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BUSINESS, POLITICS, AND GOVERNANCE IN TRANSITION: ROMANIA AND BEYOND,

1999-2008

by

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ABSTRACT OF THE DISSERTATION

Business, Politics, and Governance in Transition: Romania and Beyond, 1999-2008

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My dissertation addresses the fate of institutional reforms of market governance (such as laws of bankruptcy, capital markets, and concessions) and democratic governance (such as anti-corruption, civil service, and judicial reform) in Romania and across Eastern Europe. While progress has been limited in reforming democratic governance, the surprising turnaround in economic performance and institutional reforms of market governance in Romania challenges the prevailing view in the literature that communist-era managers were able to capture the state and prevent the creation of a sound institutional framework. I explain how this reversal of fortune was possible, as well as why this success has not been fully matched in the democratic governance domain, by focusing on the influence of private actors, economic and political, on the reform of governance institutions.

Success in institutional reform in the market domain in Romania's case came from a combination of economic elite change on the background of political change and banking reform that led to changing incentives of the business elite. Using data from the Business Environment and Enterprise Performance Survey (BEEPS), I show that banking reform also has a strong relationship to the reduction in state capture across Eastern Europe. The mixed success in state accountability or democratic governance in the Romanian case is due to the continued incentives of politicians for state exploitation in the context of quite robust political competition in Parliament, as well as competition between the President and the Prime Minister.

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Introduction

Chapter 1: The Political Economy of Institutional Change in Eastern Europe

Prosperity and democracy are complex achievements that require an elaborate institutional support system. The continuing struggles of new democracies to provide both economic growth and political freedom highlight the complexity of the institution-building task that these societies face. Corruption, perverse legacies, and opposition from vested interests are only some of the many challenges that thwart the attempts of emerging markets and democracies to create stable prosperity-enhancing rule-based environments. The good news is that the key role of institutions for political and economic development has gained rapid recognition in the last couple of decades in both research and policy. In relation to postcommunist societies, the early impetus to liberalize markets and cut out the state from the economy has gradually made room for the imperative of state-building (Fukuyama 2004). Concepts like governance and the rule of law have become commonplace in development policy circles, yet the recipe for achieving desirable institutions is still elusive. My dissertation contributes to the search for institutional quality in both the market and the democratic domains by analyzing the process of institutional change in Romania and more broadly in Eastern Europe. I examine the challenges and achievements of institution building in the region, in an attempt to find the determinants of quality political and economic institutions.

The role of institutions in economic and political development

Institutions are the rules of the game in political economy, or more specifically, they are the “formal and informal procedures, routines, norms, and conventions embodied in the organizational structure of the polity or political economy” (Hall and Taylor 1996: 938). In economics and international development circles, a focus on institutions, albeit often too vague, is replacing previous approaches based on one-size-fits-all economic policies aimed at increasing capital, or on international integration through trade and market liberalization (World bank 2005, Rodrik 2000, Rodrik et al 2004, Acemoglu et al 2005, Acemoglu and Robinson 2006). In political science, researchers are moving away from descriptions of institutions as independent structural constraints, towards a more dynamic and relational view of institutions (Thelen 2003, Hall and Taylor 1996, Thelen and Steinmo 1992). There is also more interdisciplinary conversation, with both economists and political scientists more interested in the interaction between economic and political institutions.

I capitalize on these trends by focusing on the creation of specific governance institutions, such as laws of bankruptcy, capital markets, corporate governance, secured transactions (in the economic domain), and civil service, anti-corruption, or audit courts (in the democratic domain). This focus is based on the idea that both the market and democracy survive and consolidate thanks to institutional supports. I discuss economic and democratic governance reforms as distinct, but interrelated processes.

The importance of institutions of democratic and market governance has been emphasized in many classic and recent works. In the market governance domain, the emphasis has been on securing private property rights by creating institutions that restrict the arbitrary power of the state (Haber, North and Weingast 2008, Shleifer and Vishny 1998, Frye 2004, Weingast 1997) and that protect fair investment rules (Stiglitz 2000, Pistor 2001, 2000) in order to promote economic and financial development.

In the democratic governance domain, scholars of democracy have readily adopted Huntington's (1968) warning about the dangers of lack of institutionalization in modernizing societies, and have insisted on the importance of institutionalizing democratic rules. For O'Donnell (2001), the legal system strongly influences the vigor of political citizenship, and upholds the "institutionalized wager" of democracy. Democracy, then, should be studied in relation to the state, whose legal system affords citizens the agency of making political choices.

The importance of law for democracy is embodied in the notion of the rule of law, which is the principle of the supremacy of the law, and the respect of the authorities towards the it. The rule of law is a major dimension of the quality of democracy (Morlino 2004). The definition of the rather vague concept of rule of law can be extensive, including equal enforcement of laws, no corruption in any branches of government, independence of the judiciary, ability of the courts to enforce their rulings, and supremacy of the constitution (ibid.). Strong market and democratic governance institutions are part of this broad concept, because they restrict the discretion of

powerful political and economic actors. Carothers (2006) also defines the rule of law in similar terms, including reasonable independence, fairness, competence and efficiency of the judiciary, and embeddedness of the government in a comprehensive legal framework (p.4). The rule of law, in this view, is essential to liberal democracy because it makes possible individual rights, and essential to economic growth, as the institution-building part of market reforms (ibid: 4-6).

Carothers (2006) divides the reform of the rule of law into four stages: revising the laws themselves, strengthening law-related institutions (the judiciary, legislatures, tax administrations and local governments), and increasing government compliance with the law (p. 7). I focus mostly on the first stage of institutional reform, namely the passage of law, but I discuss the implementation and complementarities of the institutions in practice as well.

In the same vein, Elster, Offe and Preuss (1998) define democratic consolidation as the institutionalization of agency. In a well-institutionalized order, the rules themselves are no longer the object of distributional conflict. In other words, there is a “hiatus between rules and decisions” (vertical dimension), so that the institutional rules, such as the market and democratic governance laws that I study, are stable and accepted, and no longer in danger of being contested or changed. Economic and political agents, however, are tempted to revise the rules according to current interests, based on the opportunity cost of compliance with existing laws, and on the trust that other actors will also comply in similar situations (ibid: 30). Both of these factors are

lacking in transitional societies, so the obsession with discretionary power is rational in these environments. Rule-making is not seen as rewarding because it involves self-restraint and empowerment of other actors. Besides, rules are anticipated to be short-lived and poorly enforced (ibid: 33). This spells one of the main difficulties of building strong, stable institutions in new democracies such as the ones of Eastern Europe.

There is also a horizontal dimension to institutionalization according to Elster et al. (1998), consisting in the separation of the economic and political spheres, and the insulation of these spheres from each other, so that status does not convert between them (p. 31). Such separation means that privileged economic or political status cannot be easily exchanged, and neither leads to a privileged legal status. The under-institutionalized environment of early postcommunism is believed to have allowed actors with privileged political status during communism, such as the high-ranking cadres of the communist parties, to transfer their political power into economic power through a conversion process called political capitalism (Staniszki 1991, Hanley 2000). Political power could be converted into economic power by taking advantage of privileged access to information and networks, by collecting bribes from actors in search of such privileges, or by preying on state resources. Therefore, the importance of institutionalization consists in restricting this kind of behavior by creating strong market and democratic governance rules that restrict such conversions of power.

Acemoglu and Robinson (2006) also argue for the importance of political and economic institutions. Political institutions embody *de jure* political power, and cement

transitory (de facto) political power by regulating the future allocation of political power between social groups (p. 23). When citizens have the ability to threaten collective action against elites, establishing strong democratic governance institutions means that their demands for redistribution will result not only in temporary redistribution of income, but also in redistribution of de jure political power, i.e. in democratization or democratic consolidation, so as to make the promise of redistribution on the part of elites a credible commitment.

Economic and political institutions are interrelated in this view. Economic institutions are key to both aggregate economic growth and to the distribution of resources, but they are endogenous, in the sense that they depend on the distribution of political power (Acemoglu and Robinson 2006). Haggard et al. (2008) agree that “property rights and the enforcement of contract are clearly endogenous to some underlying political bargains and institutions” (206).

Just as citizens at times have the capacity to engage in large-scale collective action and change the distribution of de jure political power, economically powerful actors such as the business elite of a country are likely to have de facto political power due to their wealth. As long as political institutions permit it, business interests have incentives to attempt to institutionalize their transitory, de facto economic and political power by influencing the formation of laws that affect business. However, the transformation of de facto into de jure political power is not automatic; it requires institutional capture.

The political and economic governance laws resulting from institutional capture by private interests amount to bad, rather than weak institutions, in the sense of being biased in favor of these interests. These are not inconsistently-followed, or under-institutionalized rules in a ‘huntingtonian’ sense. Rather, captured institutions amount to perverse institutionalization (Valenzuela 1992), and are the result of high-level corruption. The institutional weakness and general under-institutionalization of the early transition in post-communist countries was dangerous not only for its high uncertainty and potential for violence and reversals, but also because it was a propitious environment for the flourishing of perverse, captured institutions.

Because they tilt the rules of the game in favor of specific actors, captured institutions restrict political and economic competition and preserve inefficiencies, and can set a country on a path-dependent trajectory to a low-performance equilibrium (North 1990). Institutional capture is therefore potentially one of the practices most harmful to economic development. This is the central concept of my thesis, which I explain next.

What is institutional capture?

Institutional capture occurs when powerful actors (political and economic) create laws and institutions that allow for these actors’ continued enrichment and/or growth of political power, and that protect their narrow interests at the expense of the broader public interest. Institutional capture by economic actors is closely related to the

World Bank's notion of state capture, defined as "shaping the formation of the basic rules of the game (i.e. laws, rules, decrees and regulations) through illicit and non-transparent private payments to public officials" (Hellman et al 2000: 3). The latter is the definition used in the empirical measure of capture included in the Business Enterprise and Economic Performance Surveys (BEEPS) conducted by the World Bank and the European Bank for Reconstruction and Development (EBRD) in Eastern Europe and Central Asia in 1999, 2002, and 2005.

The notion of institutional capture I use, unlike the World Bank concept of state capture, is not only the perquisite of powerful business; it also refers to politicians' attempts to capture democratic governance institutions, such as state monitoring and oversight rules. If these rules are kept lax, politicians can maintain immunity from prosecution in anti-corruption investigations and discretion to dole out favors to various clients. In past literature the focus has been either on capture by business (Hellman et al. 2000) or on capture by politicians and bureaucrats, a phenomenon sometimes referred to as the predatory state or 'grabbing hand' (Schleifer 1997, Grzymala-Busse 2007). Institutional capture as defined in this dissertation is a broader umbrella that refers to undue influence on the state by both business and politicians.

The World Bank's definition of state capture also focuses on the illegal and non-transparent nature of the exchanges between businesspeople and politicians or public officials, bringing state capture into the domain of high-level corruption. State capture is thus generally considered to be a hidden mechanism of influencing policy, different

from the legal and transparent channel of legislative lobby, the traditional way of providing information to politicians about business preferences in industrialized countries.

Institutional capture, like the World Bank's definition of state capture, often involves illegal payments or gifts by businesspeople to politicians to gain influence over market institutions. However, my concept of capture does not necessarily involve unlawful behavior. Rather, it focuses on unfair institutional outcomes that favor powerful groups. These outcomes can come about through legal political processes. When politicians are the ones capturing institutions of democratic governance, the use of such regular political processes is most likely, because there are no intermediaries to buy off. Politicians vote on the creation of institutions of state oversight directly, and it is their prerogative to decide how many restrictions on the discretionary power of political elites relative to the state to permit. However, the fact that elected politicians are only exercising their legal powers in voting for weak institutions of state oversight does not change the reality that they are capturing the state when they are maintaining easy and unaccountable access to state funds, jobs, or contracts. Weak or non-existent institutions of democratic accountability amount to institutional capture not because they are the result of corrupt practices, but rather because they allow continued high-level corruption and state exploitation by political elites.

Similarly, in the economic domain, institutional capture does not necessarily involve illegal payments by business people. Like the definition of state capture used by

the World Bank, my concept of institutional capture resembles the notion of regulatory capture that emerged in economics with the work of George Stigler. Stigler (1971) argues that much government regulation of economic activity ends up benefitting precisely those subject to such regulation, due to political pressure from such business. The political costs to business of buying regulation consist of campaign contributions or services, and maybe employment of party workers (Stigler 1971: 12), none of which are necessarily illegal. Thus, the concept of capture is not dependent on the illegal nature of the means of capturing legislation; rather, capture is often implied by the skewed outcome.

Stigler's (1971) argument refers to regulation in the US, suggesting that even the economic institutions of advanced industrialized countries could be considered captured. This view is especially attractive in the context of the recent financial crisis, when the laws of capital markets appear to have allowed too much risk-taking by banks and other investors. However, the economies of Eastern Europe are at an entirely different stage of the institutional design process. Capital markets, bankruptcy, or corporate governance rules have to be first created from scratch in these countries, before they can be judged too liberal or social-democratic. At this initial design level, the quality of an institution of market governance is judged by its adherence to international best-practice design guidelines, set by the OECD. These guidelines only represent minimum agreed-upon standards for a market framework that protects investment and provides favorable conditions for economic growth.

Missing these guidelines implies legislation flaws that go far beyond special provisions on financial derivatives that allow too much risk-taking. For instance, captured bankruptcy laws may have lax provisions for declaring a firm insolvent, in order to keep politically connected firms alive long after they have stopped being profitable. Captured concessions laws may not specify the terms of fair competition for contracts, and thus enrich political allies, while captured competition laws may have lax definitions of anti-competitive procedures that allow the creation of politically powerful business monopolies.

In contrast, reformed institutions of democratic and market governance have strong provisions limiting the discretion of political actors, and establishing fairness in market competition. These rules may still display biases, such as the neoliberal bias against 'excessive' financial regulation. This highlights the fact that institutional capture is a matter of degree. As long as the institutional reforms have eliminated large transition-specific loopholes, institutional capture as defined here is not likely to have taken place.

Institutional capture should be distinguished from other forms of high-level corruption that focus on acquiring one-time or short-term benefits from the state (e.g. public procurement contracts). Such corruption is certainly very important also, but it may not amount to the entrenchment of the acquired benefits for the long term. The World Bank concept of state capture refers to the sale of any decisions that might affect firms, including much more than basic market rules. Particularistic decisions that affect

only one or a few firms in the short-term (e.g. temporary subsidies or exceptions from taxation) would be included in the World Bank's measure of state capture, even though they do not amount to institutional capture. Thus, state capture, while very useful as the only quantitative measure of institutional capture, is not a perfect conceptual match to my notion of institutional capture. Institutional capture can be conceived as a tougher test of state capture, as it refers to the institutionalization of state capture through influencing the basic market rules themselves, rather than more specific, or lower-level rules.

Thus, institutional capture in transition means primarily the maintenance of loopholes or poor-quality institutions in market and democratic governance that allow the continued enrichment and political influence of privileged actors. Such rules are not simply under-institutionalized; the loopholes are purposefully maintained and not likely to be remedied. By focusing on the institutionalization of inequality through institutional capture, my study fits into a broad tradition in the development literature¹, as well as in the literature on democracy and growth², of attributing wide differences in economic performance among countries to the ability of powerful actors to set the rules of the game in their favor.

¹ See Birdsall (2005) on why globalization reinforces inequality between rich and poor countries, and Engerman and Sokoloff (1997) on why highly unequal societies in the New World grew consistently less over time.

² e.g. Landa and Kapstein (2001) on the difficulty of setting up redistributive institutions, Acemoglu and Robinson (2006) on why highly unequal democracies are less likely to consolidate

Institutional reforms in Eastern Europe

The collapse of communism in Eastern Europe has been touted as “the end of history”, with democratic liberalism believed to prevail worldwide. As in Latin America, the new democracies of Central Europe and the Baltic and Balkan countries, albeit imperfect, proved surprisingly resilient to the upheavals of concomitant economic and political transitions. Economic and political reforms even seem to have reinforced each other (Elster et al 1998), in spite of the fact that the direction of causality between the two types of reforms was unclear, leading to debates about the sequencing and speed of reforms. While some believed that economic reforms should be enacted first and fast, before special interests can reorganize and oppose them, other insisted that sustainable economic reform can only occur if democratic institutions are strongly in place³.

Beyond the initial cheers for the transitions towards democracy, and in spite of the strong support for democracy provided for at least some Eastern European states from the European Union and other Western organizations, consolidated democracies and markets have not followed automatically. When initial liberalization and privatization proved insufficient in bringing about prosperity in Eastern Europe, political economists agreed that institutions matter, and insisted that market and democratic governance rules are an indispensable part of building sustainable political economies (Stiglitz 2000, Svejnar 2002, Roland 2002). The absence of such institutional reforms, it was argued, would lead to crony capitalism, partial reform and state capture by private interests.

³ Gould and Hetman (2008) provide a review of these arguments.

In his World Bank address marking ten years of transition, Joseph Stiglitz warned against regulatory capture as a potential consequence of illegitimate privatizations. He noted that “reform models based on conventional neoclassical economics are likely to underestimate the importance of informational problems, including those arising from the problems of corporate governance; of social and organizational capital; and of the institutional and legal infrastructure required to make an effective market economy”(Stiglitz 2000: 1).

The porous institutional environment of the 1990s in the transition economies of Eastern Europe presented special opportunities for institutional capture. The fear was that communist-time managers would take advantage of the initial economic opening in an unsettled institutional environment in order to gain control rights over enterprises and to enrich themselves. This led to considerable concern that they would transform these initial advantages into long-term ones by opposing further institutional reforms that would improve the market environment (EBRD 1999, Hellman 1998). Aslund (2002) for instance warns that if the window of opportunity for economic reform is missed, rent-seeking businessmen end up trapping the nation into a vicious circle. The 1999 *Transition Report* of the European Bank for Reconstruction and Development (EBRD) also notes that “where initial policy choices have concentrated economic power in particular groups, this power has been used to distort or stall reforms later in the transition” (EBRD 1999: 102). A similar argument applies to the partial reform of state oversight institutions due to the entrenchment of political power by elites linked to the former communist regimes.

The absence of legitimate channels to influence policy, such as clear party financing or lobbying rules, also encouraged state capture. In post-communism, public lobbying has been almost inexistent, to the detriment of more obscure forms of influence (Ganev 2001). Business associations are perceived more as a form of networking among businessmen (Schoenman 2004) or as a form of protection against predatory bribe-seeking by lower-level bureaucrats (Duvanova 2007), than as a form of collective action aimed at providing information about business preferences to the state.

While interest group explanations for the failure of economic reforms are common among political economy accounts of policy change (Haggard 2000), Hellman (1998) introduces a twist in his explanation of business interests' opposition to reform, by noting that these actors did not entirely oppose reform. In fact, they benefitted from early reforms, such as price and exchange rate liberalization, and early privatization. Instead, these economic actors, described by Hellman (1998) as enterprise insiders, commercial bankers, local officials, and the "so-called mafiosi who have undermined the creation of a stable legal foundation for the market economy", have aimed to "stall the economy in a partial reform equilibrium that generates concentrated rents" (204). They have done so by attempting to "block specific advances in the reform process that threaten to eliminate the special advantages and market distortions upon which their own early reform gains were based" (ibid.)

The capture of market institutions described by Hellman brings valuable benefits to the captor firms, in the form of increased sales, but also in the form of individualized protection of property rights at the expense of the firms not involved in capture (Lugon-Moulin 2010). Exclusion of the majority of firms from the benefits of market institutions, and the concentration of such benefits in the hands of a few captor firms is a main feature of institutional capture. This exclusion creates a substantial social cost: the enterprise sector in high-capture economies grows half as fast as in low-capture countries (Hellman and Kaufmann 2001). Foreign Direct Investment (FDI) is also affected, as foreign companies avoid the countries with poor generalized institutional protections. The benefits for captor firms of the individualized protection offered by captured institutions are the reason why “any reforms to improve the institutional framework, which might undermine these highly concentrated advantages, will be strongly opposed by captor firms that have the political influence to derail such reforms” (Hellman and Kaufmann 2001). This logic suggests that poor institutions are likely to persist in environments where capture occurs, and institutional reforms are unlikely to succeed, unless the opposition of captor firms can be effectively countered.

Communist legacies and institutional capture

The assertion that legacies of the past, especially those related to communist rule, have greatly influenced both political and economic outcomes in Eastern Europe is at the core of many studies dealing with the evolution of this region. Exactly how much

and which legacies influence outcomes, however, has not been easy to assess. While the statistical influence of communist legacies on postcommunist democratization is large and long-lasting, no single legacy is statistically significant across model specifications (Pop-Eleches 2007). Moreover, the legacies deemed significant in statistical analysis of democracy outcomes are very broad concepts like religion, ethnic fragmentation, or statehood experience, which do not do well in explaining smaller differences in institutions among the democratic subset of Eastern European countries.

