuable young people across the border, many of these considering emigration as the only chance for professional fulfillment.

The program "Return to Romania" initiated by the American Administration encourages the graduates of the several academic programs to come back to Romania and it represents an important signal of the preoccupation that this phenomenon generates at the international level.

Like a final view on the reform of education up today put in the light a complex process in which the reform programmes coexist with old elements and practices, like in a

puzzle, as well as the persistence, in different forms, of a group of determinant strategic purposes and objectives.

Thus, the central aims, highlighted by the reform of education in Romania, are of a functional nature and consist in the reorganization of the educational system according to the new requirements of the economic, social and politic environment and the creation of personalities with autonomous thinking and behavior, able to integrate in their individual projects and participation in social life, the fundamental values of the democratic society and market economy.

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ON SIGNIFICANCE OF TRANSACTION COSTS IN INSTITUTIONAL ECONOMICS

Cosmin Marinescu*

Institutions and institutional arrangements cannot “work” by themselves, meaning without necessary efforts – considered costs in economics - for preserving and improving them. Legal institutions and rule of law are based on systemic efforts needed to apply the ethical rule, actions that mean, in their turn, certain costs. These efforts that facilitate social cooperation process represent, for many economists, the costs of economic system functioning. In nowadays institutional economics, these costs of economic system functioning are called “transaction costs”. This paper aims to offer a critical point of view on significance of transaction costs in institutional economics.

Institutions, human action and transaction costs

In the institutional approach of Douglass North, Nobel laureate in 1993, the theory of institutions “is constructed from a theory of human behavior combined with a theory of the costs of transacting” (North, 1990:27). By combining these theories, one can understand why institutions exist and what role they play in the functioning of society. North also mentions that if you add the theory of production, one can analyze the institutions implication over the economic performance.

With no intention to underestimate the role of social institutions in the reduction of uncertainty, I will try to emphasize the *irrelevance of transaction costs criteria, as objective sources of valuation of the institutions efficiency*. Also, I will emphasize the implications of institutions utilitarian approach over the economic science and public debates on politics.

The economics of transaction costs begin with “The Nature of Firm”, the famous article of Ronald Coase from 1937¹. The Nobel laureate Ronald Coase explain the existence of the firm and the integration of the activities from this kind of organizational structure using the transaction cost concept (the cost of running the price system, in original terminology). But, as Oliver Williamson shows (1991:8), “one could say that Coase’s approach on the transaction costs did not face time as well as the theory [of firm], on the whole”. Coase neither defined in “The Nature of the Firm” the empiric character of transaction costs, nor explained how these could be recognized. Despite of all contradictions regarding the transaction costs, this theory represents today the corn stone of efficiency analyses over comparative institutional arrangements.

The economic theory reveals the universal fact that any human action entails a cost, as human action means choice, and so sacrifices and opportunities forgone. Accordingly, doing a transaction has a cost; conceptual, the transaction cost phenomenon becomes

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¹ Ronald Coase, “The Nature of the Firm” [1937] in *The Firm, the Market, and the Law*, Chicago: University of Chicago Press, 1990, pp. 33–56.

easily to be accepted. The major difficulty refers to these costs becoming operational. So, it can be said that transaction costs represent more a way of giving arguments than an efficiency indicator, of empiric nature. The confusion derives from the fact that transaction costs are considered an indicator used in order to appreciate the superiority of institutions and institutional arrangements.

For example, for North, the information costly character represents the key of transaction costs:

„The costliness of information is the key to the costs of transacting, which consist of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements. These measurement and enforcement costs are the sources of social, political, and economic institutions” (North, 1990: 27).

On the whole, in transaction costs category the economists include information costs, negotiating costs and those of writing contracts, the costs of protecting property rights and those of enforcement rules and agreements from different contractual arrangements. The problem of “measuring valuable attributes of what is changing” reveals the objectivist perspective on which North (1990:27) built his theory. But the subjectivist paradigm, on which the entire modern theory of value is built on, excludes any possibility of objective valuation (external one) for costs involved by human action, as a choosing process.