More specific legacies, like the type of communist bureaucracy (Kitschelt et al. 1999) or the composition of post-communist political elites (Ishimaya 1997, Pop-Eleches 1999) have also been shown to matter for political and institutional choices, such as presidential or parliamentary regime type, or party system development. However, in terms of the quality of institutions of democratic governance or state oversight these legacies do not seem to be the determining factors. Countries with similar outcomes in terms of institutions of state oversight, such as Czech Republic and Bulgaria, both of which have relatively exploited states, have very different historical legacies of state development according to Kitschelt et al. (1999) (bureaucratic-authoritarian in Czech Republic and patrimonial in Bulgaria). Therefore, I follow Grzymala-Busse (2007) in focusing on the effects of political competition, rather than legacies, on these institutional outcomes.

Ekiert and Hanson (2003) attempt to bring some order to legacies arguments by noting that legacies act at three levels: structural, institutional, and interactional. At the

structural level, statism and resentment nationalism are common legacies in the region, but specific causal mechanisms through which these legacies influence outcomes are difficult to establish. At the institutional level, state socialism resulted in a legacy of modernization, but also of nomenklatura rule and of informal networks of the second economy, which in turn produced outcomes such as asset stripping, recombinant property (Stark and Bruszt 1998), and political capitalism (Staniszki 1991). These outcomes were present to some extent across Eastern Europe, but their lasting power has differed considerably, and their importance for later ownership and capitalist development configurations is not at all clear.

In Romania's case, which I analyze in this dissertation, I argue that these institutional legacies of state socialism were not sufficient to lock the country into a low-performance equilibrium, as some suggested (e.g. Hellman 1998). Corruption in business and the use of informal networks and contacts (Grødeland 2007, Ledeneva 2006) has been used extensively in Romania and beyond in privatization deals, and to obtain various business advantages, but it has not extended to institutional capture. Once introduced, new market governance laws have been used by business more and more (Murrell 2003, Hendley et al. 2001), gradually replacing informal networks and bilateral relations, and disconfirming fears of the uselessness of new laws in areas where informal norms and networks were present.

Like Ekiert and Hanson (2003), I believe that the third level of legacies, namely the interactional level, is the most productive for studying postcommunist change, because

this is where causal mechanisms generate new institutional outcomes, albeit highly contextualized ones that cannot be predicted at the other two levels of analysis (p. 29). In the Romanian business case, for instance, legacies of market-phobic economic elites with strong networks and access to the communist-successor party were transformed by interaction with the rise of younger economic elites, political liberalization, privatization, and policy choices such as banking reform. Due to these interactions, Romania avoided the partial reform equilibrium that believers in path dependence and other strong versions of legacies arguments predicted.

Puzzles

In spite of somber predictions based on a discouraging evolution in the 1990s, the 2000s seem to have brought new impetus for reform and economic performance in the Eastern European laggards. While in 1999, state capture by business was a pervasive phenomenon in South East Europe, the former Soviets, and even some of the Central European and Baltic states (Hellman et al 2000, World Bank 2000), by 2002 and 2005 the World Bank surveys of the business environment in transition (the Business Environment and Enterprise Performance Survey or BEEPS) show a significant drop in state capture across the region (Grey et al 2004, Fries et al 2003, Anderson and Gray 2006). Growth has also significantly accelerated in most of the region, especially in the reform laggards. In Romania for instance, prior to the global crisis of 2008-9, the economy has grown faster between 2000 and 2006 than in any EU country (IMF 2007). There also have been significant improvements in the business legislation and the

business environments of some countries (Romania and Slovakia stand out) (World Bank 2006). This puzzling reversal of fortune merits explanation, given that some of these countries were believed to be stuck in partial reform traps due to institutional capture (Hellman 1998).

A related puzzle is that these improvements in growth rates and business environment have not always been matched by improvements in democratic governance indicators, in some cases even in spite of significant advances in legislation in this domain. In most Eastern European countries the best dimension of governance today among the World Bank governance indicators is regulatory quality, a measure of market governance, while the worst measures are in the political governance areas, especially control of corruption (World Bank 2007). New anti-corruption and civil service laws, and judicial reform have been mandated by EU conditionality in the cases of the newest EU members, Bulgaria and Romania, and have also been adopted in other Balkan (Croatia, Serbia, Albania) and Former Soviet countries (Moldova, Ukraine) with more vague prospects of EU membership. However, the functioning of these new democratic governance institutions in practice has often remained rather weak, and accounts of political parties and elected officials exploiting the state for personal gain are still commonplace. What, then, explains the discrepancy between market and democratic governance, and how is it possible that state accountability lags behind in spite of legal advances?

What explains market and democratic governance reforms?

Economic institutions

My answer to the puzzle of significant improvement in market governance is that contrary to somber predictions of partial reform traps and institutionalization of corruption in the Eastern European laggards (Hellman 1998, EBRD 1999), enterprise insiders were not able to entrench their initial benefits and state capture into market governance rules that would stall further economic restructuring. Romania escaped the partial reform trap thanks to a combination of factors: rising market competition due to the emergence of a new entrepreneurial class, political change, economic crisis and banking reform. Key among these was the rise of a new economic elite, much younger and more pro-market than the communist-era enterprise managers that engaged in asset stripping and political capitalism. These new entrepreneurs, while not immune to taking advantage of political connections and corrupt privatization deals, learnt the rules of the market quickly, sometimes with the help of foreign partners, and were not afraid of operating in an environment with sophisticated market governance rules.

The political change of 1996, together with banking reform prompted by economic crisis allowed for this elite change. The old communist-era managers, who had overwhelmingly supported the communist-successor party in power until 1996 fell out of favor politically when a new anti-communist coalition took power, and were no longer able to prevent market governance reforms. They were also unable to entrench

their initial gains by taking advantage of privatization, because the sale of state enterprises did not start in earnest until after 1997. They further lost out when banking reform ended the availability of soft loans that kept their enterprises afloat.

Banking reform stands out because even the new entrepreneurs had incentives to prevent it in order to continue benefitting from soft loans. Clientelistic allocation of finance was one of the most important features of the early post-communist political economy even in Central Europe (King 2001), and it survived longer in South East Europe and the Former Soviet Union due to the slower pace of reform. The restructuring of the banking system, which was possible due to banking crisis and cooptation of selected economic interests (who were part of the new economic elite), has changed the incentives of the new entrepreneurs away from rent-seeking and towards market strategies. The importance of banking reform in the Romanian case is confirmed in Chapter 4 by my cross-national multi-year regressions of state capture using the BEEPS data.

In this context, market governance has developed relatively independently from negative business influence, and was mostly guided by foreign advisers and EU membership requirements. The resulting market framework consists of sophisticated laws of bankruptcy, capital markets, secured transactions and others, in high compliance with OECD-endorsed best practice in these legal fields. The issues remaining in market governance are problems of correcting design mistakes and of transplanting foreign laws into unfamiliar legal territory, and not problems of institutional capture by private

actors. The market environment created with the new sophisticated market governance rules has allowed foreign firms and new domestic entrants (often small and medium firms) to flourish.

Thus, in chapter 2 I show that partial reform equilibriums can be quite unstable and vulnerable to the processes of democratization and banking reform that create the opportunity for new economic actors to challenge the old ones. The enterprise insiders' ability to consolidate their position by capturing institutions of market governance and maintaining partial reform is more limited than Hellman suggested. Such initial lock-in does not prevent the emergence of such new entrepreneurs who, given the right incentives, will focus on profit-seeking strategies guided by market competition rather than institutional capture.

Romania is not unique in its experience with institutional capture, suggesting that my argument may have broader applicability. The same factors responsible for the drop in capture in the Romanian case, namely increased market competition through the emergence of new market-skilled business elites combined with banking reform, have also prevented or reversed state capture in other postcommunist states. Central European and Baltic countries are prime examples of this trend. Asset stripping, political capitalism, and other strategies of economic actors consistent with state capture were also present early on in these frontrunners of transition (Staniszki 1991, Stark and Bruszt 1998, King 2001), but most of these countries have experienced faster political change, immediate opening of their economies to foreign investment and other forms

of economic competition, and earlier banking reform. In South-East Europe, Bulgaria's experience mirrors Romania's most closely in terms of the evolution of both political and economic competition, and of state capture.

Many transition economies further East from Romania, such as Ukraine, Russia, Georgia, and Azerbaijan, have also experienced a substantial drop in reported state capture between 1999 and 2005 (in BEEPS), but their institutional reform performance is more patchy than Romania's (see Appendix 1), suggesting that institutional capture in market governance may still occur. More patchy outcomes could be due to the fact that only some of the variables that contributed to the drop in capture in Romania, like banking reform in Russia and political opening in Ukraine, have occurred, while others, like market competition, have not improved substantially. In spite of the emergence of some new entrepreneurs (e.g. see Guriev and Rachinsky 2004 for Russia and Gould and Hetman 2008 for Ukraine), these countries' economies are still dominated by natural resource monopolies, and lack substantial foreign investment. The low reported state capture in 2005 (in BEEPS) might be due to significant underreporting in repressive political systems, or may be the result of other processes, such as a reassertion of state power over the enterprise sector under Putin in Russia.

Political institutions

The improvements in Romanian market governance have not been matched by improvements in political governance (i.e. reform of the state). Politicians have strong

incentives to delay and subvert state oversight and monitoring rules in order to maintain open access to state resources for clientelistic party purposes (to reward electoral supporters) and/or for personal gain. The parliamentary battles over specific provisions of laws such as anti-corruption and conflict of interest have been fierce, and have resulted in significant delays and implementation failures in spite of constant strong pressure from the EU. I argue that political competition and EU pressure only partially explain the current picture of relative legal strength but practical weakness of institutions of state oversight.

The extent to which politicians succeed in their institutional capture attempts is believed to depend in large part on the strength of the constraints limiting such behavior, embodied in political competition (Grzymala-Busse 2006, 2007). Nonetheless, even newer, more sophisticated measures of political competition, such as Grzymala-Busse's (2007) notion of robust competition, do not fully capture the incentives of politicians, resulting in errors of both over- and under-estimation of democratic governance reform in the case of Romania.

The rule of the communist-successor party prior to 1996 involved much state exploitation, but also some early institutions of democratic accountability, such as an independent audit court and party financing rules, which were enacted in spite of the lack of robust competition (as measured by Grzymala-Busse's (2007)). Later on, institutional reforms of democratic governance and their implementation often lagged

behind other reforms, in spite of increasingly robust competition and intensified EU influence.

As I show in Chapter 3, one reason why parliamentary political competition fails to fully explain the recent institutional reform performance in state oversight is that the intra-executive competition between the President and Parliament in a semi-presidential system can be a significant additional competitive element affecting accountability reforms. In Romania, parliamentary parties reacted to presidential accusations of corruption by uniting into a common anti-presidential stance, and opposing the passage of the National Integrity Agency (ANI) in spite of strong EU pressure. However, after almost a year of the President-Parliament stand-off, the ANI oversight institution was unanimously passed in Parliament in a version much stronger than MPs would have preferred.

Thus, the effect of intense parliamentary competition on state oversight reform can be collusion against reform, the opposite of what political competition theories anticipate, when compounded by semi-presidentialism. Nonetheless, the effect of such additional President-Parliament competition can also be beneficial for political governance reform. In the ANI case, the net effect of semi-presidentialism has been positive, but this outcome seems highly contingent on the Romanian situation of 2007.

My study of the Romanian state oversight reforms shows that the inconsistent relationship between political competition and reform is not just an issue of measurement, although imperfect measures of both competition and institutional

strength do muddy the relationship. More fundamentally, there are conceptual reasons why competition has inconclusive effects on democratic accountability institutions. As I explain in the next section, competition offers both positive and negative incentives to politicians for engaging in democratic governance reforms. Timing of competition also makes a difference, as well as factors beyond political competition.

Timing issues can make a difference in the effects of political competition on accountability reforms. Until 1996, in spite of a relatively weak opposition, the Romanian communist-successor party was the only party viewed as tainted by corruption and state exploitation. The opposition had not had a chance yet to engage in similar practices, so it had the moral high ground, raising the likelihood of electoral reversal in the following elections. Limiting state exploitation through institutions of democratic accountability was most likely to translate in electoral advantage for the incumbent communist-successor party at that point in time, by helping the party maintain its innocence, by weakening corruption-related opposition attacks, and by making voters forgive previous transgressions. Some such institutions were indeed passed in 1996 in spite of the lack of robust competition.

After 1996, when anti-communist parties spent some time in office and used the opportunity to exploit the state, both major political camps were equally tainted by corruption and clientelism accusations, and numerous politicians from both camps had much to fear from strong anti-corruption institutions. Thus, opposing parties had more incentives to collude against accountability reforms in later years.

Reform in other areas of democratic governance, such as civil service, may also be affected by specific incentives that have little to do with political competition. For instance, Meyer-Sahling (2004) suggests that, except for a very restricted window of opportunity for the first anti-communist government in countries with pacted transitions (Hungary and Poland), both communist-successor and anti-communist parties had strong incentives to maintain wide political discretion over bureaucratic appointments, because they could not trust the inherited bureaucrats, who were the previous government's political appointees. This problem of trust starts with the first postcommunist governments, who inherited highly politicized communist bureaucracies, and is not alleviated for subsequent governments. The result is a high degree of formal political discretion characterizing all postcommunist states, in addition to high state politicization in practice (Meyer-Sahling 2004: 75).

Moreover, there are factors beyond political competition that favor the persistence of state exploitation in order to maintain clientelistic linkages between politicians and citizens (Kitschelt 2000) in Romania, and in countries further East with similar economic background, historical legacies of state development, and institutional division of powers. Clientelism occurs when politicians do not invest in the typical party functions of interest aggregation through programmatic, ideological ties, but rather "create bonds with their following through direct, personal, and typically material side-payments" (Kitschelt 2000: 849). This definition of clientelism includes not only selective small cash outlays to vote-rich poor constituencies, but also the provision of public works contracts, favorable regulation, subsidies etc. to resource-rich constituencies such

as business interests (ibid.). Clientelism thus ties in with institutional capture to the extent that provision of such state benefits happens thanks to the absence of state oversight rules that would limit such behavior by politicians. Factors that encourage the maintenance of clientelistic ties also operate against strengthening institutions of state oversight. Most of the factors considered by Kitschelt (2000) are more background than the robustness of political competition. In the case of Romania, these factors are neopatrimonial rule during communism and a relatively strong presidency, while other factors, such as relatively proportional electoral rules and rising population incomes militate against clientelism.

Another problem with explaining democratic governance reform simply by reference to parliamentary competition is that even after strong laws of state oversight are passed, their effectiveness is still in doubt, especially when compared to the overall performance of market governance institutions. The National Integrity Agency is a case in point. This agency has taken seriously its task of verifying politicians' asset declarations. Its effectiveness, however, is impaired by long delays and political interference once the cases reach the judicial system, so that the only convictions obtained so far are in relatively minor cases. In addition, the agency has recently come under attack when the Constitutional Court has declared parts of the ANI law unconstitutional. Such attacks suggest that the political fight over institutions of state oversight is not over once these institutions become law. However, political competition is likely much more important at the stage of passage into law than at subsequent stages. Other factors, such as the functioning of the judiciary and the public support for

these institutions of state oversight also become important in the implementation phase.

Competition and institutional change: an analytical summary

Competition in markets and politics is often touted as a cure-all for institutional reforms, at least in the post-communist context (Hellman 1998, Grzymala-Busse 2007). My dissertation shows that competition is indeed a key necessary factor for reforms in both institutional domains, but it is not a sufficient condition for reform.

In market governance, the role of competition is a relatively unrecognized and understudied element. Hellman (1998) and Hellman and Kaufmann (2001) suggest that more competition in the market would be beneficial for escaping a partial reform trap, but they give no clues as to how such competition might be achieved. In my dissertation, I explain how increased market competition can be achieved with the emergence of new entrepreneurs with market skills, who gradually replace market-phobic enterprise insiders thanks to a combination of political change and banking reform. These two factors are crucial, beside the availability of market competition, for lessening the political power of the old business elite, and for firmly directing the incentives of the new elite towards market, rather than rent-seeking strategies.

The market governance improvements that followed in the absence of business opposition to such reforms further increased market competition by allowing market entrance of a variety of new firms, including foreign, and small and medium enterprises.

These new entrants provide a further constituency for a strong market governance framework and for stronger democratic accountability that threatens clientelist ties between firms and politicians. The economic growth and higher population incomes resulting from better market conditions also threaten such clientelist ties and encourage political reform, suggesting a way that market governance reforms can positively influence democratic governance improvements.

Just like increased market competition was key to economic governance reforms, political competition is a necessary condition for reform of democratic accountability institutions. Without competition, it is difficult to imagine what could effectively restrict incumbents' incentives to use state resources for political and/or personal use. The communist party-states of Eastern European countries are great examples of what happens in the absence of political competition: the state is captured by political elites and used to keep them in power indefinitely.

However, the presence of political competition is certainly not a guarantee of accountability reforms. The incentives created by political competition depend on politicians' time horizons and on their reaction to uncertainty. In the short-term, politicians have incentives to use state resources unrestrictedly in order to reward their supporters (e.g. with public contracts or jobs), and thus ensure further electoral and financial support. This strategy may be particularly attractive shortly before elections, when dispensing even relatively small amounts of public cash can be an effective vote-buying tactic. More electorally insecure incumbent parties, such as those facing higher

political competition, or having weak programmatic appeal, are likely to find state exploitation more tempting. Incentives for state exploitation by political parties can be compounded by the incentives of individual politicians for personal enrichment through state exploitation, especially if holding political office is perceived as a one-time shot, rather than an on-going career.

In contrast, in the long-term, if incumbents can expect to return to power after a period in opposition, they are likely to want to restrict their rivals' access to the state once these rivals win elections. Incumbents can do so by passing strong state institutions of state oversight. These institutions may also help politicians in office to avoid opposition criticism, and win votes for committing to reduce for state exploitation. Legislating strong state oversight may also be more attractive right before elections, when the commitment to restrict clientelism does not come at the expense of several years of state exploitation opportunities. Romania's experience with state reform suggests some support for this assertion, as many state oversight reforms were passed within a year or so of election times.

Overall, it is unclear theoretically whether the short-term or the long-term incentives should prevail. Empirically, Grzymala-Busse (2007) has argued convincingly that the long-term incentives have prevailed in Eastern European countries with robust competition. In the case of Romania, I show that in practice, political competition is sometimes not sufficient for such reforms, or is even counterproductive (e.g. when it is too polarized).

Institutional reforms of state oversight may require more than competition, and may be hard to come about, but their passage into law is very important, even when effective implementation does not follow immediately. These institutions, once enacted, create precious opportunities for various actors, including competitive politicians, the media and civil society, or market entrepreneurs, to chip away at clientelist democracy by holding political elites accountable to the public at large.

Why is reforming market institutions easier than reforming the state?

My argument about the success of market governance reform emphasizes the emergence of a new economic elite, equipped with the skills and incentives to survive in the market. It is reasonable to expect, then, that the weaker performance of democratic governance reform is due to the absence of such a new elite in politics, that would take over from the 'old guard', and accept the constraints of democratic accountability. Nonetheless, no such story emerges about the political elite. The Romanian political elite has gone through substantial ideological and generational change, but this has not translated in higher incentives for democratic governance reforms, and the pull of clientelism is still guiding politicians' behavior.

The fall of communism has inevitably brought about a change in the political elite, especially in a country like Romania, where the communist legacy was completely compromised, to the point that even the communist-successor party was unwilling to claim it. While many of the leaders of the National Salvation Front had been part of the communist establishment, the most controversial leaders were sidelined in 1990, and

personnel continuity with the communist party was lower than in more advanced reformers like neighboring Hungary (Pop-Eleches 1999). Younger leaders replaced older politicians fairly fast in all parties, and new faces like PSD leader Mircea Geoana, former Liberal PM Calin Popescu-Tariceanu, president Traian Basescu, or former PM Adrian Nastase gathered all their political experience in post-communist politics.

Nonetheless, the emergence of this new political elite did not have the same effects on democratic governance as business elite change did in market governance. Building programmatic party linkages to citizens as an alternative to clientelism through state exploitation is difficult, and the two strategies for political survival may be somewhat incompatible (Kitschelt 2000). Once clientelism becomes dominant, even robust political competition is often insufficient for changing politicians' incentives, as I explained in an earlier section.

Unlike the sometimes unclear implications of advanced market governance rules for specific firms, strong institutions of state monitoring and oversight have very immediate implications for the ability of politicians to exploit the state. Not only is politicians' ability to use the state for political support immediately curtailed when these institutions come into force, but politicians can come personally under attack from anti-corruption or integrity prosecutors for past or current bad behavior. Therefore, politicians' incentives in keeping these institutions weak are much stronger and more direct than the incentives of new entrepreneurs in keeping, say, bankruptcy legislation weak.

Moreover, politicians are much closer to democratic governance reform than business leaders are to market governance institutions. Politicians are the intermediaries in business influence on market institutions, making capture of market institutions potentially costly, while incumbents' position in the legislature allows them direct access to changing democratic accountability institutions. Also, in the market domain there were powerful external factors, such as banking reform (forced by economic crisis), that constrained the behavior of economic elites and helped change their incentives. In contrast, in the democratic governance field, external pressure for change, such as EU conditionality, has been much easier to circumvent. Politicians responded to such pressure by reforming institutions that did not directly affect them, and that have less clear distributional implications, such as market governance institutions. In contrast, they bitterly fought reforms that would put them in danger of prosecution.

Finally, market governance reform was also easier than democratic governance reform because of the different implications of these two sets of institutions. Market institutions are key to economic growth because they provide property rights to all participants in the market, promoting investment and market competition. However, these institutions do not necessarily preclude business people from engaging in clientelist relationships with politicians in order to obtain particularistic benefits such as exceptions from specific regulations or subsidies. These types of state exploitation, while not amounting to institutional capture, do help some business obtain undue short-term or one-time benefits. In Romania, the new entrepreneurs have sought such

benefits even while accepting basic market institutions. The protections against clientelism are embodied into institutions of state oversight, which target the behavior of incumbent politicians or government officials. These institutions thus are more threatening to those involved in clientelism than market governance institutions, making them more difficult to reform.

Methodology and case selection

Institutional capture involves processes of a hidden nature, which make this issue difficult to pursue empirically. I use both quantitative and qualitative methods to get as complete a picture of institutional capture as possible. The main quantitative data source is the BEEPS from the World Bank and the EBRD, which contains data on post-communist firms' perceptions of state capture across time (1999-2005). I complement this dataset with democracy and reform indicators from the EBRD and the World Bank.

I also use qualitative methods to contextualize and explain the evolution of institutional capture. My data sources include press articles of high-level corruption scandals, think tank publications, international organizations' reports on the quality of market and democratic governance, minutes and reports of parliamentary debates, and interviews with analysts, politicians, and businesspeople conducted in Bucharest in the spring of 2008. I also use a narrative of several important episodes of transition in order to trace the mechanisms through which the change in economic elite came about. In

addition, I compile data on the socio-economic background of the wealthiest Romanians from *Capital* magazine, in order to determine the composition of the business elite.

The main case study that my thesis is centered around is that of Romania, a Southeast European country that has been the slowest reformer of the EU accession group. Romania's growth path is typical of the Balkan countries, namely a more pronounced recession than Central European countries, and a slower subsequent recovery (the average growth rate 1989-1998 was -3.04%), so that by 2001, it had not yet reached 1989 GDP levels again (Svejnar 2002). Romania fared badly on the BEEPS state capture measures: about 25% of firms answered in 1999 that legislative capture, as well as non-transparent party finance and central bank capture were significantly affecting their business, compared to (for legislative capture) under 20% in Czech Republic and Slovakia, and just over 10% of firms in Hungary.

Romania was one of the few countries where firms were more concerned with corruption than with crime or regulations in 1999, suggesting the relative importance of this topic for business. Three quarters of firms interviewed in BEEPS (1999) declared they would pay additional taxes to eliminate corruption. The extent of state capture and the slowness of economic reform in the 1990s suggest that vested interests were particularly powerful in Romania; entrenchment of these interests through institutional capture by select firms was most likely to have occurred here.

Legacies of communist rule were also more onerous here than in other EU Eastern European member states. A hyper-centralized economy dominated by heavy

industry and unreformed in the 1980s, and a sultanistic political system (Linz and Stepan 1996) centered around Ceausescu made Romania hard to reform both economically and politically. Vachudova (2005: 143, 202-4) notes that Romania followed an illiberal path out of communism, and did not respond well to active leverage of the EU in spite of reformists taking power in 1996. EU leverage is believed to have had significantly weaker results here than in liberal states due to the perverse institutionalization of corruption, and to the domination of the economy by the “directocracy”: the managers of state enterprises from the communist nomenklatura (ibid.). Thus, Romania is a most likely case for entrapment in a partial reform equilibrium.

Since 1999, some important changes have taken place in the Romanian business environment. The 2002 round of the BEEP surveys shows only 10% of business declaring to be moderately or more seriously affected by legislative capture. While this is still a level higher than that of Czech Republic, Hungary and Poland, Romania is now considered, in the World Bank’s assessment, a low-capture economy. Moreover, Romania has been enjoying relatively rapid growth since the turn of the century, and has reformed, at least on paper, many institutions of both political and market governance. Accession to the EU in January 2007 means that this country has a functioning market economy and meets the political requirements for membership, including significant legal efforts to curb high-level corruption.

Perceptions of rampant high-level corruption persist in Romania in spite of a multitude of recent legislative state reforms, such as a new anti-corruption package, a

National Integrity Agency, and changes to the public procurement legislation. Moreover, political governance indicators have stagnated or even worsened in some areas (World Bank 2007). Thus, in spite of legislative improvements, good democratic governance remains a serious challenge for Romania. The fact that strong EU involvement in democratic governance reform, often backed by direct conditionality (especially in 2005-7), has not significantly changed democratic governance in practice highlights the strength of domestic politics. The contrast with market governance reforms makes Romania a good case for investigating the differences in institutional capture in the democratic and market governance domains.

The Romanian case study will also be a welcome addition to existing accounts of economic and political transformation in Eastern Europe. Previous explanations of both business and politicians' influence on reform have focused on the Central European countries and on Russia, leaving Southeast Europe, and Romania in particular, understudied (see Stark and Bruszt 1998, Orenstein 2001, Frye 2001, Schoenman 2005, Grzymala-Busse 2007, Johnson 2000, Shleifer and Treisman 2000 on Russia and Central Europe, and Barnes 2007, Ganev 2007 on Bulgaria). Most of these studies also do not focus directly on the relationship between institutional reforms and state capture attempts.

While Romania is a puzzling case due to the sharp drop in state capture by business and the persistence of significant problems in democratic governance, it is not a singular case. Some countries further to the East, like Russia and Ukraine, have also

seen large reductions in state capture by business (as measured by BEEPS) on the background of disappointing democratic governance performance. Thus, Romania could be indicative of a wider pattern of disjuncture between institutional capture by business and by politicians.

Conclusion and outline

The aim of this dissertation is to explain the impressive drop in perceptions of institutional capture by business in Eastern Europe, as well as the less impressive performance in improving democratic governance. Market governance institutions in Romania and beyond were not captured by business interests, and thus developed in spite of high levels of other forms of corruption, while political governance institutions have been open to capture by politicians when there were inadequate constraints on rent-seeking. Success in reducing institutional capture in the market domain in Romania's case came from a combination of economic elite change on the background of political change and banking reform that led to changing incentives of the business elite. Across Eastern Europe, banking reform also has a strong relationship to the reduction in state capture by business. The mixed success in state accountability or democratic governance in the Romanian case is due to the continued incentives of politicians for state exploitation in the context of quite robust political competition. Thus, the challenge to good governance in the region appears to be coming not so much

from business setting the rules of the market game, but from politicians attempting to keep the rules of state oversight and accountability lax.

The dissertation proceeds as follows: in chapter 2, I detail my argument about institutional capture in the business domain in Romania, and the development of market governance rules. Chapter 3 presents the democratic governance side of Romanian institutional reforms, while chapter 4 takes my argument about state capture by business across borders, expanding it through a quantitative analysis of the entire region. Chapter 5 concludes by summarizing the argument, presenting the limitations of the study, and directions for future research.

Chapter 2: Romanian Business Interests and Market Governance

The economic accomplishments of many Eastern European countries in the last decade have been remarkable, in spite of the current economic crisis. Romania, together with Slovakia, Bulgaria, and countries further east, have long been known as transition laggards, with slow growth and reform, and high inflation and corruption. By contrast, in 2007, even the International Monetary Fund (IMF) was praising Romania for its sound macroeconomic management, restructuring progress, and economic performance (IMF 2007). While Romanian incomes are still very low compared to the EU average, standards of living measured in GDP per capita have tripled since 2001⁴. Inflation and unemployment have dropped, inflows of FDI have taken off, and the share of population living in poverty has declined from 30 percent in 1999 to just under 13 percent in 2003 (EBRD 1999, 2008a). The business environment has also improved considerably in many areas, including dealing with licenses, employing workers, getting credit and protecting investors (World Bank 2006: 2), transforming Romania in a short period from a transition laggard to an investment destination. Corruption perceptions have improved, albeit from a low base (TI 2008), and companies report less frequent bribery, as well as lower values of bribes and kickbacks as a share of firm revenues (EBRD 2005).

These improvements are all the more impressive from a theoretical point of view, given the prevailing view in academic and policy circles that communist-era

⁴ From US\$1,793 in 2001 to US\$5,616 in 2007 (EBRD 2007).

managers were able to gain long-term advantages in the first decade of transition and to prevent restructuring by opposing the creation of market rules that would level the economic playing field (Hellman 1998, EBRD 1999, Stiglitz 2000). Political competition and economic reform, especially early on in transition, were believed to be the antidotes for this situation (Hellman 1998, EBRD 1999, Orenstein 2001). In Romania, both of these conditions have been lacking. Large-scale privatization did not start in earnest until the second half of the 1990s, and the communist successor party (now called the Social Democratic Party (PSD)) dominated the political scene, holding power between 1990 and 1996, and then again between 2000 and 2004. Vachudova (2005:50) calls the first seven years of the Romanian transition “a textbook case of the capture of a partially reformed economy by former communist cadres linked closely to the ruling political parties”. The period between 1996 and 2000, when an anti-communist coalition ruled, is also considered a disappointment from the point of view of economic and state reform (Pop 2006, Gallagher 2005).

Scholars of postcommunist political economy believe that inauspicious political beginnings of transition are likely to set a country on an illiberal path that even a vigorous subsequent push for reform cannot entirely change, due to the ample time and opportunities that political and economic elites had to secure their continued dominance (Grzymala-Busse 2008, Vachudova 2005). Under unfavorable initial conditions, EU influence in Romania has constrained and moderated the parameters of domestic politics, but cannot enforce “more than superficial reforms”, because the perverse institutionalization of clientelism and corruption are “very difficult to dislodge”

(Vachudova 2005: 220, 207). As an unlikely case of diminished influence of business interests, Romania presents an excellent opportunity for identifying the conditions under which the influence of 'early winners' can fail to translate into capture of market governance rules by narrow economic interests.

In this chapter, I show that significant institutional reforms in the market domain⁵ did come to pass in Romania, thanks to a combination of international influence and domestic factors. I argue that early rent-seeking by economic actors has not resulted into long-lasting institutional capture due to the rise of a new economic elite that has displaced communist-era enterprise managers. In spite of having benefitted from soft loans, shady privatization deals and government contracts in the first decade of transition, the new entrepreneurs have not opposed sophisticated market rules that limited rent-seeking opportunities. The factors that made possible the rise of the new economic elite were the political change of 1996, and the economic crisis of the late 1990s, which resulted in pivotal banking reforms by the anti-communist coalition government. While necessary for the change in economic elite, none of these factors were sufficient by themselves, or in combination, to explain the absence of institutional capture, and the positive, uniform, and sustained change in the market governance framework that Romania experienced. The demise of the old industrial technocracy, and the rise to prominence of a younger, pro-market elite, is a previously unrecognized condition for the transformation in market governance. The new

⁵ On the political or democratic governance side, unsettled institutions of state monitoring and oversight persist, and politicians are struggling to prevent rules that might make them vulnerable to prosecution. This could explain some of the blanket pessimism about Romania's reforms. I focus here on advances in the less talked about domain of market governance.

entrepreneurs did not resist the new bankruptcy, capital market, concessions, collateral, or corporate governance legislation advised by international organizations, resulting in an advanced, sophisticated market framework.

Explanations of market governance reform

The emphasis on concepts like governance and rule of law by international organizations highlights the relatively new belief in development circles that institutional reform is a necessary complement to economic reforms in the search for high and sustainable economic performance. In this paper, I refer to market governance as the basic institutional rules of the market game, which includes laws regarding insolvency, secured transactions, capital markets, concessions, corporate governance, competition and company law. Creating the institutional framework for a functioning market economy was considered a critical second phase of economic reform, and a key follow-up to initial liberalizing reforms (price liberalization, macroeconomic stabilization and privatization) (Stiglitz 2000, Svejnar 2002).

However, the creation of an effective legal framework for the market economy can be prevented through institutional capture, which occurs when powerful actors create laws and institutions that protect their advantages in the future and that allow for their continued enrichment and power. Capture can be achieved by blocking laws or reforms that would even the playing field, and is potentially more pernicious for economic performance than high-level corruption targeting one-time benefits because

it maintains and institutionalizes inequality by setting the rules of the market game in favor of the captors.

Interest group opposition is a popular explanation for the difficulty of enacting policy reform in developing countries (Haggard 2000), and is closely related to legacies-inspired arguments in post-communist countries (Ekiert and Hanson 2003). Countries like Romania that had very centralized economies during communism, and no attempts at liberalizing reforms in the 1980s were believed to be the most difficult to reform. Proponents of shock therapy also believed that another important determinant of the outcome of transition were the early reform policy choices, because early choices have disproportionate influence on outcomes by foreclosing certain paths initially open; later choices matter less, because they cannot change the path already chosen.

Romania, together with Bulgaria, Ukraine, Russia and most countries east of the Central European frontrunners, were burdened by both onerous communist legacies and by the wrong initial choices, by postponing or reversing early reforms (EBRD 1999: 106). Wild or crony capitalism, or capitalism 'with a comrade's face', and partial reform, were believed to be in equilibrium (Hellman 1998), able to endure for the long-term in these Eastern European laggards. Romania's market governance performance in the second decade of transition, which I detail in the next section, shows that neither initial choices nor communist legacies were sufficient to lock the country into a low-performance equilibrium.

The three solutions to the grim predicament of partial reform discussed in the literature are economic crisis, political change, and external influence. Economic crisis is a potentially powerful event that could jolt the government into reform mode and provide sufficient incentives to policy-makers to overcome interest group opposition. The logic of this standard interest group explanation of policy reform is that crises are periods of extraordinary politics, when the electoral costs to governments of policy inaction rise substantially, surpassing the costs of attacking entrenched interests opposed to reform (Haggard 2000). The electoral benefits from reform are also expected to rise due to the beneficial impact of reform on the general public, potentially changing the electoral calculus of politicians. This may have been the explanation for Yeltsin's reforms of the Russian banking system during the 1997 financial crisis, when some of the undue benefits of wealthy bankers were cut back (Johnson 2000).

Political change arguments also offer potentially powerful explanations of how economic reform can occur in unlikely environments. Orenstein (2001) shows that governmental stability has allowed the continuation of policy mistakes in the Czech Republic, whereas changes in leadership have resulted in better economic reform policies in the long-term in Poland. Likewise, Hellman (1998) and Hellman and Kaufmann (2001) note the high correlation between political rights and economic reform, and between civil liberties and low state capture, and advocate more transparency in government to reduce state capture. The underlying rationale is that when the losers of partial reform have a political voice, economic policy abuses are harder to sustain. Grzymala-Busse (2008) similarly argues that robust competition leads

to less state exploitation, as well as earlier and stronger institutional reforms such as stock market regulation. Moreover, Gould and Hetman (2008) and Gould and Sickner (2008) suggest that even semi-authoritarian regimes like Ukraine can become more politically competitive, due in part to the change in loyalties of post-privatization elites.

Finally, there is a set of arguments that point to the influence of the international organizations, such as the European Union, on both political change and market governance reforms. Vachudova (2005), Grabbe (2006, 2001), and Pridham (2007) point out that even in candidate countries like Romania that followed an illiberal path in postcommunism, the EU was strongly influential, through both economic and political conditionality or active leverage, as well as through more diffuse processes of elite socialization, passive leverage, and Europeanization. Active EU leverage contributed to improving political competition in illiberal states by encouraging the development of the information and institutional environment (Vachudova 2005: 107). In part due to EU influence, mid-1990s elections in all three illiberal candidate states, Romania, Bulgaria, and Slovakia, brought political change in favor of reformist parties. However, most scholars of the EU enlargement are also ambivalent about the extent and results of EU influence, and agree that domestic politics matters, with Romania considered the most difficult case. Vachudova (2005: 143, 202-4) notes that Romania did not respond well to active leverage in spite of reformists taking power in 1996, and that EU leverage had significantly weaker results here than in liberal states. Pridham (2007: 347) concurs that in Romania there were “repeated conditionality failures due to a marked gap between government rhetoric and government action”. The key domestic

economic actors believed to be responsible for the ineffectiveness of EU influence are the “directocracy”: the managers of state enterprises from the communist nomenklatura (Vachudova 2005: 214).

Crisis, political change, and EU influence all play important roles in Romanian market governance reform. However, these factors do not provide a sufficient explanation. I argue that elite change made a key contribution to the reform market institutions. The Romanian economic elite no longer consists mainly of communist-era enterprise managers with little market acumen, who can only survive on political connections and on taking advantage of unclear property rights and market institutions. Instead, it is composed of businessmen who were relatively young at the beginning of transition, and who learned the rules of the market game fast, and now resemble typical Western businessmen. The new entrepreneurs have certainly benefitted from shady privatization deals and government contracts, but the rents obtained from such endeavors were large one-time benefits, which in most cases did not depend on the continuation of lax rules, unlike rents from arbitrage or from unclear property rights early in transition. The initial wealth accumulation afforded by political connections has often been crucial for making these businesspeople important market players, but these actors have not opposed the introduction of a Western market governance framework, and are now playing a game with sophisticated market rules.

A key episode of transition that marked the decline in political influence of the old state-owned enterprises (SOEs) and the rise of the new entrepreneurs was the

banking reform of 1998-2000, on the background of the new political leadership that came to power in 1996. Maintaining the availability of clientelistically disbursed soft loans is one of the few areas where the new entrepreneurs and the SOE managers had shared interests in preventing reform. When imminent banking system collapse forced banking reform in the late 1990s, debt forgiveness had the effect of co-opting the new entrepreneurs into acquiescing to reform. The end of soft financing combined with the start of large-scale privatization marked the demise of the old “industrial technocracy” (Pasti 1997). By the end of the year 2000, the dominant business interests were no longer market-phobic communist-era SOE managers, but rather new entrepreneurs, who had obtained enough capital (often from the state) to start market-based ventures.

The paper proceeds as follows: in the next section, I discuss the advances in market governance in Romania, and other evidence suggesting the absence of institutional capture in market governance. I then detail my main argument about the rise of a new economic elite, and the conditions that brought about this change. I also address the international influence argument before concluding.

Market governance in Romania

The main way in which communist-era managers had captured market institutions early in transition is by maintaining partial reform, or legal loopholes in market rules that allow the continued accumulation of unfair benefits. Examples of captured institutions are capital market laws that do not have adequate disclosure or

redress protections for minority shareholders, insolvency laws that unfairly protect either debtors or creditors, or concessions laws that do not specify competitive procedures for awarding contracts. Thus, the final form of the law and its subsequent enforcement are good indicators of whether capture has taken place. Apart from the quality of market laws and their enforcement, survey measures of businesspeople's perceptions of state capture, press high-level corruption scandals, and interviews also offer glimpses into institutional capture.

By 2007, Romania had made great strides toward a developed market governance framework, judging by the standards set by the EBRD⁶. The country had reached high levels of compliance with international standards in the fields of bankruptcy, capital markets, and secured transactions, and medium compliance in the fields of concessions and corporate governance (Appendix 1). This compares favorably to the performance of the frontrunners of transition⁷. In contrast, the performance of countries like Ukraine, Russia, Belarus, or Azerbaijan on these indicators ranged from dismal (all five legal areas in low or very low compliance) to mixed at best. The EBRD (2006) even notes that the Romanian insolvency law is one of the leading such laws in the bank's countries of operation. The EBRD's Composite Country Law Index, which assesses the general state of legal transition in commercial and financial laws, ranked

⁶ The EBRD measures address not only legal extensiveness, but also fairness as a synonym for quality of laws. EBRD's general benchmark for assessing quality is how the law would affect the investment desirability of the country in question from the point of view of a third-party investor (one not involved as a party in a legal dispute).

⁷ Hungary also has three legal areas of high compliance with OECD principles, while Poland and Czech Republic have two and one such high compliance areas respectively. Hungary and Czech Republic also have one legal domain with low/very low compliance, unlike Romania (Appendix 1).

Romania 6th in the region in 2005, ahead of countries more advanced in other transition measures, such as Poland, Czech and Slovak Republics, and Latvia (Nussbaumer 2005).