The real foundations of economic science are built on theory of opportunity cost. This theory does not prescribe a specific type of cost, but an economic way of thinking through which individuals’ behavior in society is explained. In fact, the central argument comes from the very simple idea that the cost phenomenon derives naturally from human action, which means choice and exchange. So, the cost’s significance is the satisfaction forgone (the value of the best sacrificed opportunity – as economics textbooks show).

Economic science learns us too that valuations that determine human choices are, necessarily, *ex-ante* and subjective economic categories. These valuations represents the importance, utility or value that individual gives to goods and events taken into consideration. Today, despite many inconsistencies in *mainstream* economics, the theory of subjective value is the corn stone of economic science, as demonstrated over more than a century by economists of Austrian School¹. For example, in one of the most cited paper dedicated to the economic theory of the cost, the Nobel laureate James Buchanan emphasize too that *all costs that influence our decisions are always subjectivist valuations reported to potential opportunities*². The source of these conclusions derives from the economic way of thinking of the Austrians, Ludwig von Mises and Friedrich von Hayek, whose influence over researches of L.S.E. (London School of Economics)

¹ In his *magnum opus* “Human Action”, Ludwig von Mises show that “value is the importance that acting man attaches to ultimate ends. Only to ultimate ends is primary and original value assigned. Means are valued derivatively according to their serviceableness in contributing to the attainment of ultimate ends. Their valuation is derived from the valuation of the respective ends. They are important for man only as far as they make it possible for him to attain some ends. Value is not intrinsic, it is not in things. It is within us...” (p. 102).

² James Buchanan, *Cost and Choice: An Inquiry in Economic Theory*, Markham Publishing Company, Chicago, 1969; James Buchanan și G. F. Thirlby (eds.), *L.S.E. Essays on Cost*, Willmer Brothers Limited, Birkenhead, Great Britain, 1973.

was a significant one¹.

Cost (including transactions costs) analyze has to start necessarily with emphasizing the distinction between the measurable *objective* cost (the accountancy cost) and the cost as subjective essential element for the choice process (the economic cost). Within the neoclassical theory, the cost has a material dimension, being not presented through the distinction *ex ante* – *ex post*. The formal theory of human action is based on the recognition of the fact that cost phenomenon (impossible to be separated from choice process) has a subjective dimension when speaking about utility. This perspective reveals insuperable difficulties when making transaction costs operational and when appreciating their influences. Murray Rothbard pointed out about the nature of the cost when he wrote the followings:

„But if costs, like utilities, are subjective, nonadditive, and noncomparable, then of course any concept of social costs, including transaction costs, becomes meaningless. And third, even within each individual, costs are not objective or observable by any external observer. For an individual's cost is subjective and ephemeral; it appears only *ex ante*, at the moment before the individual makes a decision. The cost of any individual's choice is his subjective estimate of the value ranking of the highest value foregone from making his choice” (Rothbard, 1997, 269).

Despite of these arguments against the possibility of making transaction costs operational, almost all approaches on institutional economics use transaction costs as criteria for efficiency of institutions. For example, inefficiency is explained by high transaction costs, assimilated to a presumed failure for the parts of an exchange when trying to obtain information over the exchange terms. The secret of obtaining efficiency could be decreasing of transaction costs – the Ronald Coase famous idea:

„The argument has proceeded up to this point on the assumption . . . that there were no costs involved in carrying out market transactions. This is, of course, a very unrealistic assumption. In order to carry out a market transaction, it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost”. (Coase 1990, p. 114)

The conclusion could be that, if potential exchange parts can be better informed or more able to communicate one to another, then it won't be unconsumed exchanges and losses over the property rights value. But, this perspective involves difficulties impossible to be overcome. For the external observer, *the existence of unconsumed exchanges does not reveal, necessarily, lack of information and communication* or institutional