The European Commission was satisfied with the Company Law chapter of Romanian accession negotiations by 2005, asking only for efforts to improve financial reporting and efficient follow-up of these provisions (EC 2005: 37). Complete legislative alignment with the EU, improved decisions and increased activity were also achieved in the area of competition regulation in 2005, while in 2006 the requirement of pre-approval of state aid by the Competition Council made this council one of the most independent market regulators in Romania (Young 2008).

Concession legislation showed medium compliance with international standards since 2005. Significant legal changes in 2006/7 have aligned public procurement rules with EU regulations, but have also created a too-complex law uniting public procurement and concession rules under one legal framework. In spite of shortcomings in the definition and scope of the concession law, some of the areas with the highest potential for institutional capture, namely the selection of the concessionaire⁸, and the settlement of disputes received high compliance scores. In the area of flexibility of the concession agreement, Romania even scored higher than all Central European countries except for Slovenia (EBRD 2008b).

⁸ This core area of the concession law refers to mandating a fair and transparent selection process, and allowing limited exceptions for direct negotiations, as well as the possibility to challenge illegal awards (EBRD 2008d).

Corporate governance, contained mostly in Company law, Capital Markets law and securities regulations, was, until 2004, the worst commercial law area for Romania in terms of compliance with international standards. Issues of disclosure and transparency were noted as in need of improvement. However, the EBRD improved its assessment in 2008, reflecting legal changes since 2004 (EBRD 2008c). The World Bank's *Doing Business 2008* report also noted good investor protection in Romania. As part of this criterion, the transparency of transactions and director liability for self-dealing were showing a surprisingly good performance, better than the averages for the region, and similar to OECD averages (Badulescu and Badulescu 2008).

Law on the books is often a different matter than law in practice, with legal improvements often remaining on paper due to a variety of implementation problems, such as poor enforcement or corrupt and incompetent judges and regulators. The EBRD measures the application of market legislation through the Legal Indicator Surveys (LIS), which ask legal practitioners how the laws would operate in their countries based on specific scenarios. Every year, the LIS focuses on a different sector of market governance.

Overall, the EBRD legal surveys suggest enforcement of the Romanian commercial legislation is strong in many areas. The 2007 securities markets LIS placed Romania in a top position in terms of the effectiveness of private enforcement mechanisms and legislation regarding the market regulator. This performance was equaled only by Hungary, Estonia, and Croatia for private enforcement mechanisms,

while Romania was second only to Lithuania for the effectiveness of the market regulator (EBRD 2007). Romanian insolvency legislation, whose extensiveness was graded highest in Eastern Europe in 2004, also showed effectiveness levels similar to those of Hungary, and better than those of Czech and Slovak Republics, Latvia and Lithuania (EBRD 2004). For corporate governance, in spite of a bleaker overall implementation picture, some measures of effectiveness were showing the country in a favorable light. Enforceability of disclosure⁹ was higher in Romania than in all the rest of Eastern Europe except for Lithuania and Croatia, simplicity of disclosure was significantly better than in Poland and Hungary, while the speed of disclosure was much higher than in Hungary and Czech Republic (Cigna and Enriques 2005). Moreover, Romanian firms' perceptions of the impact of sale of commercial court decisions have dropped considerably between 1999 and 2002, from 17 percent (for significant and very significant impact) to just over percent (World Bank 1999, 2002).

The remaining challenges in implementation do not suggest capture of market governance laws by private interests, but rather more innocuous transition pains, such as critical lack of expertise in many specialized fields (e.g. financial markets) (World Bank 2005b), and cumbersome functioning of the legal system (interviews). In spite of remaining problems, by 2007 the Romanian legal framework for market governance was relatively stable, the economic and political domains were separated, and the market economy was believed to be a solid pillar of the state (Toma 2007). The improvements

⁹ Disclosure and redress are the two dimensions of corporate governance measured. Disclosure refers to the ability of a minority shareholder to obtain information about the company, while redress is about the options available to a minority shareholder whose rights have been breached. The rankings for redress are very similar to those for disclosure.

over the last eight years have been significant, showing that reforms in the market governance field, both in written law and in practice, have not been stalled by special interests, and have not languished in a partial reform equilibrium.

Another type of evidence that corroborates the absence of institutional capture in market governance is the type of high-level corruption scandals reported in press. Keyword searches and day-by-day browsing of major Romanian newspapers show that press scandals related to the institutional capture of market legislation are virtually absent¹⁰. In contrast, other types of corruption are widely reported. The typical high-level corruption scandal reported in newspapers involves a construction company closely connected to some important political figure, that gets a public procurement contract in exchange for a bribe or some work on the politician's house. In the late 1990s and early 2000s, corruption scandals related to the collapse of banks, investment funds, the businesses of former members of the security services, and especially privatization decisions were the norm, but scandals related to the capture of market rules were largely missing. This suggests that instead of fighting over basic market rules, powerful Romanian firms tried to secure particularistic benefits from interactions with politicians.

Another relevant data source on institutional capture is the Business and Enterprise Economic Performance Survey (BEEPS), put together by the World Bank and

¹⁰ My interviewees warned me about the undeclared biases of various newspapers, but also remarked that the press is doing a good job at publicizing corruption, and pointed out the more reliable newspapers and news sites. In spite of the perceived weakness of investigative journalism, and of attempts at political manipulation of the press documented in Freedom House country reports, the Romanian mass media is enthusiastic about reporting on corruption scandals, and there is no reason why the capture of market governance rules should be overlooked relative to other scandals.

the EBRD. In 1999, Romanian firms believed that state capture¹¹, measured as the sale of parliamentary votes to private interests, had a very significant or significant impact on 22 percent of firms¹², making Romania a high-capture economy (Hellman et al 2000). In high-capture economies, the strategy of state capture by individual firms was believed to create a vicious circle, in which political connections are rewarded more than innovation and other market strategies, encouraging firms to further engage in state capture (ibid.). In contrast to this gloomy perspective, in 2002 only 4 percent of Romanian firms declared that the sale of parliamentary votes affected them in a decisive or major way (World Bank 2002)¹³, suggesting that the vicious circle of state capture has not materialized.

Overall, my dependent variable, the market governance framework, has improved substantially in the second decade of transition. Reforms have not been stalled by special interests, and Romania has not languished in a partial reform equilibrium. These reforms in the market governance field do not preclude continuing high levels of corruption in the economy. Bribery of state officials in exchange for specific benefits is still common, but it does not extend to the capture of the market

¹¹ The concept of institutional capture used here is somewhat different from the notion of state capture from World Bank/EBRD surveys. The latter refers to the sale of any decisions that might affect firms, including much more than basic market rules. Particularistic decisions that affect only one or a few firms in the short-term (e.g. temporary subsidies or exceptions from taxation) would be included in the World Bank's measure of state capture, even though they do not amount to institutional capture. Institutional capture can be conceived as a tougher test of state capture, as it refers to the institutionalization of state capture through influencing the basic market rules themselves, rather than just more specific decisions.

¹² 17% of firms also felt, in 1999, that the sale of commercial courts' decisions affected them significantly, and 21% complained about being significantly affected by sale of presidential decrees.

¹³ Other aspects of state capture beside the sale of parliamentary votes had improved as well: only 4.8% of firms were majorly affected by the sale of government decrees, and 5.3% by the sale of commercial courts' decision (World Bank 2002). In 2002, there were some minor changes in the BEEPS question phrasing, although the meaning of the question has not changed significantly.

governance framework. I now focus on explaining what prevented this partial reform equilibrium from taking place.

New and old economic elites

Initially, the actors believed to engage in state capture and to oppose institutional reforms were the communist-era managers of SOEs, or what Pasti (1997) calls 'the industrial technocracy'. The survival of the old nomenklatura and its transformation into a new bourgeoisie, a process called elite reproduction in the economy, was believed to be the main dynamic of elites in post-communism (Hankiss 1990, Staniszki 1991, Szalai 1994). This dynamic, based on Bourdieu's theory of the convertibility of social assets, was based on the idea that the top ranks of communist cadres and the nomenklatura were likely to transform their political capital into economic capital and become the new propertied class¹⁴ (Bozoki 2003).

With the notoriously imperfect information that characterized the early transition, the economic strategies of economic actors were believed to be shaped by their subjective models or ideology (North 1990), allowing a reproduction of communist-style thinking in the post-communist economy. Path-dependence and communist ideological legacies mean that most of the managers in question not only have little competence in navigating their enterprises through market conditions, but

¹⁴ Bozoki (2003) notes that systematic elite research has been done only in Poland and Hungary, while for the rest of the transition economies all that is available in this field are memoirs, philosophical essays and journalistic accounts.

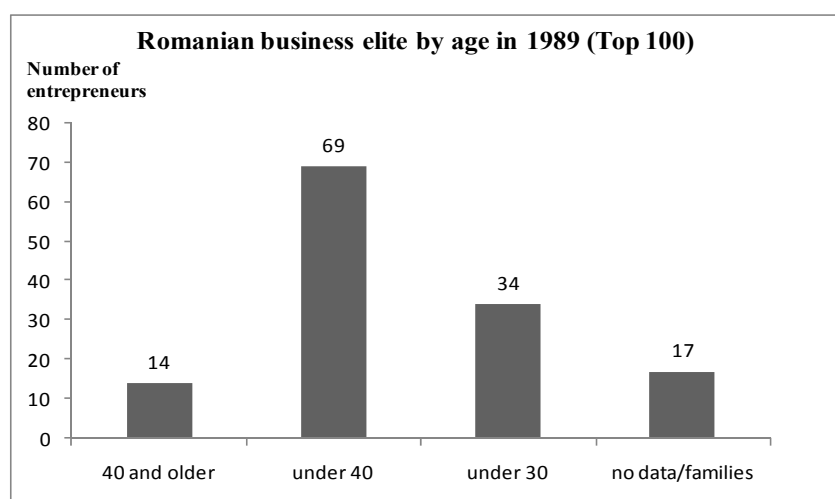
also have an aversion to change, and an over-dependence on the state. They owe their jobs to their position in the communist nomenklatura, so they “still hanker for the safe bureaucratic diktat that reduced the need for managers to make any decisions or take any initiatives” (Ibrahim & Galt, 2002: 109). Stan (2004:44) also notes that “deep distrust of the impartial hand of the market has reinforced heavy reliance on the visible hand of state”.

After the regime change, these managers often created private ‘tick’ firms (*firme căpușă*), in effect transferring valuable resources from these large enterprises into private hands by buying up raw materials from the SOEs at very low prices, and selling intermediary goods back to them at inflated prices. The conversion of state property into private property through such satellite firms has been called by Stark and Bruszt (1998) ‘recombinant property’, and is not unique to Romania. Recombinant property was characterized by blurred boundaries between the public and private domains and by the discretionary distribution of assets and liabilities, which amounted to an informal process of spontaneous privatization. This conversion has involved the state’s tacit cooperation; the siphoning off of SOE resources was made possible by the state’s acceptance of growing tax arrears of the large SOEs, as well as arrears towards state-owned utility companies.

By all (qualitative) accounts, the industrial technocracy was the dominant economic elite in Romania until 1996, and had achieved institutional capture through partial reform. Unfortunately, this dominance is difficult to quantify. My list of the top

one hundred wealthiest businesspeople in Romania, drawing on the list from *Capital* magazine (Capital 2007), describes the situation in 2007, and earlier data is not available. By then, the typical Romanian multi-millionaire was someone who was younger than 40 in 1989 and thus unlikely to have held an important position in the communist nomenklatura (see also Appendix 2). The average age in 1989 of the top 100 wealthiest Romanians was only 32, which brings them to 52 on average in 2009. In contrast, today's wealthiest 100 Americans are on average over 66 years old, almost 15 years older than the Romanian elite (Forbes 2009).

Figure 2.1



Notably absent among the richest Romanian businessmen are those who managed industrial enterprises during communism. Part of the explanation for this absence, detailed in the next section, is that most of the enterprise insiders were actually unable to transform their short-term benefits from partial reform into long-term advantages. Starting in 1997, with a new party coalition in power, the privatization

agency began to cut SOEs loose from the state, by initiating bankruptcy procedures against them, and by curtailing subsidies (Pop 2006). Enterprise managers were some of the main opponents to privatization through direct sales, both because they could lose their jobs and social position, and because delay in privatization allowed them to develop their own tick firms (Stan 2004). Thus, the beginning of large-scale privatization in 1997 meant that the privileges of the industrial technocracy started to come to an end. Some of these managers were undoubtedly able to convert their tick firms into successful market enterprises, but they are not among the most successful Romanian business people.

The gradual demise of the industrial technocracy was met by the gradual rise of the new entrepreneurs. In the early years of transition, while the enterprise insiders had a hold on the economy and the state, new entrepreneurs with fewer connections to the state gradually entered the market, often building their businesses from scratch. Such are the cases of Gelu Tofan, whose tire company was initially financed by a loan from relatives living in the US, or George Copos, who started with electronics imports and bakery products, eventually building a \$700 million business group. Other examples are Gabriel Valentin Comanescu (age 22 in 1989), Zoltan Teszari (age 19 in 1989) and Robert Negoita (age 18 in 1989), who started with very small retail businesses in 1990. Yet other new businesspeople (now in the top) were repatriates who made fortunes abroad or who benefited from restitution of pre-communist wealth (e.g. Ion Tiriac, Iosif

Constantin Dragan, Dimitrie Sturdza), or foreign-born business people who settled in Romania after 1989 (e.g. Fathi Taher, Enrico Perini)¹⁵.

Slightly older among the top Romanian businesspeople were those who worked in international trade before 1989. Dan Voiculescu¹⁶, for instance, was 43 in 1989, but his position in international trade was a privilege reserved to those with close communist party and *Securitate* connections. George Constantin Paunescu has a similar background. Some of the younger members of the list are also suspected to have had close relationships with the former or present secret services after 1989 (e.g. Sorin Ovidiu Vantu, Viorel Catarama, Ioan Niculae, Ovidiu Tender). Although some of the new entrepreneurs may have used their communist-era connections to get ahead in business after 1989, most of them were too young to have enjoyed much political power that could be converted into economic power, as the political capitalism thesis suggests (Staniszki 1991, Hanley 2000).

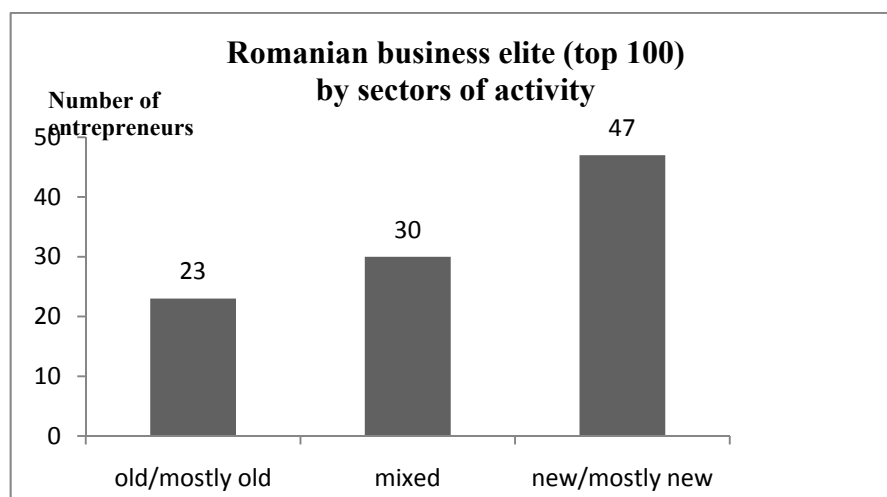
Apart from age, the sectors of activity of the wealthiest businesspeople indicate that they are open to new markets, such as media, telecommunications, IT, finance, and real estate, which were mostly uncharted territories during communism. Forty-seven of the top entrepreneurs acquired most of their wealth from such new sectors of the

¹⁵ Eight out of the 14 businessmen older than 40 in 1989 are re-pats or foreigners.

¹⁶ Dan Voiculescu himself is no longer in *Top 300*, because he renounced his business positions in favor of his two daughters in order to engage in full-time in politics. Wherever possible, I have explored the possibility that the younger Romanian entrepreneurs are the sons and daughters of communist-party apparatchiks, but other than Voiculescu's daughters and Paunescu's family, there is no evidence that this was a major dynamic.

economy, while much fewer (23) focused mostly on older sectors of the economy, such as manufacturing, energy and tourism¹⁷.

Figure 2.2



While communist managers who made fortunes from privatizations could have easily expanded into other sectors of activity, such as real estate, other new sectors like telecoms, IT, and finance are less accessible to people without specialized skills. Moreover, if enterprise insiders had made huge fortunes from their tick firms, they would have had little incentives to move out of these sectors altogether, so we would expect to see manufacturing overrepresented among the holdings of the wealthiest Romanians, which is not the case. It is also telling that almost half of the top Romanian businesspeople had virtually all of their assets in new economic sectors, in spite of many

¹⁷ The predilection for new or old sectors of activity does not appear to be a function of age. Many young businessmen have ventured into industrial sectors, and some older entrepreneurs are active in new sectors, especially real estate.

of the new entrepreneurs also moving into profitable old sectors like energy or tourism. Dinu Patriciu, for instance, who was an architect before 1989, has built an important part of his \$3 billion empire by buying oil refining capacity from the state, while many other top 100 businesspeople have privatized hotels in their portfolios.

The new business elite was not immune to the attractions of preying on the state, and did take advantage of lax or poorly enforced rules and of political connections for getting heavy discounts on state assets and debt write-offs¹⁸. However, these entrepreneurs were not dependent on the state for the continued survival of their business, and were not afraid of conducting business under Western market rules. According to a foreign businessman I interviewed in 2008, the money these Romanian entrepreneurs managed to siphon off from the state was important for aiding their learning process in business management, by allowing them to make more costly mistakes in business on their way to becoming professional business people. They now run competitive businesses, focusing on performance and on improving business practices. When *Capital* interviewed Adrian Porumboiu, the owner of one of the biggest Romanian agricultural production companies, about the secret of success, he emphasized hiring high-performing managers, merging agricultural production with food processing plants into an integrated system, weighing and monitoring all expenses, and managing risk (*Capital* 2003b). Likewise, in spite of his suspicious early dealings with

¹⁸ Examples are the collapse of investment funds connected to new entrepreneurs (Vantu, Catarama) due to lax capital market rules, as well as the controversial and highly discounted privatization of the Petromedia refinery and subsequent \$700million debt write-off in favor of Dinu Patriciu (*Hotnews.ro* 2007, Miculescu 2005).

the state, Patriciu is widely credited with transforming Rompetrol from a dying state refinery into a high-performing profitable venture with international reach.

In addition, many of the new entrepreneurs are members of business associations like the Businessmen's Association of Romania that promote a better business environment (AOAR). The activities of this association, which include lobbying for reform of market legislation, suggest that the new economic elite may at times even be an active promoter of market governance reform¹⁹. Business sophistication does not always mean a commitment to playing by the rules, or to productive practices. For instance, many of these entrepreneurs are now expert in financial speculation and in the use of offshore companies to hide the identity of owners and to take advantage of differences in tax regimes. However, the professional business skills of the new entrepreneurs clearly differentiate them from the old enterprise insiders who depended solely on political connections, and emphasize these entrepreneurs' ability to play by advanced market rules.

The professionalization of some Romanian entrepreneurs has benefited from foreign partners who likely contributed much-needed business know-how. Dinu Patriciu, for instance, was associated with the American Phil Stephenson in his largest company, Rompetrol, and with French and German companies in other ventures started in the

¹⁹ Another piece of evidence along these lines consists of the reform-promotion activities of politicians closely connected to major businesspeople, such as former Industry Minister Codrut Seres, and Silvia Ciornei, the former president of the Senate's Economic, Industry and Services Commission. In spite of having worked for Voiculescu's "Grivco" business empire, they were also young professionals with extensive foreign management training, and quite open to and active in modernizing the legal business environment.

early 1990s, while Dan Voiculescu was helped in his early business days by a Cypriot partner.

How did this new elite come to displace the old communist managers? The next two sections take up the challenge of explaining this process. The two domestic factors that contributed to institutional reform in the market domain are the political change of 1996, and the banking crisis and reform of the late 1990s. I show here that these factors did not lead to market governance reform by themselves, but rather were necessary for the fall of the old elite and the rise of the new entrepreneurs.

Political change

Romania's democratization, like its economic reform, lagged behind that of Central European countries. It was not until 1996 that Romania achieved the status of a 'free' country by the standards of Freedom House. The first two postcommunist elections, in 1990 and 1992, were marked by "brazen electoral irregularities, fraud and unaccountability and tolerated by a disinterested, deliberately misinformed, or naïve public" (Carey 2004: 557). Electoral process improved with the 1996 elections, which produced the first switch in power from the communist-successor (social-democratic) party (PSD), to the Democratic Convention (CDR) anti-communist coalition. It also marked the shift from president Iliescu, a former mid-level communist party official, to president Constantinescu, a former university professor. I argue that this political change does not explain, by itself, the reformation of market governance.

In spite of Romania joining the ranks of Freedom House liberal democracies in 1996, complaints about the democratic process remained high, especially in relation to media independence and the quality of civil society. The 2009 *Nations in Transit* report, which focuses on Eastern European countries and includes media and civil society factors, still places Romania only in the category of semi-consolidated democracies, with the lowest democracy score among the new EU members (Freedom House 2009). While there has certainly been much improvement on these issues, Romania's totalitarian past is still believed to significantly weaken civil society, the media, and political competition (Carey 2004, Vachudova 2005). Due to these weaknesses, institutional reforms in market governance are not likely to have occurred simply as a result of increased transparency and government accountability prompted by a vibrant civil society. Moreover, media and NGO activism are unlikely to have driven institutional reforms in market governance, because unlike judicial and political reforms, market governance institutions received virtually no attention from either forum.

Apart from societal factors, political change can help reform due to the change in ideology and methods that new political leadership can bring. I argue that the 1996 government change in Romania contributed significantly to the end of partial reform. However, this contribution was not because the new government forcefully confronted business interests and passed market governance reforms in spite of their opposition. In fact, the reform performance of the CDR government was rather weak, and its reformist image tainted by corruption scandals and coalition infighting (Gallagher 2005, Vachudova 2005). Rather, the new government contributed to market governance

reform by taking steps that actively led to the rise of the new elite during the CDR's time in power. One of these steps was speeding up privatization through the method of direct sales. The other was banking reform, which I address in the next section.

A key change that the new government made was to replace the head of the National Property Fund (FPS), the institution responsible for privatization, and to bring this institution, previously controlled by parliament, under direct ministerial control. This move speeded up the privatization process, although it also meant cutting corners on transparency and benefiting the business supporters of the new government (Pop 2006). Members of the new economic elite (e.g. Dinu Patriciu, Viorel Catarama) were prominent supporters of anti-communist parties in 1996, and their rise in business can be considered closely linked to the coming to power of these parties. In contrast, the old elite, consisting of state enterprise managers, overwhelmingly supported Iliescu and the communist successor party (Gallagher 2005, Pasti 1997). Prior to 1996, the enterprise insiders had managed to delay economic restructuring and privatization by using their political influence to virtually transform the FPS into "some sort of mutual financial aid house" of the enterprise technocracy (Pasti 1997). However, they lost direct political influence when the CDR took power.

Theories of political capitalism and elite circulation argue that privatization is the major link that converts the political power of the communist nomenklatura into economic power in postcommunism (Hanley 2000, Walder 2003). This link was largely absent in Romania. Because privatization was delayed, enterprise insiders were unable

to transform their early influence into valuable assets. Several rounds of mass and insider privatization until 1997 managed to transfer only about a quarter of state industrial capital into private hands (Pop 2006). The start in earnest of large-scale privatization through direct sales (auctions) in 1997 directly contributed to the rise of the new Romanian business class. Most of the privatizations of 1997-2000 focused on sales to local, rather than foreign investors, at heavily discounted prices, amounting to a short-lived 'golden age' of local capital²⁰ (Pasti 2006).

My interviews with business people and local analysts in Romania suggest an important link between privatization and the preferences of the new elite. Some interviewees pointed out that once the Romanian economic elite has acquired substantial wealth, became less willing to fight for additional state benefits. Others noted that with the conclusion of privatization corruption has become both more limited and more sophisticated (less visible). These observations suggest that large one-time wealth transfers like privatizations through direct sales may carry different incentives than the more continuous but 'trickle' process of wealth accumulation allowed by unsettled market governance rules such as lax or incomplete collateral or capital market laws. As noted earlier, the new Romanian entrepreneurs had or acquired the requisite market skills to survive the exigencies of market competition. Once the needed capital has been acquired, these entrepreneurs' incentive in investing in productive activities may outweigh continued rent-seeking incentives, especially given the costs of investing in institutional capture. The one-time nature of the wealth

²⁰Privatization continued after the return to power of the social democrats in 2000, but was reoriented towards foreign buyers.

transfer through privatization means that once in possession of the privatized assets, business people had less reason to insist on the continued weakness of market legislation.

To the extent that the new economic elite still had incentives for institutional capture²¹, the increase in political competition brought about by the 1996 fall of the communist-successor party made state capture more costly. While connections to the anti-communist government have undoubtedly helped many new entrepreneurs to obtain privatized assets, political connections became a less reliable way of securing desired outcomes. Unlike in Ukraine, where semi-authoritarianism and a strong presidency made lobbying the president a sensible business strategy (Gould and Hetman 2008), in Romania there have been overlapping sources of political power, which made it difficult for business to successfully capture policy. Frequent coalition and minority governments, the competition for power between the president and the government, as well as electoral upsets have introduced uncertainty about business alliances with politicians. The case of Patriciu, long-standing member of the Liberal Party, which was part of the coalition in government in 1996-2000, is instructive in this respect. After obtaining his privatization deal days before the 2000 elections, Patriciu was harassed by the social-democratic government (in power between 2000 and 2004) for this privatization and sent before the anti-corruption prosecutors (Avram 2004), but paradoxically he became even more controversial after 2005, when his Liberal Party was again part of a coalition government. In 2006 he found himself used in the political fight

²¹ Even after privatization, the new entrepreneurs still benefitted from the lack of banking reform, which allowed them access to soft loans. I discuss banking reform in the next section.

between President Basescu and Prime-Minister Tariceanu, accused of guiding Liberal Party policy from the shadows (Nicut et al 2007), and had to sell his Rompetrol oil empire to escape legal troubles related to shady financial deals.

Other businesspeople, like the Paunescu brothers, have displayed “contingent loyalties” (Gould and Sickner 2008), or have tried to ensure their business future by supporting parties from both sides of the political spectrum²². Yet another set of entrepreneurs have attempted to get political leverage by building their own parties. Gigi Becali, real estate magnate and controversial owner of soccer club Steaua, presides over the xenophobic New Generation Party. Nonetheless, Becali was unable to convert his personal popularity into electoral success or policy influence. A more successful example is Dan Voiculescu, whose small Conservative (previously Humanist) party briefly played a pivotal role in Romanian politics in 2005 due to post-electoral coalition changes. Voiculescu’s party was able to place a few party members in key government positions, but only for short periods of time before his party returned to obscurity. Overall, the new entrepreneurs’ involvement in politics has not proven to be an easy or sure way of securing benefits or of capturing institutions. Institutional capture became more costly due to the more fragmented political landscape that democratization brought about in 1996. The most important contribution of political change to market governance reform, however, has been through the change in actors and in their incentives that the new privatization policy has brought about. Political change and

²² Paunescu is believed to have supported President Constantinescu’s electoral campaign in 1996, in spite of previously being close to the former social-democratic government (Gallagher 2005), while Liberal Party member Patriciu has supported social-democrat Mircea Geoana’s mayoral campaign.

privatization through direct sales have severely weakened the old economic elite, and have allowed the rise of a new set of pro-market entrepreneurs.

Banking crisis and reform

Another potential cause of market governance reforms is economic crisis. The short-term political capital governments obtain from the impetus to solve an economic crisis provides a window of opportunity for defeating interest group opposition to reform. I argue that while crisis has provided the government with an opportunity to defeat banking interests and engage in banking reform, its contribution to market governance reform was indirect, via changing the incentives of the new business elite.

In 1997-9, the sudden price liberalization and subsidy pullbacks brought on by the new government's shock therapy approach resulted in GDP contraction, and inflation rates of over 100 percent. In 1998, the Romanian banking sector was also in crisis, the share of doubtful and non-performing loans reaching 66 percent of total private loans (Doltu 2002: 299). In 1999, the IMF, the World Bank and the EU signed loan agreements with Romania, helping to narrowly avoid default on sovereign debt caused by liquidity constraints. The National Bank of Romania, with a new Board of Directors, launched an ambitious banking reform program supported by laws upgraded in 1998-9, such as the Banking Act (Law 58/1998), the National Bank of Romania Act (Law 101/1998), and the norms added to the Bank Insolvency Act (Doltu 2002). Banking supervision and other powers of the National Bank were also increased with the

legislative changes of 1998-9, and the Bank Asset Recovery Agency was established to deal with failing banks in a centralized manner.

Privatization of the Romanian Development Bank and of BancPost in 1998 and the exit of eight banks from the market in 1999-2000 followed the legal reforms and brought about some immediate improvement. Interest rate spreads narrowed, bad loans as a percentage of total loans and of GDP plunged rapidly, and a credit boom, especially in retail lending (mortgage in particular) ensued. By 2005, Romanian domestic credit to private sector had grown to 11 percent of GDP (from 7 percent 2000), and stock market capitalization, another indicator of financial development, rose spectacularly from 3 percent of GDP in 2000 to 22 percent in 2005 (EBRD 2007)²³.

In agreement with standard arguments, economic crisis created a window of opportunity for the government to overcome the opposition of banking sector interests and to engage in banking sector reform. Reform success may be in part due to the fact that banking in Romania was not deregulated during the last years of communism, so private banks had less time to consolidate their influence on the state, unlike in Russia or Bulgaria (see Johnson 2000, Barnes 2007). However, Romanian banking reform was not a story of open government attack on anti-reform interests²⁴, but rather one of

²³ In spite of rapid improvement, these figures are still much below Central European averages, let alone world or EU averages. In particular, the share of domestic credit to private sector in Romanian GDP (11.3%) is still only half of the average for South-East Europe of 23.9%, and only a fraction of the average for Central Europe (42.3%) or for the EU (85.8%).

²⁴ There is virtual consensus that in spite of declared reform zeal, Constantinescu's time in power was a disappointment in terms of reform results (Vachudova 2005, Gallagher 2005, Pop 2006, Pasti 2006).

strategic cooptation of selected business interests opposed to reform²⁵. This led to a change in the incentives of the new entrepreneurs, which softened their opposition to other institutional reforms as well.

Banks in transition economies had plenty of perverse incentives, which often resulted in vicious circles. These include political rationing of credit for the state-owned banks, insider lending by small new private banks to their owners, a need to hide non-performing loans by lending even more to the problem debtors, moral hazard created by indiscriminate bail-outs by governments, and tax and accounting loopholes allowing the hiding of insolvency. Pasti (2006) argues that if until 1995 bank credit was a means of transferring subsidies to politically connected SOEs, since 1995 bank credit started to be used for the financing of private politically connected entrepreneurs at negative interest rates and without much hope of repayment. Thus, soft credits benefited both the old and the new economic elite. Soft credits allowed new private entrepreneurs the accumulation of working capital, either for new investments, for private consumption or for buying off SOEs offered for privatization. Some beneficiaries of these credits, such as George Constantin Paunescu, were able to get personal credits of more than \$10 million, and open private banks with this money, so that credit could keep flowing to their private businesses (Pasti 2006).

To soften opposition to banking reform of the new entrepreneurs who had benefited from clientelistic finance, the government effectively offered them

²⁵ Shleifer and Treisman (2000) use the strategic reformer argument to explain how the Russian government was able to reform the banking system in the wake of the 1997 financial crisis.

compensation in the form of writing off large portions of bank debt, by transferring such debt to Bank Asset Recovery Agency (AVAB) with few chances of recovery. This amounted to a permanent transfer of assets from banks to those whose loans had been forgiven. This transfer of wealth had a high cost to the economy, estimated at between 4 and 6 percent of GDP. By the end of 1999, \$2.3 billion were in AVAB's portfolio, and very few of those bad loans were ever recovered, amounting to the lowest recovery rate for bad debts among reforming countries (Movit 2006). The new Romanian capitalists also managed to avoid prosecution for fraudulent behavior. For instance, the bankruptcy of Columna Bank, started in 1998, was still surrounded by uncertainty in 2004, and Razvan Temesan, a main actor in the Bancorex case, was able to use his political connections to escape prosecution (SAR 2002). Once banking reform was enacted, however, soft loans were no longer available, and business people had to focus more on market, rather than rent-seeking strategies.

The new economic elite's closeness to the government in power meant that it likely benefited disproportionately from debt forgiveness. In contrast, the managers of many SOEs who had taken soft loans were unable to save their firms from being slated for privatization or bankruptcy. There is no evidence that the compensation offered to the new entrepreneurs in the form of bank debt write-offs and protection from prosecution was an intentional government policy²⁶. A transition government that makes an honest attempt to recuperate debt can encounter many real difficulties due to

²⁶ This argument was used by Johnson (2000) as a critique of Shleifer and Treisman (2000)'s strategic reformer thesis. She noted that it is unlikely that the Russian government was intentionally co-opting Russian banking elites.

judicial system weakness. Nonetheless, intentionality aside, the result of the government's attempts to reform the banking system has essentially been cooptation of selected elites, softening their opposition to banking reform by allowing the Romanian entrepreneurs to obtain the capital necessary to acquire state assets up for privatization.

Banking was one of the few areas where the incentives towards institutional capture of new and old economic elites coincided, as both groups would have preferred continued access to easy finance. However, once banking reform occurred, and soft loans were no longer available, the new entrepreneurs had no incentives left to oppose other institutional reforms of market governance. They reoriented toward market strategies, for which they now had both the necessary skills and the much needed capital. The result is that today most important Romanian business people operate like Western businessmen, capable and willing to conduct their business within a sophisticated legal framework, and not like communist-style managers with little business knowledge and an aversion to markets.

Thus, political change and banking reforms contributed to the reform of the market framework by aiding in the fall of the old economic elite, the rise of the new entrepreneurs, and the alignment of their incentives to market production and away from institutional capture. Without an economic elite with preferences favorable to advanced market governance, the government would have found it much more difficult to reform market institutions.

International influence

Even with a business elite opposed to market governance reforms, Romania's advanced market framework could have in principle developed due to strong international pressure, especially from the European Union. I argue that while policy-makers have passed these laws at the advice and with the help of the EU, conditionality by itself cannot explain the level and consistency of market governance reforms.

The influence of international actors in the market governance domain is undeniable, especially in the case of Romania, a country that had to harmonize its legislative framework with the EU's *acquis communautaire* in a short period of time (between 2000, when negotiations for accession started, and 2006, when accession became certainty). The IMF, the World Bank, USAID and numerous other international advisors also contributed to the creation of these laws. Compared to other policy domains, market governance was more easy to influence because it displays a relatively consistent international model, low density of domestic actors, and virtual absence of established prior policy (Grabbe 2001, 2006, Jacoby 2005, Epstein 2006). Indeed, market governance laws show high compliance with European requirements.

Reference to EU Commission principles, directives, and recommendations, sometimes specifically point by point, is abundant in parliamentary documents that present government's proposals to change market governance laws. Expressing acquiescence to international norms so overtly suggests that market governance

reforms owe more to policy-makers' desire for internal and external legitimacy²⁷ than to outright conditionality. Conditionality arguments suggest that domestic factors like opposition to reform from interest groups can be rendered ineffective by external pressure, and countries desiring aid or membership in a select club can successfully be forced by external pressure to change their institutions. If conditionality were the main instrument of institutional change, we would expect to see high differences between the institutions of countries subject to conditionality and those of other similar countries. We would also expect policy areas directly subject to conditionality to fare better than those where external influence was not direct. Moreover, if conditionality is the driver of reform, policy domains with a lot of domestic opposition should see as much reform as those in areas with little opposition.

The Romanian case does not fulfill these expectations. Romanian market institutions are as highly ranked in some areas as the institutions of neighboring countries with much lower prospects of becoming EU members. Securities and bankruptcy laws in Serbia and Moldova, or concessions laws in Albania are in the category of high compliance with international standards in spite of the lack of EU direct conditionality (Appendix 1). This suggests that in the absence of domestic opposition, desire to emulate international norms, and even weak chances of becoming EU members, are sufficient for some reforms.

²⁷ Vachudova (2005) and Pridham (2005) hint at the idea of reform as a legitimacy-seeking exercise by domestic policy-makers when talking about the "passive leverage" of the EU, and the "pull" of the EU respectively.

Moreover, market governance in Romania has improved not only in the areas specifically covered by the *acquis*. Areas such as bankruptcy are not covered in the EU *acquis*, and thus were not subject to direct conditionality, but improved at least as much as legislation specifically monitored by the EU, such as competition law. These similarities again show that while international influence played an important role in reform, 'soft' influence has been sufficient, and conditionality was not necessary in the field of market legislation. The external influences on market governance legislation were to a large extent pushing on an open door, in the sense that the government willingness to gain international legitimacy through such reforms was not met by antagonism from business interests.

In marked contrast to the market governance domain, there were numerous difficulties in adoption of EU-required democratic governance rules (such as reform of the judiciary and the National Integrity Agency) due to opposition from politicians (Young 2008). As noted earlier in the paper, many scholars of EU enlargement believe that domestic factors can significantly delay or derail reforms imposed through external conditionality, and give Romania as an example (Pridham 2007, Vachudova 2005). Political conditionality is considered to have been relatively ineffective in Romania, due to political elites' constant attempts to protect themselves from criminal prosecution by paying lip service to EU requests while weakening democratic governance rules such as anti-corruption, transparency, and criminal procedure laws. In contrast, the successful adoption of market governance structures shows that the absence of opposition from vested interests is critical to successful reform.

Conclusion

At the end of the 1990s, the lackluster economic and reform performance of most transition countries outside Central Europe and the Baltics convinced many analysts that burdensome economic and cultural legacies of communism and poor initial policy choices created vicious circles of partial reform (Hellman 1998, EBRD 1999). These countries were believed to be set on “illiberal paths” (Vachudova 2005) that kept them away from restructuring and growth, and led them to a low-performance equilibrium. Institutional capture of market governance rules is a key mechanism believed to create vicious circles, as it has the effect of automatically reproducing outcomes that favor the captor firms in multiple transactions. Captured bankruptcy laws may have lax provisions for declaring a firm insolvent, in order to keep politically connected firms alive long after they have stopped being profitable. Captured concessions laws may not specify the terms of fair competition for contracts, and thus enrich political allies, while captured competition laws may have lax definitions of anti-competitive procedures that allow the creation of politically powerful business monopolies. If market governance rules had remained lax in Romania, the managers of communist state enterprises would have been able to maintain the early advantages they obtained from strategies like tick firms and clientelistic finance.

These gloomy scenarios of vicious circles and captured market governance institutions have not materialized in Romania. Corruption in business and the use of

informal networks and contacts to obtain personal benefits (Grødeland 2007, Ledeneva 2006) is still commonplace, but it does not extend to institutional capture. Rather, like in corruption scandals of advanced economies, Romanian firms pay bribes or kickbacks to get individual, particularistic benefits, within the context of developed market rules. This sort of corruption is no doubt problematic, but it does not lock Romania in a low performance, partial reform equilibrium.

Instead, market governance laws have been significantly reformed thanks to 'soft' international influences, in the context of the rise of a Western-style business elite. I argued here that banking reform and political change were necessary conditions for reform, but their contribution was indirect. These factors were instrumental in the rise of a new economic elite, who did not have the same incentives to oppose institutional reform as the previous elite comprised of communist era managers. The critical juncture of this transformation occurred in the late 1990s in Romania, when these factors converged to allow the new entrepreneurs to become the dominant business interest. Once opposition to reform was neutralized through the loss of influence of old elites and through the elimination of soft loans, improvements to the market governance framework quickly followed.

Romanian improvement in market governance rules is not unique in the region. Bulgaria, where business interests also preyed on the state in early transition (Ganev 2007, Barnes 2007), also experienced substantial market governance reform, and now has three legal areas of high compliance with international standards, and two of

medium compliance (Appendix 1). Countries with different democratic credentials and levels of EU influence, like Macedonia and Moldova, also appear to have well-developed market institutions. Further research is needed to determine to what extent the rise of a pro-market business elite has influenced market reform in other Eastern European countries.

It remains to be determined how beneficial the creation of a sophisticated market governance framework is for the Romanian economy. The optimists suggest that “a well-established market system characterized by clear and transparent rules, fully functioning checks and balances, and a healthy competitive environment reduces rent-seeking opportunities and, in turn, the incentives for corruption” (Broadman and Recantini 2000: 16). Indeed, there are some signs of improvement on the corruption front. However, for the advances in market governance to fulfill their promise in reducing corruption, they may still need to be complemented by reforms of the democratic governance framework, such as judiciary reforms and reforms of state oversight and monitoring institutions, which have yet to prove their effectiveness in Romania.

Similarly, it is unclear to what extent these market institutions, in spite of high compliance with international standards, can protect the economy against severe shocks like the global economic crisis of 2008-9. As a result of this crisis, Western economies are reevaluating their own market governance frameworks. Tighter financial and other market regulations in advanced economies may lead to new waves of market

governance reforms in Eastern Europe as well, and business elites may again play a significant role in such reforms.