¹ In “The Essential von Mises” (1973, <http://www.libertarianpress.com/rothbard/essential/toc.htm>), Murray Rothbard show that although untranslated until well after World War II, “Mises’ ideas on methodology were brought to the English speaking world in highly diluted form by his student and follower at the time, the young English economist, Lionel Robbins. Robbins’ *Essay on the Nature and Significance of Economic Science* (1932) in which the author acknowledges his “especial indebtedness” to Mises, was acknowledged for many years in England and the United States as the outstanding work on the methodology of economics.

inefficiency. The real problem consists in the difficulty to reveal the existence of transaction costs and also the impossibility of measuring these costs¹. On the other hand, the implications of the entrepreneurship over institutional change process must be taken into consideration. Let us presume that actual institutional arrangement does not reveal, through market process, the “relevant knowledge” form hayekian approach. So, initial institutional arrangements are appreciated to be “inefficient”. But, in this conditions, the entrepreneurial process will generate institutional change, on “*the human action, but not human designed*” model.

Let us consider the following example: there are two villages, Ronald and Coase, which does not communicate with each other. In the first village, two pheasants are exchanged for a beaver. In the other village, two beavers are exchanged for a pheasant. In isolation, as there is free exchange in both villages, the result of this allocation can be considered efficient. But isolation cannot provide the maximum advantage of the deepened division of labour and extended commerce, generated through exchanging on the market of the two villages. In this circumstance, the entrepreneurial activity will seek for the benefit of the unvalued opportunities of this inefficient arrangement which will sooner or later, generate the exchange between the two villages.

Anticipating price discrepancies for the same product, as in the previous example, indicates the existence of profit opportunities (incorporated in the price structure). These opportunities will enhance entrepreneurship, which will adjust the inefficiency of isolation. Profit opportunities stimulates the entrepreneurship, which can, thus, improve the efficiency of allocation process. As a consequence, the institutional constraints and incentives will be restructured and the communication and informational environment improved.

On free market, entrepreneurship is not just the result of existing institutions, but it itself creates new institutional constraints and unblocks organizational inertia². So, entrepreneurship can be considered a fundamental source of institutional change, not just its catalyst, as it appears in North approach³. As Israel Kirzner argues, the profit

¹ Despite the fact that cost and choosing theory has especially subjective foundations, I emphasize North’s empiric trying of measuring transaction costs. According to a research done with Wallis (1986), in the United States economy, more than 45% from national revenue is represented by transactions allocated resources. On this analyze basis, the authors emphasize the transaction costs and services aria’ increasing dimension within the analyzed period (1870 – 1970). So, I intend to introduce an alternative approach: transaction costs do not represent exclusively the reflection of the exchange barriers. They represent, too and probably in a more important sense, the existence of greater profit opportunities (exchange ones). So, transaction (co-ordination) costs’ increasing dimensions represent the institutions and institutional arrangements’ result itself, presented within labor division and exchange process. Increasing the relative dimension of transactions within services area represents the mechanism of transaction costs’ attenuation and also the mechanism of revaluation as much exchange opportunities as possible.

² See, for this the institutional reforms developed in China, generated by the entrepreneurship, which have become a factor of political pressure, directed toward the relaxation of formal legislation in business.

³ Simply by conforming to the institutional constraints, the creative and the anticipative ability of the entrepreneurs will be completely ignored. This is why an entrepreneurial approach of institutions is necessary.

opportunity existing on the free market, sustains competition: "...if the greatest entrepreneurship talent is insufficient for removing all "misallocations", even giving the profit reason, then the rest of "misallocations" are simply undetectable¹ (the "misallocation" term is used by Kirzner referring to an allocation inefficiency, to a presumed individual plans lack of co-ordination).