Chapter 3: Political Competition and Democratic Governance in Romania

In the early years of the Eastern European transition to capitalism and democracy, the reform of the state received little scholarly interest, as the state's role in society and in the economy was deemed to be rightly shrinking. After a decade or so of transition, state weakness was becoming obvious. "The problem liberal reformers face is no longer censorship and the command economy...but something quite new: an incoherent state tenuously connected to a demoralized society", Holmes (1997) noted. Twenty years after 1989, scholars of Eastern Europe are gradually bringing the state back into analyses of democratization and economic reform. Studies of the quality of democracy (Diamond and Morlino 2004, Morlino 2004, Rose-Ackerman 2005, Ciobanu 2009) are replacing those of democratization for the more advanced reformers of the region. The reform of state institutions indeed deserves much attention, as both democratic consolidation and the creation of a well-functioning capitalist system depend on a strong democratic state. Measures of state strength vary substantially across the region, not only along the traditional sub-regional divides of Central Europe versus the Balkans and the Former Soviet Union, but also among frontrunners of transition (Grzymala-Busse, 2007), raising the question of what makes for successful democratic postcommunist states.

Defining and assessing the strength of democratic states is a complex endeavor. State capacity is often mentioned in the definition of state strength, with high capacity

states able to perform a wide variety of tasks, such as establishing a monopoly of violence, enforcing property rights, controlling their populations, regulating the economy, extracting resources through taxation, and providing public goods (Soifer and vom Hau 2008). Here I am interested in state strength as it relates to democracy (Linz and Stepan 1996), a concept necessarily including some measure of accountability. Strong states in this context are accountable to their citizens through strong institutions of state monitoring and oversight, have little high-level corruption, and are governed by the rule of law. In contrast, exploited states are those with weak or missing state institutions of oversight and regulation, and numerous public procurement, privatization, and other corruption scandals (Grzymala-Busse 2007). The setup and reform of institutions of democratic governance, such as audit courts, civil service and anti-corruption laws, is a vital component of this concept of state strength. The absence of such institutions not only allows political actors to engage in state exploitation; it also ensures that these opportunities continue indefinitely, amounting to state capture. While grass-roots aspects of democracy provide an important complement to an accountable state, the political in-fighting about the passage of state oversight laws and about their final form means that these institutions at least have a promising potential to affect political actors, and to help build stronger democratic states.

Accounts of state reform, pioneered by Barbara Geddes (1994) in the Latin American context, pose that political competition is key to such reforms. For the postcommunist context, Anna Grzymala-Busse (2007) offers the most compelling account in this vein. I argue that in the case of Romania, the only Eastern European

member of the European Union (EU) left out of Grzymala-Busse's (2007) analysis, parliamentary political competition does not explain the degree of state exploitation by politicians. To present a better picture of the role of political competition in democratic governance reform, I discuss measurement issues, President-Parliament competition, and the various strategies of political actors regarding state exploitation.

Parties and the state

Unlike Western European states, where external war pressures had a key impact on state-building (Tilly 1992, Ertman 1997), Eastern European states were re-constructed after communism by political elites (O'Dwyer 2004, Grzymala-Busse and Luong 2002, Grzymala-Busse 2003, 2006, 2007). The parties' enormous discretion in distributing resources through privatization and building institutions is summarized by Grzymala-Busse (2007: 42):

The sheer volume of laws to be drafted and the unresolved debates about powers and functions led to political parties dominating policy making and implementation. It also meant that political parties in parliament had a unique opportunity to create institutions and build in subsequent access to state resources, in ways that bureaucrats, ancient regime economic and security apparatus elites or other political actors did not.

Traditionally, political science research about the relationship between political parties and the state has focused on clientelism, a typically Latin American practice of rent distribution to very poor constituencies in exchange for electoral support (Stokes, 2007). O'Dwyer (2004) has attempted to extend this analysis to the Eastern European

context. In postcommunism, however, parties did not have extensive local links or organizational endowments, and the costs of buying constituency support has been higher, due to the relative wealth of the constituents compared to Latin American cases (Grzymala-Busse 2008). Thus, they engaged instead mainly in state exploitation, or the “direct extraction of state resources and the building of new channels for such extraction” (ibid. 2007: 2). Politicized privatization deals, public contracts awarded to political supporters, or weak civil service laws that allow for hiring of political acolytes are examples of such state exploitation. The unsettled institutional environment of the transition to capitalism and democracy in Eastern Europe in many cases allowed various actors not only to take advantage of state resources for private gain in the short-term, but also, whenever possible, to entrench these gains, transforming them into long-term advantages, through the process of state capture. While some scholars have focused on the role of business elites in this process (Hellman 1998), here I discuss state capture by politicians.

There are several competing explanations about the effects of political competition on the strength of state institutions. By creating uncertainty about electoral outcomes, political competition can shorten the time horizons of politicians, and compel them to maintain as much discretion as possible in dealing with the state, in order to extract state resources while they still can. The inability to compromise for politicians with short time horizons has also been invoked as a reason why strong executives are needed at least in the short-term to pass economic reforms (Haggard and Kaufman 1995, Frye 2002). At the same time, however, high political competition can also have

beneficial effects on reform (Hellman 1998, Grzymala-Busse 2003, 2006, 2007, 2008), by making political parties more accountable for their actions. Rival parties have an incentive to expose incumbents' state exploitation in order to influence policy, and this in turn pushes incumbents to moderate their behavior. Under opposition criticism, incumbents limit their discretion by building strong institutions of democratic governance in order to avoid their rivals' use of discretion against them when they lose power. Uncertainty over the next electoral outcome, typical of democratic party systems, is key to strong institutions. In the principal-agent language of a large body of rational choice literature on this topic, mostly in the US context, if the government party is not sure it will be around to implement its program in the future, it will limit the discretion of bureaucratic actors by creating strong formal institutions of state oversight and monitoring (Grzymala-Busse 2006: 9-10).

In the Eastern European context, Anna Grzymala-Busse's (2007) model of robust political competition is one of the most prominent explanations of the strength of democratic governance institutions. She argues that only where competition among parties is robust, meaning clear, plausible and critical, will parties moderate their exploitative behavior and commit to building strong institutions of state oversight in anticipation of the possible consequences of losing elections. Clarity of competition means that the communist successor party has exited from power immediately after the fall of communism, and has regenerated. Plausibility means that no parties are ostracized, so that many alternative governments can potentially be created. It is measured by the average seat shares of plausible parties. Critical competition refers to

an opposition that takes its role seriously, and constantly criticizes the government. It is measured by the average number of questions per Member of Parliament (MP).

Like other measures of political competition (fractionalization, polarization), these three elements of robust competition attempt to measure the potential of the opposition to restrain the incumbents. In addition, robust competition also captures actual behavior of incumbents and oppositions through three specific mechanisms: moderation, anticipation, and cooptation. When robust competition is present, incumbents moderate their behavior to avoid exposition of flaws by the opposition, they anticipate losing the next elections and being on the receiving end of their rivals' revenge, and they try to co-opt critics through power-sharing in order to both share responsibility in the voters' eyes, and to minimize any reprisals once out of office. In sum, robust competition, more than other measures of competition, provides incentives for incumbents to credibly commit to strengthen the state, by creating strong institutions of monitoring and oversight.

The main indicators of state exploitation of interest here are the timing of adoption and the strength of institutions of state monitoring and oversight, such as civil service laws, the Ombudsman, the National Accountability Office, and the anti-corruption institutions (Grzymala-Busse 2007). Late adoption of institutional rules means that they were likely pushed by the EU, and were often passed in weakened forms in the absence of robust competition. Institutional strength is assessed by the extensiveness of the law, and the independence of the institution from incumbent

control. Dependence on the executive, rather than on parliament, and limited scope, such as no powers to investigate certain transactions, or to issue sanctions, indicate the presence of state exploitation.

Robust competition has important advantages in explaining state exploitation over other measures of party competition, as well as over broader measures of transition progress, like democracy or economic reform rankings. Unlike fragmentation or polarization, robust competition is significantly correlated on average across the post-communist spectrum with indicators of state exploitation, as well as with more traditional measures of accountability like corruption rankings from Transparency International and the World Bank. Moreover, the speed of market reform is not a reliable correlate of state exploitation. One of Grzymala-Busse's (2007) most interesting findings is that market leaders like the Czech Republic and Latvia are equally vulnerable to state exploitation as liberalization laggards like Bulgaria. In Grzymala-Busse's (2007) analysis, the countries with strong democratic states are Hungary, Estonia, Slovenia, Lithuania, and Poland, while those with exploited states are Czech Republic, Slovakia, Latvia, and Bulgaria.

Unlike robust competition, alternative explanations, such as voter pressure, communist legacies, and EU influence, do not offer very accurate explanations of the variation of state exploitation across countries. Voter influence on reform of the state can be limited and indirect in multi-party systems, where a strong reform stance by one party brings only small and uncertain electoral gains (Grzymala-Busse 2007: 50-1).

In terms of communist legacies, a favorite explanation of postcommunist outcomes, Grzymala-Busse (2007: 21) argues that historical legacies of state development (Kitschelt et al. 1999) mattered less than political competition. Some of the less exploited states, like Hungary and Poland, are those where “accommodative” communist regimes should have produced highly politicized states. In contrast, Czech Republic and Slovakia, who benefitted from more professional bureaucracies during communism, could not avoid the state exploitation brought about by weak political competition. Moreover, legacies of reform during communism, like in Hungary, have meant early asset stripping, also called spontaneous privatization or “recombinant property” (Stark 1996), but have not resulted in higher state exploitation. Alternatively, the start of reform during communism has been associated with greater subsequent reform, but even states that did not liberalize under communism, like Estonia and Lithuania, have been able to avoid state exploitation later on (Grzymala-Busse 2003: 1128).

The EU did not start its targeted influence on state institutions in Eastern Europe until 1998, so early adoption of strong state oversight rules in some countries requires a domestic explanation. Conversely, where institutions were built as a result of EU pressure, they were often weak and full of loopholes. Grzymala-Busse (2008: 658) points out that when political competition was robust, Eastern European countries voluntarily implemented 85% of formal state institutions of oversight before EU demanded them, while in the countries lacking competition, only 31% of these

institutions were implemented before 1998, when EU influence became more visible, and in many of these cases, the institutions were politicized.

Romania is not included in Grzymala-Busse's (2007) analysis because of the questionable democratic credentials of the country early on in transition. However, this exclusion from the list of democratic Eastern European countries is unwarranted. In spite of early hiccups, Romania's democratization path converged to that of Central European frontrunners quickly after the 1992 elections (McFoul 2002, Pop-Eleches 2008). The country became free according to Freedom House in 1996, after most Central Eastern European countries, but before Slovakia, who achieved the free status only in 1998. Romania also became an electoral democracy in 1992 (Freedom House 2009), suggesting that the effects of political competition on state institutions should have followed the same mechanisms as for the other countries in the region as early as 1992.

In my search for determinants of Romanian institutional outcomes, I perform an empirical test of the model of robust competition in the only EU post-communist state that Grzymala-Busse leaves out of her analysis. I consider whether competition was robust in Romania, and whether the constraint mechanisms on parties implied by robust competition were effective in building strong Romanian institutions of state oversight and monitoring. I show that in spite of relatively robust political competition, many Romanian democratic governance institutions are still weak. I then explain why robust

competition does not fully capture the evolution of Romanian state oversight and monitoring institutions.

Robust competition in Romania

Clear competition

Political opposition is clear when there are “mutually hostile camps” (Grzymala-Busse 2007: 60). Clarity is measured by whether the communist party exited power and reinvented itself. Where this has happened, two clear opposed camps exist: the former communists and the former anti-communist opposition, who have reasons to be mutually suspicious.

At first sight, Romania is a clear example of unclear political competition. The main Romanian communist successor party (initially FSN, now PSD) did not exit power until 1996 and did not fully regenerate until after that²⁸. Indeed, many analysts of the Romanian transition attribute the country’s delays in economic and political reforms to this delayed exit from power of the communist successor party, itself inextricably linked to the totalitarian communist legacies. Gross and Tismaneanu (2004) call PSD rule semi-authoritarian and anachronistic, Stan (2003) and Gallagher (2005) note that the reproduction of communist elites and their early hold on power are the main reasons for Romania’s handicap, while Fish (1998) declares that “the supreme importance of a

²⁸ Gross and Tismaneanu (2004) argue that the PSD was not yet reformed in 2005, while Ishimaya (2006) claims that this party had become “social-democratized (reformed) in 1997.

single political juncture: the result of the initial elections” held in postcommunism as a determinant of economic reform (p. 31).

There are several issues running against the notion that Romanian political competition was unclear. First, in spite of the lack of organized opposition during communism, immediately after 1989 a clear anti-communist opposition formed on the basis of historical parties (e.g. Liberals and Christian-Democrats) that had been banned during communism. In spite of its limited initial electoral appeal, this was a very vociferous and uncompromising opposition, leading some scholars to assert that it is the extreme polarization of early transition Romanian politics, rather than the absence of clarity, that delayed the process of reform (Stan 2003, Pop 2006, Ciobanu 2007). Pop (2006) notes that this high polarization in the early transition, with its resulting emotional, inflammatory tone of debates in parliament, and the opposition’s unwillingness to cooperate or compromise with the FSN, is responsible for the lack of reform early on.

Second, the Romanian communist successor party did not have the same level of continuity with the Romanian Communist Party as communist successor parties in other Eastern European states, so labeling this party as unreformed communists is inaccurate. In spite of scholarly consensus about the role of the PSD as a communist successor party (Pop-Eleches 1999, 2008, Ishimaya 1997), the PSD is not a typical such party. The PCR was outlawed right after the fall of the communist regime, and in spite of taking over the resources of the Communist party-state, the National Salvation Front did not claim

the ideological legacy of communism. Moreover, despite the close ties of several PSD leaders to high-level communist circles, (but without having played important roles in that regime), other controversial leaders (Mazilu, Brucan, Chitac) were sidelined in 1990. At lower levels, personnel continuity with the communist party was lower in the original FSN than in the Hungarian communist-successor party (Pop-Eleches 1999, 2008).

Moreover, it is not clear theoretically why the exit and regeneration of the communist successor party should be the only way to provide clarity of political competition. Even Grzymala-Busse (2007) admits that “clear opposition is not limited to the ideological distance among parties and other spatial understandings of political competition” (p. 60). In Poland, she notes that ideologically close parties were quite hostile to each other, while in the Czech Republic ideologically opposed parties cooperated closely. It is not clear, then, why the clarity of opposition should depend so much on the regeneration of the communist successor party and its exit from government. In the Romanian case, there was competition not only between the communist successor party and the anti-communist camp, but also among the “potential political heirs” of the Romanian Communist Party (Pop-Eleches 2008: 477). According to Pop-Eleches (2008), several Romanian parties (the PSD, the PD-L, and the PRM²⁹) have inherited ideological and institutional elements and leadership personnel

²⁹ Pop-Eleches (2008) notes that not only PSD leaders like Iliescu and Nastase, but also PRM’s Vadim Tudor had close ties to the communist leadership (Tudor was a former court poet for Ceausescu’s regime). In terms of institutional continuity, the PD inherited the original FSN (Iliescu’s hard-line faction splintered into the FDSN and later PSD), still uses the initial electoral symbol of the rose, and in 2004 had the highest

connected to the former PCR. While at times these parties have cooperated (such as the nationalists and the social-democrats in 1993-1996), they have more often been in open competition with each other. The PD, for instance, was the reformist wing of the National Salvation Front, and allied with the anti-communist parties in 1996-2000 and 2003-2006 in opposition to the social-democrats.

Finally, in spite of the absence of exit from power of the main communist successor party, this party did not have an easy ride politically after 1992. It won only about 35% of seats in the 1992 elections, and it had to rely on varying support other parties in order to pass important pieces of legislation, as well as to withstand intense criticism from the anti-communist parties, including several votes of non-confidence.

The arguments above suggest that the late exit from power and regeneration of the main Romanian communist successor party do not necessarily mean lack of clear political competition. The clear ideological opposition with the anti-communist camp, the competition with other communist-successor parties, and the demands of minority government mean that the social-democrats' ability to exploit the state should have been constrained. In terms of resulting institutions, there are some signs that these constraints were indeed operating; several Romanian institutions of oversight were created in this period. The Court of Accounts, which audits the financial resources of the entire public sector, was set up in 1992, the National Securities Commission, which regulates the stock market, was created in 1994, and party financing regulations

proportion (15%) of reelected FSN MP's from the 1990-1992 Parliament (compared to PSD's 9%) (ibid: 468).

distributing state resources to all parliamentary parties and regulating campaign contributions were put in place just before the 1996 elections. These institutions can be considered strong by Grzymala-Busse's criterion of extensiveness and independence from executive power. Both the Court of Accounts and the Securities Commission are under the broad control of parliament, and the Court of Accounts has a wide scope, its jurisdiction applying to the entire public sector, including publicly-owned enterprises and political parties receiving state funds.

Plausible competition

The second criterion of Anna Grzymala-Busse's (2007) robust competition is plausibility, measured as the average seat share of parties that could plausibly form alternative governments. These are the parties that are not being a priori excluded from partnership considerations by other parties. Excluded parties' opposition is an empty threat, and it does not affect government behavior (ibid: 61).

In early Romanian elections, no parties were clearly ostracized. Between 1993 and 1996, the minority government of the communist-successor party cooperated, with various degrees of visibility, with the ultra-nationalists of PUNR and PRM, and the nostalgic communists of PSM, after the anti-communist parties refused to part-take in government (Roper 2000, Pop 2006). Most importantly, the Hungarian minority party, the UDMR, has not been ostracized like the Hungarian ethnic party in Slovakia, or the Russian minority party in Latvia (Grzymala-Busse 2007: 106).

Since before the 2000 elections, the social-democrats followed the example of the anti-communist parties, emphatically rejecting any cooperation with the nationalists (Pop-Eleches 2001: 162). This makes the PRM an excluded party, in spite of the large number seats it held (24% in 2000-2004, and 14.5% in 2004-2008). There are, therefore, two distinct phases of the plausibility of the Romanian political competition: pre-2000, when all parties were potential partners in government, and thus plausibility was very high, and after 2000, when plausibility dropped considerably with the ostracism of the nationalists.

Nonetheless, in the post-2000 period, in spite of low plausibility of opposition, the reform of institutions of state oversight really took off. Higher EU influence through membership negotiations was certainly a factor in this increase in law-passage activity, and some dismiss these legal changes as “cosmetic surgery” (Ciobanu 2007: 1439). However, in spite of continued state exploitation and attempts to keep institutions of oversight weak, there were some genuine advances, such as the first specific anti-corruption framework, improvements on earlier versions of the civil service reform, and a reform of the role of prefects, local administrators with previously unchecked powers. The reduced plausibility of political competition did not appear to impede state reform.

Critical opposition

Whether or not the opposition is critical, constantly and carefully policing and criticizing government actions, is, I think, the most crucial component of the concept of

robust opposition, because it has the most direct connection to the mechanisms of moderation, anticipation and cooptation that restrict state exploitation in Grzymala-Busse's (2007) model. To curb state exploitation, parties must have a conflict of interest manifested in a vociferous opposition, and have the capacity to criticize, and to publicize their criticism (ibid: 61).

This criterion is measured by the average number of questions per MP per year. Countries with robust competition have an average number of questions of 2.37, while those without robust competition have an average of only 1.07 questions. More than two questions grant the country a score of 1 on this criterion (Grzymala-Busse 2007: 14). The number of questions (both queries and interpellations) asked by Romanian MPs (lower chamber) is available on the Romanian Chamber of Deputies' website since 1997. I calculated an average number of questions per MP of 1.62 in 1997-2000, 2.9 in 2001-2004, and 7.66 questions in 2005-2008. For the Senate, there is even less data available, but the 2005 and 2006 figures of 5.68 and 8 questions per MP/year are consistent with the remarkable rise in opposition activity over time. We can conclude, then, that the Romanian opposition was critical since 2001.

Another way to assess the critical nature of the opposition is by looking at the number of non-confidence votes that each government received (Table 3). Judged by this criterion, competition was robust in Romania in all electoral terms except perhaps the 2000-2004 one. There were plenty of serious political threats to ruling coalitions, which should have restricted state exploitation.