According to the above mentioned example, it is exaggerated and unfair in the mean time, to suggest that the initial institutional arrangement (isolation of the two villages markets) prevent efficient allocation because of the transaction costs' barrier. Free exchange means including entrepreneurship efforts of obtaining all possible exchange earnings, which means recognizing the existence of informational and communication constraints permanent restructuring. If present constraints are artificially imposed, politically or through administrative rules, entrepreneurship that may generate exchange barriers optimal restructuring, cannot be stimulated or can even been stopped. On these artificial constraints conditions, which do not allow volunteer agreement over property rights involved, the allocation frame can be labeled, shows Buchanan (1985:98), as "inefficient".

Transaction Costs Relevance for Institutional Efficiency

Free market represents a voluntary exchange system of legitimate private property rights. Its dominant rule is unanimity. On the condition political constraints are absent, the market process restructures behavior rules, constraints and institutional stimulants and so encourages the exchange. *Well defined and sure property rights are much easier to be exchanged than the insufficient defined and uncertain ones.* This does not demonstrate the fact that the exchange external observer can indicate the real nature of the exchanges' difficulties or measure the transaction costs' decreasing dimension, as an institutional efficiency appreciation instrument. On the other hand, transaction costs (the cost of using pricing system in Coase's terms) can be presented as production costs' expansion, more or less important, taken or not into consideration, depending on perceptions and subjective valuations of those involved in the market process.

The fundamental problem will be formulated as it follows: *which is the relevance of transaction costs for the methodological corpus of economic science? How can transaction costs be compatible with subjectivism (the one the theory of cost is founded on) and with free market (as an institutional arrangement, which excludes the relations of power)?* Entrepreneurial approach reveals that on free market transaction costs cannot be more than conceptual/linguistic innovation, of no scientific importance.

Within free market private economy, resources are allocated on commercial bases to information production and selling direction: business consulting agencies, real estate agencies, different services offices, etc. are *organizations involved in services and information production.* Great competition and legal practices in contracts area are important sources of transaction costs reduction (for example, generalizing standard contracts and "commercializing" them and consolidating goods such as *trust, good reputation*), too.

¹ Israel Kirzner, *Market Theory and the Price System*, Princeton, New York: Van Nostrand Co., 1963, p. 304.

The central argument of Ronald Coase's essay "The Problem of Social Cost" (1960) is the fact that volunteer exchanges, on the condition property rights are well defined, represent the sufficient condition of efficiency¹. But Coase completes this proposition by the so called "zero transaction cost" clause. The approach aims to suggest that, on the condition there are zero transaction costs (which means lack of uncertainty), resources efficient allocation does not depend on initial definition of property rights. As a paradox, this clause is the one that weakens Coase's arguments. Coase's approach gained a lot of laudatory comments, but also contradictory ones and scientific critics from great academic personalities who indicated grave errors about what is wanted to be "law and property rights' economics"².

As Buchanan (1985:93) shows, it is unhappy that Coase presents his arguments in terms of *cost-benefit relation independent determined and measurable supposed*. In Coase's examples these relations are the same in all involved parties perception. So, the "unique" resources allocation exists and become conceptually undeterminable for every external observer. On the other hand, "zero transaction costs" hypothesis make resources allocation not to be influenced by property rights structure. In this case, the structure of property rights is of no interest.

This kind of arguments reveals that the economic analysis *à la Coase* cannot establish a scientific criterion for economy of law or for private property rights; as well, it cannot create an adequate medium for the positive approach of the economic science. Furthermore, the impossibility of measurement of transaction costs reveals their irrelevance for evaluating the efficiency of the exchange, or for the efficiency of the alternative structures of property rights.

In a fundamental manner, it is argued the unrealistic character of the hypothesis used by Coase. The costs that we deal with in economic science — opportunity costs — are a real-world phenomenon. Real-world behavior results from choices and that to choose means to do something and not to do other valuable things that could have been done instead. The costs of real-world behavior are the values of such real alternatives. But transaction costs as Coase understands them can only be defined in terms of "alternatives" that have never been open to human beings and which never will. To be a human being means to act under uncertainty. This fact permeates all aspects of human behavior. It is therefore meaningless to hold up perfect foresight as a standard in terms of which real-world human action appears to be costly.