Table 3.1. Romanian non-confidence and political votes

Year	1992-1996	1996-2000	2000-2004	2004-2008
Non-confidence votes	5	4	2	6
Political votes³⁰	8	10	34	27

Source: Author's calculations based on the Romanian Senate's webpage, www.senat.ro

All non-confidence votes, and the great majority of the political votes were defeated, but they suggest nonetheless that the opposition was doing its job trying to keep the government accountable, often on topics related to state exploitation and economic and political reform. The only political vote that passed in the Senate shortly before the 2000 elections is a case in point. This vote, called "Privatization", and initiated by social-democratic and nationalist opposition MPs, asked the prime minister not to allow the privatization agency, which they accused of illegally serving the interests of the ruling coalition, to sign any more privatization contracts until the elections. The text of the resolution cites some of the pernicious practices of state exploitation that also formed the subject of numerous press scandals, such as favoritism towards political clients in the conduct of the privatization auctions, forgiveness of debts for selected newly privatized companies, low privatization revenues for the state, and attempts to speed up the privatization of major assets just before the election. Thus, the opposition does

³⁰ Political votes (*motiune simpla*) are similar to non-confidence votes, but they only express a joint political statement of the respective chamber (if passed), usually in opposition to government policy, rather than having the power of taking down the government.

appear to have been a good critic of government at least after 2001, based on Grzymala-Busse's criterion, but perhaps even earlier, judging by the large number of non-confidence motions.

Other measures of competition

While Grzymala-Busse's (2007) finds that conventional measures of competition, such as fractionalization, polarization, and volatility, do not reliably indicate state exploitation across Eastern Europe, I briefly consider these measures here, and their correlation with democratic governance reforms in Romania, in order to assess whether any of these measures may have special explanatory power in this case.

The effective number of parties provides a measure of the fragmentation of the political system. Fragmentation can make party collusion more difficult, and increases electoral uncertainty, creating incentives for strong institutions of oversight (Grzymala-Busse 2007:51). In Romania, except for the first elections, in which the National Salvation Front (FSN) dominated a very fragmented opposition, the effective number of parties has been high enough to allow for vigorous opposition.

Table 3.2. Effective number of legislative parties (Chamber of Deputies)

1990	1992	1996	2000	2004	2008
2.2	4.79	4.32	3.55	4.9	3.71

Source: author's calculations based on Parties and Elections in Europe, <http://www.parties-and-elections.de/romania 2. html>

In 1999, the average effective number of parties for the countries with less exploited states in Grzymala-Busse's (2007) study was 4.52, close to the Romanian figure for that year of 4.32. The average for the countries with exploited states was lower at 3.88. The two averages, however, were not statistically different, suggesting that having a reasonably high effective number of parties allows for the beneficial effects of competition on state institutions, but by no means guarantees such effects.

In contrast to those who believe that higher political competition has positive effects on reform (e.g. Hellman 1998, Grzymala-Busse 2003, 2007), Frye (2002) claims that political competition in the form of polarization between the ex-communist and anti-communist factions is bad for growth and for policy continuity. Where these groups have roughly equal power, intense competition and disagreement about economic policy results in "a war of attrition over economic and political resources" (Frye 2002: 309). A highly polarized country is one that has at least 20% of parliamentary seats held by one faction when the other faction is in power. Romania is joined in this category by

Bulgaria, Albania, Belarus, Kyrgystan, Moldova, Russia and Ukraine, while the rest of the Eastern European countries are in the non-polarized camp.

State oversight reform is different from economic reform, because it is not a main topic of contention between left and right-wing parties. However, ideological polarization could make parliamentary debates so contentious that parties cannot agree even on laws that do not have stark distributional implications. While high polarization is not significantly correlated with measures of state capture, corruption or institutional reform across Eastern Europe (Treisman 2003, Grzymala-Busse 2007), it may have played an important role in the inability to build institutions of state oversight in early transition Romania. The uncompromising attitude of the anti-communist camp regarding the culpability of the communist regime and the responsibility of the communist successor party in this regard marked Romanian politics until the 2000 election (Pop 2006, Ciobanu 2007). Instead of focusing on practical criticisms of specific policies, the historical parties preferred a blanket opposition based on their claim to moral purity. They used counterproductive practices, like attempting to delay the passage of important legislation, and refusing to participate in debates (Pop 2006: 68). Little direct negotiation and compromise on specific laws was possible under these conditions. The lack of a political culture of consensus, does not lead to political responsibility³¹.

It is possible, however, that such ideological polarization still amounted to effective opposition in terms of its effects on institutions of state oversight. Effective

³¹ Interview with Cristian Preda, University of Bucharest, and Presidential advisor, May 12, 2008.

political competition, Grzymala-Busse (2007: 63) notes, does not only depend on the opposition's ability to force the incumbents to pass certain laws. Rather, incumbents' anticipation of electoral loss compels them to *unilaterally* build institutions that would protect them once out of office. It does appear that the social-democrats acted somewhat on this incentive. They established the Court of Accounts in 1992, which for a long time was led by an academic expert and considered independent (Global Integrity 2008), and placed the privatization institution (State Property Fund or FPS) under parliamentary, rather than executive control to alleviate fears of government corruption (Pop 2006:66). Shortly before the 1996 elections, the former communists even passed an amendment to the local administration law, a well-known source of government patronage, that forbade prefects (local government officials) to dismiss elected mayors (ibid: 60). While this did not amount to a comprehensive state oversight system, it is evidence of advancement in the right direction. Unfortunately, some of these actions were reversed after the 1996 elections, when the new anti-communist coalition government could not resist trying its own hand at corruption and patronage through selective dismissals in the local administration, and through bringing the FPS under direct government control. Thus, even the extreme ideological polarization of the early 1990s, and the culture of conflict it created, did not prevent reasonably robust competition from bringing about some positive institutional results.

Party system under-institutionalization has also been identified as one of the main causes of ineffective political competition (Innes 2002, O'Dwyer 2004, O'Dwyer and

Kovalcik 2007)³². Under-institutionalization often results in vertical accountability failures, due to the inability of voters to correctly identify the parties with the closest policy preferences, to lack of organization and cohesion of the opposition, and to easier cooptation of the fragmented opposition by the party in power (O'Dwyer and Kovalcik 2007). The continuous entry on the parliamentary scene of many new parties, and the high uncertainty about making it into Parliament in the next elections, creates extreme short-termism, and incentives to use state exploitation while available, rather than creating oversight institutions that ensure long-term survival at the expense of short-term illicit benefits. Lack of institutionalization of the party system is reflected in electoral volatility, measured as the sum of the net change in the vote of each party from one election to another³³.

Across the sample of postcommunist countries, volatility does not appear to be significantly correlated with the corruption index, and does not vary significantly on average between exploited and unexploited states (Grzymala-Busse 2007: 54-5).

Romanian electoral volatility is, however, generally higher than that of all other Eastern European EU members throughout the last two decades.

³² O'Dwyer and Kovalcik (2007) attribute the success of bold second-generation economic reforms like the flat income tax to the lack of party system institutionalization in Slovakia, Romania, and Estonia, countries considered laggards of the first decade of reform. Under-institutionalization, however, has the opposite effect on the reform of state institutions.

³³ A closely related concept to volatility is the incumbency rate, measured as the percentage of parties and coalitions that were re-elected to Parliament. In Romania, this was an average of 50% until 2008 (Roper 2007: 108).

Table 3.3. Romanian electoral volatility, 1992-2008

	2nd election (1992)	3rd election (1996)	4th election (2000)	5th election (2004)	6th election (2008)
Author	71.3%	28.8%	51%	27.8%	37.7%
O'Dwyer and Kovalcik	76.0%	53.4%	72.7%	75.1%	—
O'Dwyer and Kovalcik (2)	78.9%	31%	49%	38.5%	—

Source: Author's calculations, based on Parties and Elections in Europe, [http://www.parties-and-elections.de/romania 2. html](http://www.parties-and-elections.de/romania2.html) , and O'Dwyer and Kovalcik (2007). The third row represents O'Dwyer and Kovalcik's (2007) calculation using electoral blocks, rather than single parties.

Table 3 shows that volatility figures can vary substantially based on whether we count parties or party coalitions, and on how we calculate volatility within coalitions³⁴. Moreover, the significant variation in time in Romanian electoral volatility does not appear to be correlated with clear trends in the creation of democratic governance rules.

An additional problem is that it is not clear what constitutes a high enough level of volatility to justify the label of under-institutionalized party system, and to create perverse incentives for state reform. If Poland's volatility of 29% (Grzymala-Busse 2007: 54) can be considered normal, and even countries with volatility as high as Estonia's

³⁴ More accurate calculations require more contextual knowledge to help decide whether intra-coalition volatility is indicative of larger shifts. My calculation counts electoral coalitions as single blocks. I do consider, however, the PD-L separately, given that its roots and ideology have been different from those of anti-communist coalition partners. The following blocks were relatively constant features of Romanian elections: the main communist-successor party (FSN/FDSN/PDSR/PSD), the communist-successor splinter party (PD/PD-L), anti-communist parties (mainly PNL and PNTCD), Hungarian-minority party (UDMR), and Nationalists (two parties: PRM and PUNR). These ideological blocks can be considered single units because redistribution of votes within these blocks does not amount to a wholesale reconfiguration of the political scene.

39% can escape state exploitation (ibid), Romania's electoral volatility since 1996 may not appear so extreme. Other measures also contradict the widespread notion of under-institutionalization of Eastern European party systems. Using data on individual MPs in Poland, Czech, Slovakia and Hungary, Bakke and Sitter (2005) find that all countries had the expected or even slightly higher than expected elite stability in Parliament, in spite of much wider variation in volatility (in excess of 30% for Slovakia). Some studies of political cleavages in post-communism also suggest relative political stability. Societal cleavages that structure electoral competition by providing ideological basis of support for parties are more present and stable in the region than previously assumed (Whitefield 2002).

Another measure of political competition is the average excluded vote, measured as the percentage of the vote going to parties that did not meet the electoral threshold. This fluctuated in Romania between 20.5% in 2000 and 6.1% in 2008³⁵, with the last two elections displaying much lower shares of excluded votes. These average excluded vote measures are higher until 2000 than in all countries in Grzymala-Busse's analysis, but are lower than other Eastern European countries since 2004. The sharp drop in the vote for excluded parties suggests the consolidation of the party system. This drop, however, does not seem to translate into less state exploitation, perhaps because in general the parties excluded were not the most important competitors. For instance, in 2008, the nationalists failed to enter Parliament, but they had been an ostracized party since 2000, so Parliament did not lose a particularly effective competitor.

³⁵ Author's calculations based on "Parties and Elections in Europe", www.parties-and-elections.de/romania2.html

At the cabinet level, there was more stability early in transition, during President Iliescu's time in office, then after 1996, during President Constantinescu's mandate. There was less turnover in ministerial positions, and fewer portfolios in government until 1996 (Stan 2002). Ruling through executive emergency ordinance, which lowers the input of the parliamentary opposition, was much more a feature of the Constantinescu regime (684 ordinances) than of the Iliescu 1992-1996 regime (20 emergency ordinances) (ibid: 92). This suggests that when power is vested in a coalition of parties, both stability and accountability of decision-making suffer. Nonetheless, reform of the state has not been higher in periods with more cabinet stability.

While the above measures do not appear to do a better job than the concept of robust competition at explaining institutional evolution, they do concur with my analysis of the elements of robust competition in the conclusion that Romanian political competition has been higher than generally expected. Romania is often placed in the same 'laggard' category as Bulgaria, and the weakness of political competition, assessed foremost from the failure of communist successor parties to exit power in the initial elections, is generally considered the culprit for poor institutions (Ciobanu 2007, Grzymala-Busse 2007). However, the ambiguous status of Romania's main communist successor party, its plausible competition, even from the nationalists, until 2000, its surprisingly critical opposition since 2001, its reasonably high number of effective parties, and its numerous votes of non-confidence all add up to relatively high and robust political competition in Romania. Polarization and volatility, the ugly sides of political competition, do not appear to have caused intractable problems.

Romanian institutions of state monitoring and oversight

If competition compels politicians to build strong institutions of state oversight, Romanian political governance institutions, then, should be strong given high competition. Nonetheless, the picture of these institutions is quite mixed. Specifically, while formal institutional outcomes indicate moderate to high strength, effectiveness and perceptions of strength are generally low.

In spite of the setup of some basic institutions of state oversight in the early 1990s, reform of the state institutions gathered speed and prominence in 1999, coinciding with increased EU influence and the start of negotiations for membership. The first civil service law was passed in 1999 under the CDR coalition government, and was improved in 2003 by the social-democratic government that followed. Specific anti-corruption legislation was introduced for the first time in 2002. The 2003 revised Constitution lessened the powers of prefects, administrative local officials whose powers used to be extremely politicized. After the 2004 elections, reforms intensified, reflecting more targeted conditionality by the EU, as well as the reformist zeal of independent Justice Minister Monica Macovei. Political in-fighting curbed the reform impetus since 2006, but Parliament did manage to pass, after numerous delays and amendments, the last piece of the anti-corruption legislation in the form of a National Integrity Agency (ANI) in May 2007. This completed a well-developed legal framework for democratic governance.

Table 3.4. Romania's 2008 Institutional Reforms (Integrity Indicators Scorecard)

Administration and civil service	Oversight and regulation	Anti-Corruption and rule of law
75 (Moderate)	80 (Moderate)	84 (Strong)
Civil Service Regulations: 84	National Ombudsman: 84	Anti-Corruption Law: 84
Whistle-Blowing Measures: 67	Supreme Audit Institution: 81	Anti-Corruption Agency: 84
Procurement: 74	Taxes and Customs: 90	Rule of law: 84
Privatization: 77	State-Owned Enterprises: 65	Law enforcement: 69
	Business Licensing and Regulation: 79	

Source: Global Integrity Report, <http://report.globalintegrity.org/> Scores are out of a maximum of 100.

The above scores suggest a fairly rosy picture of state institutions. However, the implementation gap is considered very large for Romania (a score of 30 points), suggesting that in spite of this relatively advanced legal framework, practical problems with applying these laws are still significant. A more detailed look at some of these institutions confirms this gap.

Civil service

Civil service regulations were adopted in Romania in 1999, in response to EU demands. Law 188/1999 established provisions against nepotism, cronyism, and patronage, and established a National Agency for Civil Servants to provide a redress mechanism for issues involving civil servants. Civil servants convicted of corruption are

banned from future government employment, and senior civil servants have to file asset disclosure forms, and are prohibited from being involved in policy decisions that might impact personal interests, from accepting undue gifts, and from taking private employment in companies they monitored as civil servants for two years after being a civil servant. The asset disclosure requirements started as early as 1996, through law 115/1996, which includes political office holders and magistrates, and which was improved through Law 158/2005. On the plus side, the public has easy access to these forms, as they are available on each institution's website. The forms are supposed to be audited by a newly set up institution, the National Integrity Agency, but the setup of this agency has been delayed so much that at the end of 2007 it was still not functional (Global Integrity 2008). However, easy public access has meant more journalistic investigations into the wealth of public servants and politicians, making accountability more of an issue.

In spite of these laws, top and middle management government jobs are still intensely politicized (Global Integrity 2008, Ionascu 2006), with contracts, hiring and promotion rules often bypassed, and redress mechanisms being only moderately effective. The regulations restricting post-government private employment and gifts, and protection of whistle blowers are only 25% effective in practice, while those governing conflicts of interest and auditing of the asset disclosure forms are rated at 50% (Global Integrity 2008).

The civil service law presents an interesting example of the dilemmas faced by politicians when proposing laws that place significant resources outside party control. The PDSR strongly opposed the civil service law in 1999, arguing that it would force the new government to maintain all the outgoing government's political appointees (Roper 2006). The law only passed when the Vasile government connected it to a confidence vote. Everyone expected that when the PDSR would come back to power, the law would be repealed. Instead, after the 2000 elections, the PDSR kept the law, while attempting to dismiss tenured civil servants in practice (Ionascu 2006). Rather than repelling a crucial law while the EU membership negotiations were going on, the party in power tried to find innovative ways to avoid the law in practice. Such avoidance schemes include using the excuse of reorganization and restructuring of ministries to fire old employees, forcing existing employees to take unfair 'tests of competence' to keep their jobs, appointment of those who passed these tests to temporary positions from which they could be later dismissed, creation of new ministries staffed with the party in power's political appointees, and duplication of administrative jobs with political ones, so as to neutralize the influence of some employees (ibid.).

Ombudsman

The same picture of relative legal strength and practical weakness observed for civil service regulations also applies to the ombudsman institution. The "People's Lawyer" office has been set up relatively early, through Law 35/1997. It is a by-partisan appointment under parliamentary control, which qualifies it as an independent

institution. However, Global Integrity (2008) notes that the lack of political pressure on the Ombudsman is only due to the perception that it is a “weak and inconsequential institution, almost invisible to the public”. Contributing to this perception of weakness is the fact that the Ombudsman cannot impose penalties, which is a serious limit on its legal powers.

National Audit Institution

The Court of Accounts was set up early in transition, through Law 94/1992. It is protected from political interference by being under the control of parliament, rather than the executive, and it has a wide scope, controlling the financial resources of the entire public sector, including political party financing, special funds, the National Bank of Romania, and autonomous public companies. The independence of the agency staff, including its head, is relatively credible in practice also, and funding is not a problem (Global Integrity, 2008). However, the Court of Accounts is not a high profile institution in the anti-corruption fight. It has generally steered clear in its investigations of sensitive areas (ibid.), such as irregularities in party financing, or verification of asset declarations.

While the Court of Accounts is not subordinated to the government, the members of the court’s executive, appointed by Parliament, are party members and MPs themselves, although they have to renounce their parliamentary seats and become independent when taking up their new jobs. Nonetheless, these people reflect the division of political power at the time of appointment, and are unlikely to challenge the

government unless new elections bring in a different set of political forces (the court mandates are for nine years, while parliamentary elections happen every four years). The current membership of the court of Accounts, for instance, consists mostly of former liberal and social-democratic MPs, reflecting the PSD-supported liberal government of their 2008 appointment. The liberal members of the Court of Accounts executive, however, may now be in a position to cause trouble for the PD-L and PSD coalition government.

Another obstacle to the effectiveness of the Court of Accounts draws from the little importance given to these institutions by political actors. The court had to wait until 2008 before Parliament passed a new operational law for the court that would agree with the 2003 Constitution (Anghelescu-Stancu 2008). During this time, all the decisions of the court, including the mandates and salaries of the executive members of this court, were in question, seriously imperiling the effectiveness of this institution.

Anti-Corruption agency

Together, the Romanian anti-corruption institutions represent legislation and resources superior to those of other EU countries³⁶. The National Anti-Corruption Department (DNA) is also the most active institution of state oversight in practice. Corruption was criminalized under the 1996 penal code, but anti-corruption activities

³⁶ Interview with Laura Stefan, anti-corruption expert, Romanian Academic Society, May 6, 2008.

received a stronger push in 2000, with Law 78/2000, which was specifically aimed at the prevention and fight against corruption, and which represented an attempt by the Romanian leadership to gain some EU goodwill at the start of accession negotiations. The National Anticorruption Prosecutor's Office (NAPO), a specialized agency for fighting corruption, was established in 2002, but was initially weak and politicized. The NAPO head was a ruling party MP's brother, and NAPO prosecutors did not have independent budgets for their investigations (Freedom House 2005). In 2005, under a new coalition government, the anti-corruption agency became the current National Anticorruption Directorate (DNA) and gained the power to prosecute MPs.

The anti-corruption framework was complemented in 2007 with the National Integrity Agency (ANI) (Law 144/2007), charged with investigating conflicts of interests for MPs and other public officials. The ANI law initially proposed by Justice Minister Macovei was draconian, with the wealth of up to fourth degree relatives of public officials being under ANI control. Compared to these provisions, the version adopted by Parliament, in which only first degree relatives' wealth can be checked, appears as a weak compromise, but is the strictest such law in Europe. ANI is, nonetheless, still considered a very weak institution (Global Integrity 2008), although it has recently established an operational record of cases (EC 2009), including an investigation of government party MP Dumitru Oprea (Ziare.com 2009).

Since 2005, the DNA has become the main battlefield of the fight for better democratic governance in Romania. Protected by law against political interference, DNA

had been under intense political pressure in practice. Parliament has tried to scale back the DNA's legal scope, and the Minister of Justice has attempted to fire one of the main anti-corruption prosecutors (Mungiu-Pippidi 2008). Meanwhile, the head prosecutor of the DNA, Daniel Morar, has been accused by MPs to be "the President's man"³⁷.

These intensified political pressures are a reaction to the increased assertiveness of the DNA. Starting in 2005, the agency has investigated MPs, ministers and ex-ministers from all political parties, including former PSD Prime-Minister Adrian Nastase, former Minister of transport Miron Mitrea (PSD), former deputy PM George Copos (Conservative Party), the Liberal Minister of Justice himself, as well as several mayors, former high-ranking government officials, and MPs from the President's Democratic Party. Unfortunately, this explosive increase in anti-corruption prosecution has not been matched by convictions. Judges have used legal instability and procedural mistakes by anti-corruption prosecutors to return cases to the DNA and delay prosecution. In the few instances of conviction of lower-level officials, judges have only granted suspended or weak penalties (Mungiu-Pippidi 2008).