Hülsmann (2004:50) pointed out about irrelevance of Coase's hypothesis:

"We do not wish to insinuate that it is useless to compare our real world with fictitious other worlds. The point is to be careful in defining and using fundamental

¹ Within externalities theory frame, Coase argues that free exchange between parts shows that all Pareto-relevant externalities tend to be eliminated.

² I mention here some of most critical replies against "*The Problem of Social Cost*" and Coase's economic analyse of the law: Walter Block, „*Coase and Demset on Private Property Rights*”, *Journal of Libertarian Studies*, I, nr. 2, 1997, p. 111-115; Robert Cooter, „*The Cost of Coase*”, *Journal of Legal Studies*, XI, 1982, p. 1-34, Murray N. Rothbard, „*The Myth of Efficiency*” și „*Justice and Property Rights*” în *The Logic of Action: Method, Money and Austrian School*, 1997, p. 269-297, „*Law, Property Rights, and Air Pollution*”, *Cato Journal*, 1982, p. 58-59; Gary North, *The Coase Theorem. A Study in Economic Epistemology*, Institute for Christian Economics, 1992, James M. Buchanan, *Liberty, Market and the State*, 1985, p 92-107.

concepts lest we invalidate analyzes of the real world. The cost concept underlying Coasian transaction costs has nothing to do with the opportunity costs that we use in economic analysis. Rather, transaction costs have affinities with what a distinguished follower of Coase has called “the nirvana approach”¹ - identifying “inefficiencies” in our world through comparisons with a perfect-foresight nirvana. This is a deficiency that vitiates Coasian explanations of the emergence and transformation of social institutions”.

So, it is misleading to say that those practices and institutions spring from a special type of “costs” – transaction costs. And it is wrong to infer that one can explain the evolution of those practices and institutions in terms of transaction costs. Explanations that rely on the nirvana approach can be more or less exciting literature, but they add nothing to science. Valid explanations of human action and human institutions must stress real-world choices among real-world alternatives. This approach too has been known before 1937. It is called methodological individualism.

If the entire coasean approach is analyzed in the meaning of the methodological individualism, then there is no way to determine the identical character of the exchange for all parties involved. If person A refuses an X \$ offer for good T, then one can suppose that person A considers that good T has a greater value than X \$. In a certain institutional frame in which A and B are parties of a potential exchange, the absence of exchange reveals that T remains in its most valuable utilization. Therefore, in a given institutional environment, resources will be efficiently allocated as long as the parties involved are free to participate or to refuse the exchange².

What happens when, for example, the legal system institutes property rights over land, but not as well over transacting them? In this circumstance the coasean economist will blame transaction costs – their increasing being synonymous with a greater inefficiency. Actually, inefficiency is the result of altering property rights, through interference of the political system, which obstructs the market in creating prosperity. Thus, it would be a glaring mistake to explain the perpetuation of poverty for a major part of people through high transaction costs. It would mean to ignore the inability of legal and judicial systems to protect property rights; the alteration of productive incentives through major governmental interference with the market; the distribution of privileges on the *rent-seeking* channel of the democratic “*game*”, meaning the pattern of an institutional arrangement totally opposite to the principles of economic development.

The market process cannot develop into an institutional vacuum. Any resources allocation is necessarily influenced by the structure of rules and rights, defining the institutional environment in which the decisions of evaluating and using resources are taken. Naturally, resources have a different allocation, in different institutional arrangements. But this means nothing more than the fact that people act different under

¹ Demsetz, (1969). To avoid misunderstandings, let us emphasize that our present criticism concerns only the concept of transaction costs. Coase’s precept for judges and legislators — maximize social product, minimize social costs — is coined in terms of relevant alternatives and thus avoids the nirvana fallacy. As I have argued above, however, this precept suffers from other grave shortcomings.

² Given other conditions than the free market, the judgment of transaction cost – as an obstacle for the exchange – could obtain an intuitive significance, which would consist in appreciating institution’s ability to favor social cooperation and prosperity. Every governmental policy is defined through exerting coercion over certain categories of persons.

different structures of constraints and incentives. As a result, the structure of property rights – the institutional environment – cannot be a neutral one.

In the world of Coase, in which there are no transaction costs, the allocation of resources will not be altered by the structure of property rights. This famous idea is as useful as the fact that in Eden all people are omniscient. In the real world, the other aspect becomes true: when transaction costs are positive, the allocation of resources is altered by the structure of property rights. In the virtue of this conclusion, transaction costs turned into the paradigm of institutional economics. For the economists of Chicago School, *efficiency* is the criterion for institutional solutions. This way, the ethics of private property have tenuously been substituted by the *cost-benefit* criterion. From such an utilitarian approach it arises the ill-fated “*need*” for law as an instrument of maximizing the *social wealth*: it is what the judge Richard Posner argues in its works (1983).

The corollary of Posner approach is that on the condition of high transaction costs (I wonder who establishes what high or low transaction costs means?), will efficiently result when the court will offer the rights to the one who will evaluate them in the highest degree¹. According to Coase (1991:253) “*it is obviously wishful that the rights should be distributed to those who can use them at their highest efficiency, and for achieving and maintaining such a distribution, the cost of transfer for these rights must be minimal and the law must favor its achieving*”. In this approach Coase and Demsetz pleads for “*the allocation of property rights in any structure which will minimize the social transaction costs*”. In other words, if by aggregating individual costs and incomes it is obtained a “*social net income*”, then the policy which created this income is desirable, no matter the degree of coercion. It reflects the unfortunate aspect that for Coase (1990:15), “*the economic problem, in every case of negative economic [externality] effect, is maximizing the value of production*”. This view clearly indicates the subordination of private property ethics in favor of arbitrary considerations over their efficiency.

The subjectivism of efficiency, as well as the impossibility of interpersonal comparison of utility, demonstrates why efficiency can't be a scientific criterion – especially in evaluating law, property rights or state policy. Something else must be the reference point for social science². Even though, there is a general understanding – through economists – that individual utilities cannot be measured, and thus compared, they still sum up and subtract “*social benefits*” and “*social costs*”. As a proof for this statement are standing the analyses of “*scientific evaluation*” of benefits and losses in welfare for the entire society, for the “*national economy*”. Moreover, there is the amount of studies such as: “*The costs and benefits of Romania's accession to UE*”, in which it is of little importance that economists have “*their hands bound*” in measuring and

¹ For Posner (1983), “*this is the economic reason which entitles the worker to sell his labour, and the woman to choose her sexual partners*”, which means the impossible perspective for establishing rights according to the intensity of their evaluation (the efficiency criterion), not on reasons regarding the ethics of private property.

² In “*The myth of Efficiency Criterion in Economic Science*” (Marinescu, 2005), I argued that the only and fundamental criterion which can confirm the scientific nature of economy, is the criterion of “*ethics*”. The economic judgments are complete when there are placed in an ethical environment, as long as law and ethics are naturally connected and the essential means for a right understanding of human nature.

comparing advantages and costs (especially because these belongs to someone else). What remains is purely political speculation.

Finally, Coase, Demsetz and Stigler's studies postulate an epistemological mistake, in concluding that the distribution of property rights, in circumstance of positive transaction costs, must be subordinated to the criterion of monetary value maximization of "social" production. In fact, the cost-benefit criterion ruins the entire coasean theory, when the one "negotiating" the negative externalities that are imposed to him, will shout – as Gary North did (1992:79): "*Coase, get your cattle off my land!*"

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