Corruption scandals among Members of Parliament, ministers and ex-government officials of all parties are still very common. In a top of anti-corruption files put together by the *Romania Libera* newspaper, PSD is the leader with 40 investigations, reflecting its long time in government, followed by the small Conservative Party and the Greater Romania Party with 6 files each, and the center-right and Hungarian minority

³⁷ Interview with Anton Caragea, University of Bucharest, and director of programs, N24 TV station, May 13, 2008.

parties with 3 files each (Oprea 2007). Politicians have found ways to avoid prosecution for corruption, in spite of serious accusations hovering over the heads of most important political figures for quite some time. None of the most important corruption cases have been finalized yet, or even gotten to the level where evidence is being analyzed by the court (Petrisor 2009). Therefore, in spite of its good reputation, even the anti-corruption agency has yet to prove its effectiveness in practice.

In sum, while formal democratic governance laws are relatively strong in Romania, and corruption and state capture have declined, institutional weakness shows in practice, raising question marks about the eventual effectiveness of these reforms. Moreover, several reports have noted already that Romania has taken steps back in its reform of state institutions since gaining membership into the European Union in 2007 (Mungiu-Pippidi 2008, EC 2009). In the next sections, I consider why reasonably robust competition did not result in more effective oversight institutions.

Competition and institutions: an assessment

The first major obstacle to identifying a stable relationship between political competition and strong institutions is that effective political competition is difficult to measure. Even models of political competition like Anna Grzymala-Busse's (2007), with an explicit focus on opposition behavior, do not fully capture the mechanisms of accountability, and can result in both overestimation, and underestimation of political competition.

In pre-1996 Romania, the robust competition measure underestimates the effectiveness of competition: the continuation in power of the communist successor party, and the inability of the opposition to engage in constructive criticism did not prevent the incumbents from creating an independent audit institution, from placing some limits on the politicization of the local administration, or from passing the first law against conflicts of interest of MPs. The mechanisms of anticipation of exit from power and opposition criticism (albeit of an inflammatory nature) seem to have sufficed to bring about these first institutional innovations.

In recent years, the robust competition measure overestimates actors' incentives to engage in institutional reform. Several analysts of Romanian politics agree that the consensus in Parliament regarding state oversight institutions has been that these institutions should not attack any MPs, independently of political orientation. Laura Stefan notes that "the compromise among politicians is not to let matters get to prosecutors" (personal interview, May 6, 2008), and Ana Maria Mosneagu³⁸ concurs that "when there is a risk that something might happen to them, politicians are united" (personal interview, May 7, 2008). This political protection pact held in spite of high competition among parties, marked by the soaring number of questions per MP since 2005.

Another problem with the concept of robust competition is that it focuses exclusively on parliamentary competition, ignoring other potential sources, such as the intra-executive competition between president and prime-minister typical of semi-

³⁸ Executive Director, Pro-Democracy Association.

presidential forms of government. In Romania, like in Bulgaria, Lithuania, Moldova and Poland, the popularly elected president shares executive functions with the prime-minister, and has the prerogative of nominating him, but cannot dismiss any members of the cabinet, who are maintained in office through a confidence relationship with Parliament. Among Eastern European semi-presidential regimes, Romania is unique in that it has never had a president and a prime-minister from opposing parties in power at the same time, but has nonetheless managed to experience recurring episodes of president-prime-minister conflict in the twenty years since the end of communism (Protsyk 2006). Examples are the Iliescu – Roman conflict in 1990-91, the Constantinescu - Vasile conflict in 1998-99, and the Tariceanu – Basescu conflict in 2005-08.

This last episode of president-prime-minister conflict was particularly long and acute, and involved accusations of state capture, and debates about the reform of state oversight institutions. Traian Basescu, the Romanian president since 2005, and former Mayor of Bucharest representing PD, has not had a smooth ride, although to a large extent his pains were self-inflicted. He was nicknamed ‘the President-player’ for his constant attempts to push the limits of presidential power, and to get involved in governmental business that presidents have traditionally avoided. These attempts included direct consultations with parties in order to create a majority around his agenda, legal battles with the parliamentary parties at the Constitutional Court, referendum and early elections threats etc. The Liberal-led government, as well as Parliament, where the President’s party was initially part of the ruling coalition, have

strongly resisted these attempts. After Basescu accused the government of being subordinated to the business interests of prominent Liberal party members, the PM struck back by eliminating the President's party (PD) from the coalition government, including the independent Minister of Justice, Monica Macovei, who was widely seen, in Romania and abroad, as the champion of anti-corruption reform. The move to a minority government was a risky one, because the Liberals had to rely since on the tacit support of the social-democrats, who just narrowly failed to pass a vote of non-confidence against the government. In 2007, government MPs, supported by the PSD, continued the fight against the president, trying to impeach him for unconstitutional conduct. A referendum brought him back a month later, confirming the President's still strong popular support.

The President's accusations of widespread parliamentary corruption (he likes to call Parliament "the corrupt political class") have united previously opposed political parties, the liberals and the social-democrats, into a common anti-presidential stance in the interest of self-protection. One of the ways that this joint stance manifested itself was to attempt to block anti-corruption investigations. In October 2007, Justice Minister Chiuariu closed the commission that advised the President on lifting the immunity of current and former ministers suspected of corruption. He decided instead that these corruption investigations would require parliamentary approval granted by a commission that would hear cases prior to sending them to the DNA. This decision led to several months of delay in these cases, but also to a wave of 'Parliamentary justice', with MPs debating the cases of former and current colleagues openly in Parliament.

MPs tried to protect even the least popular of corruption suspects, former social-democratic PM Adrian Nastase, whose own party had earlier shunned him.

Other attempts by politicians to avoid the conclusion of corruption cases, or the initiation of new investigations also revolve around legal changes. For instance, MPs have tried to change the Criminal Procedure Code, which governs punishments for crimes including corruption. The maximum sentences for some instances, like abuse of public office, would be reduced from 15 to 5 years, which means that the maximum term in which a case can be finalized would become 7.5 years. The immediate result would be a “de facto amnesty” due to the fact that most files currently being judged have already taken several years of investigation, and would have to be closed (Stefan 2009). By changing Criminal Code provisions, MPs have also attempted, so far unsuccessfully, to reduce the powers of prosecutors, and to introduce severe punishments for journalists who leak information in on-going investigations (Mungiu-Pippidi 2008).

In spite of this parliamentary collusion against state oversight reform induced by presidential antagonism, the final effect of this President-PM competition has been positive for anti-corruption institutions. The debates around the National Integrity Agency Law exemplify not only the complicated attempts of parliament to restrict the power of state institutions of oversight, but also incumbents’ final compromise, induced by presidential competition. The initial draft law proposed by reformist minister Macovei was sent to Parliament in July 2006, passed the Chamber in a modified form in

November 2006, saw more amendments in the Senate, and was finally passed unanimously in a different version in May 2007. The November 2006 version passed by the Chamber was criticized for restricting the scope of the law by eliminating conflicts of interests, and verifying wealth of only first degree relatives of public sector high-level employees, rather than up to fourth degree relatives, as initially proposed. Macovei's successor, however, reverted some of the loopholes, reintroducing the verification of conflicts of interest and tying them to stronger penalties, and mandating the confiscation of illicit wealth. Some saw this new version of the law as an attempt to make ANI vulnerable to non-constitutionality attacks, and to delay the law's adoption, by giving rise to new negotiations in Parliament (Mungiu-Pippidi 2008).

In the plenary debate of May 9, 2007, the law still seemed highly contentious, with MPs unable to even agree on what version of the law they had previously discussed, and passing several new amendments, in spite of ample previous discussions in the specialized commissions (Parliamentary debates, 2007). Discussed issues included who could be a whistle-blower, and how the institution's independence was going to be ensured, but also very specific issues, such as whether the word "illicit" (wealth) should be replaced with the word "unjustified" (ibid.)³⁹. The surprise of these heated debates was the unanimous adoption of the law the same day. No political party wanted to be seen as the spoiler of strong state institutions.

³⁹ These issue turned out to be very consequential. Due to a confusing article in the Romanian constitution, defendants charged with illicit enrichment were able to escape prosecution (at least in the short term) by filing for non-constitutionality (Mungiu-Pippidi 2008).

The President, with his support for Justice Minister Macovei's anti-corruption initiatives, was widely considered an anti-corruption champion, which put Parliament in the uncomfortable position of being seen as defending corruption. In particular, the Liberal party that ran the minority government at the time was successfully cast, often for good reasons, as attempting to dismantle anti-corruption institutions in order to protect its corrupt members. To fight back against this perception, Liberal ministers and MPs had to propose improvements to the anti-corruption framework, such as strengthening the ANI law. In the final debate over ANI, the MP who suggested replacing the word "illicit" with the word "unjustified" to avoid constitutionality issues was Puiu Hasotti from the Liberal party (Parliamentary Debates, 2007). He also tried to clear his party's image by blaming former Justice minister Macovei for the delay in passing the law, due to her lack of support for the parliamentary commissions debating the law, and to her overt hostility towards Parliament (ibid.).

Thus, while the President-Parliament conflict initially induced the liberals and social-democrats to collude on weak oversight laws, the same competition, in conjunction with the anticipation of both parties of losing the 2008 elections, eventually forced Parliament to pass a harsher ANI law than MPs would have preferred. However, the positive effect of the President-Parliament competition, like that of robust parliamentary competition, is not automatic, and was highly specific to the 2007 political conjecture.

In addition to measurement problems and the omission of semi-presidentialism, there are problems in Grzymala-Busse's model of robust competition with correctly assessing the dependent variable. Timing of adoption and formal institutional strength, measured as institutional independence, scope, and powers, provide a good first approximation of the ability of politicians to exploit the state, but can also lead to some false positives. In particular, the concept of institutional independence is problematic. The example of civil service reform, where achieving neutrality has meant keeping the political hires of the government that passes the law, shows that the neutrality of an institution is not a straightforward concept. What an outside observer can see as an attempt by a reformist government to delegate power to a neutral institution, a political insider can validly interpret as an attempt by that government to capture the state by entrenching political appointees. Likewise, the recent staffing of the Court of Accounts with liberal and social-democratic MPs shows that parliamentary control of an institution does not necessarily guard against politicization.

Another problem with the reform of the state in Romania is that even the most politically independent institutions can fail to perform their functions if their members are afraid of political reprisal. As anti-corruption activist Laura Stefan told me, "some judges practice self-censorship; they are careful not to upset... they cannot risk phoning the Prosecutor's Office, but courts are afraid of important cases, although they are not necessarily incompetent". This may explain in part why some Romanian institutions of oversight, such as the Court of Accounts, have been unnecessarily shy about exercising their independence. The good news is that, perhaps thanks to EU influence, there does

appear to be a part of the judiciary led by the DNA that is not afraid of confronting politicians.

The logic of Grzymala-Busse's (2007) model of robust competition, consisting of mechanisms of constraint and punishment that induce politicians to pass strong institutions, is very compelling. Nonetheless, the loose fit of this model in the Romanian case suggests some caveats to the robust competition argument. First, when under pressure from intense accusations of corruption, and possibly the threat of early elections, MPs of competing political colors can respond by colluding to protect their privileged access to the state. This mechanism seems particularly likely when the concentrated threat is coming from outside Parliament, such as from a strong Presidency. Another strategy used by MPs is to pass oversight laws that satisfy conventional notions of independence, but in fact are meant to protect the advantages of the authoring party even after the elections, while restricting the new victors. Laws that entrench political appointees by making them civil servants are an example of this strategy. Only when all else fails, incumbent MPs may decide to make short-term sacrifices in the form of strong oversight institutions, in order to ensure long-term political survival against the ire of new incumbents.

These various strategies are overlapping. In particular, the compromise strategy is not automatic. It may only be tried as a solution of last resort, and for this reason, it may be especially attractive right before elections, when incumbents do not have to give up much in terms of time feeding off the state, and have extra-incentives to appear

reformist. In sum, political competition does matter, but often in more convoluted ways than even robust competition can describe.

Conclusion

The story of the battle over Romanian institutions of state oversight indicates several caveats to Grzymala-Busse's (2007) model of robust competition. First, there is the issue of concept measurement: robust competition can both overestimate and underestimate political competition. Second, the robust competition model ignores competition arising from the President-Parliament relationship in semi-presidential republics. Third, it does not fully capture actors' incentives in institution building. The logic of political competition is often more tentative and complex than Grzymala-Busse's (2007) mechanisms of constraint suggest.

While law on the books does not guarantee effectiveness, once the institutional rules have changed, there is a good chance that the payoffs of the political game in Parliament will also change, and the results could advance the cause of strong state oversight. Civil service reform offers an example in this respect. Instead of changing the 1999 law that put them at a disadvantage, the 2000-2004 PSD government chose to put in place new provisions that would allow them to continue state exploitation in the short term. However, this strengthened the law in the long term, by creating a category of high civil servants, and by introducing conflict of interest provisions (Roper 2006), which makes it harder for subsequent governments to politicize civil service.

Moreover, once a law is on the books, political competition has the potential to strengthen that law in practice. The ANI law, for instance, may not have been used effectively under PNL-PSD collusion, but could serve for increased accountability when the parties in power change.

Corruption accusations are a strong political weapon that has been used effectively in Romania, first against the PSD in the 2004 elections, then against the Liberal government in 2007-8, and is now being used against the PDL government. Due to the incentives of using corruption accusations as a political weapon against rival parties, parliamentary collusion on joint protection against anti-corruption prosecution is not a stable equilibrium, but one that can easily dissolve when coalitions change. The apparent willingness and haste of Parliament to send the case of PDL Youth and Sports Minister Monica Iacob Ridzi to the anti-corruption prosecutor is a case in point (Georgescu 2009). Parties' frequent incentives to use oversight institutions to keep incumbents accountable can strengthen these institutions, and make them, in time, effective guarantors of political accountability.

Chapter 4: The Determinants of State Capture

Having explained the evolution of state capture in the market and state domains in the case of Romania, in this chapter I shift gears to a quantitative approach, focusing on the statistical determinants of state capture across Eastern Europe. The measures of corruption used in this chapter, which come from the Business Environment and Enterprise Performance Survey (BEEPS), are based on the perceptions of firms in transition economies, rather than perceptions of experts or the general population. These surveys, which cover the 1999-2005 period, are commissioned by the World Bank and the European Bank for Reconstruction and Development (EBRD) to study the business environment in transition, and therefore contain many questions that are specific to the experiences of firms in these countries. The most valuable feature of these surveys, from the perspective of this study, is that, in addition to asking firms more common questions about corruption, they include a measure of state capture, which is fairly similar to the concept of institutional capture central to this thesis. Hellman et al (2000) define state capture as “shaping the formation of the basic rules of the game (i.e. laws, rules, decrees and regulations) through illicit and non-transparent private payments to public officials” (p.3). In this chapter, I assess the determinants of state capture as evidenced by the Eastern European sample.

A review of explanations of state capture and corruption

There are three main waves of World Bank research based on the BEEPS. The 1999 wave of the survey, inspired in part by Joel Hellman's notion of partial reform (Hellman 1998) is where state capture was initially introduced and featured prominently. Several working papers by Hellman and coauthors analyzed this first wave, focusing on the determinants of state capture (Hellman and Kaufmann 2001, Hellman et al 2000a, Hellman et al 2000b, World Bank 2000).

The most important finding from the 1999 BEEPS wave was that state capture is a distinct phenomenon from administrative corruption and influence, with separate causes. New large firms (de novo, or start-ups) are found to be significantly more affected by state capture than privatized or state-owned firms. Firms who felt that their property and contract rights were insecure were also more likely to be affected by state capture. Hellman et al's (2000a) explanation for state capture can be summarized as follows:

Large incumbent firms with formal ties to the state tend to inherit influence as a legacy from the past and tend to enjoy more secure property and contractual rights and higher growth rates. To compete against these influential incumbents, new entrants turn to state capture as a strategic choice – not as a substitute for innovation but to compensate for the weaknesses in the legal and regulatory framework. When the state underprovides the public goods needed for entry and competition, “captor” firms purchase directly from the state such private benefits as secure property rights and removal of obstacles to improved performance – but only in a capture economy (summary findings).

To test some the relationship between property rights/ the legal system and state capture, and to assess how well this relationship has held over time (from 1999, the survey year of the above findings, to 2005, the third wave of the survey) I include

variables related to firm perceptions of the legal system in my regressions of state capture.

Another important contribution of early state capture research is to divide Eastern European countries into two groups: low-capture economies (calculated as a capture economy index of 20 or less Hellman et al 2000a)), which include Albania, Armenia, Belarus, Czech Republic, Estonia, Hungary, Kazakhstan, Lithuania, Poland, Slovenia, and Uzbekistan, and high-capture economies, which refers to the rest countries, including Central European countries like Latvia and Slovak, South Eastern European countries like Romania, Bulgaria, and Croatia, and former Soviet Union states like Moldova, Azerbaijan, Kyrgyzstan, Ukraine, Russia, and Georgia. The interesting point of this divide is that both advanced reformers and very slow ones, where the private sector remains small, can lack state capture. In contrast, the high-capture economies are mostly countries mid-way in the process of economic and political liberalization. This finding is consistent with the partial reform thesis (Hellman 1998), and suggests that “capture might be expected to thrive in an environment of partial economic reforms and concentrated political power” (Hellman et al 2000a: 11).

The importance of the distinction between high and low-capture economies hinges on the different private benefits for captor firms in the two types of economies. All firms who engage in state capture are seeking private benefits from the state, but Hellman et al (2000a) conclude that “private gains to capture are only realized in high capture economies”, whereas “in countries with more limited levels of state capture,

those firms that engage in state capture perform worse than other firms” (p.4). The effects of state capture on the rest of the economy are more negative (lower average firm growth rates) in high-capture economies than in low-capture ones. Moreover, state capture is deemed more likely to persist and become more entrenched through a vicious circle in high-capture economies. Hellman et al (2000a) note that “the fact that in high capture economies such embryonic oligarchs also appear to be the most dynamic new firms might explain why, once entrenched, state capture is so difficult to remedy” (p.18).

One important issue that the 1999 research on state capture begins to address is the impact of political variables on state capture. Hellman (1998) argues that democratization, in the form of enhanced civil liberties and political competition, can lift a country from partial reform. As partial reform and state capture are intrinsically connected, we would expect democracy to play a prominent role in the reduction of state capture as well. However, introducing the Freedom House measure of civil liberties in regressions of state capture has a confusing effect. The civil liberties variable is either statistically insignificant, or has a significant *positive* effect on state capture. To explain this ambiguous effect, Hellman et al (2000a) note that civil liberties “raise the costs to politicians of actions that provide highly concentrated gains to a small set of powerful actors”, but they also “increase the demand for state capture by newly autonomous firms”, creating an overall ambiguous effect (p.32). However, when a second variable representing the square of civil liberties is introduced, it becomes apparent that the relationship between civil liberties and state capture is non-linear,

and takes the shape of an inverted “U”. Hellman et al (2000a) explain this by noting that “the initial stage of liberalization might lead to increases in state capture in comparison with the previous system, followed by a decrease in the capture index as civil society oversight increases over time” (p.33). As democratization plays an important role in my case-based explanation for the change in state capture, I include measures of democracy in my regressions, and test whether Hellman et al.’s (2000a) non-linear effect holds once the 2005 data is included.

The subsequent focus of the World Bank publications of BEEPS analysis of the 2002 and 2005 waves has shifted in focus away from state capture, perhaps due to the substantial drop in the values of this variable. Nonetheless, state capture is still analyzed among other forms of corruption. There are three broad classes of determinants of state capture (and of other forms of corruption) in World Bank studies based on the 2002 and 2005 waves of BEEPS. First, there are firm characteristics such as size, age, origin, location and sector. Next, there are political and institutional variables: government tenure, recent election, and an index of institutions called the Country Policy and Institutional Assessment (CPIA) that includes institutions like the quality of public administration, budgetary and financial management, property rights and rule-based governance, and management of inflation. Finally, control variables are included, mostly related to the economic environment.

These more recent World Bank analyses of the BEEPS show that state capture has very few significant regression correlates in both 2002 and 2005 (Gray et al 2004,

Anderson and Gray 2006). Manufacturers (in a subset of panel data only) and firms located in cities reported a slightly higher impact of state capture on their business, while smaller, more optimistic, and older firms felt less affected by state capture than other firms in 2005, but the effects are very small (Anderson and Gray 2006).

Most importantly, political variables (legislative elections and years in office) and institutional variables (the World Bank's Country Policy and Institutional Assessment (CPIA) indicator), while significant for other forms of corruption, do not seem to influence state capture in the region, or the change in state capture between 2002 and 2005 (Gray et al 2004, Anderson and Gray 2006). These results could occur because the institutional measures used are too aggregate, or are simply not the most appropriate ones. The CPIA is a very broad index, similar to the World Bank's governance indicators, which averages a range of policies, from macroeconomic management to quality of public administration and property rights.

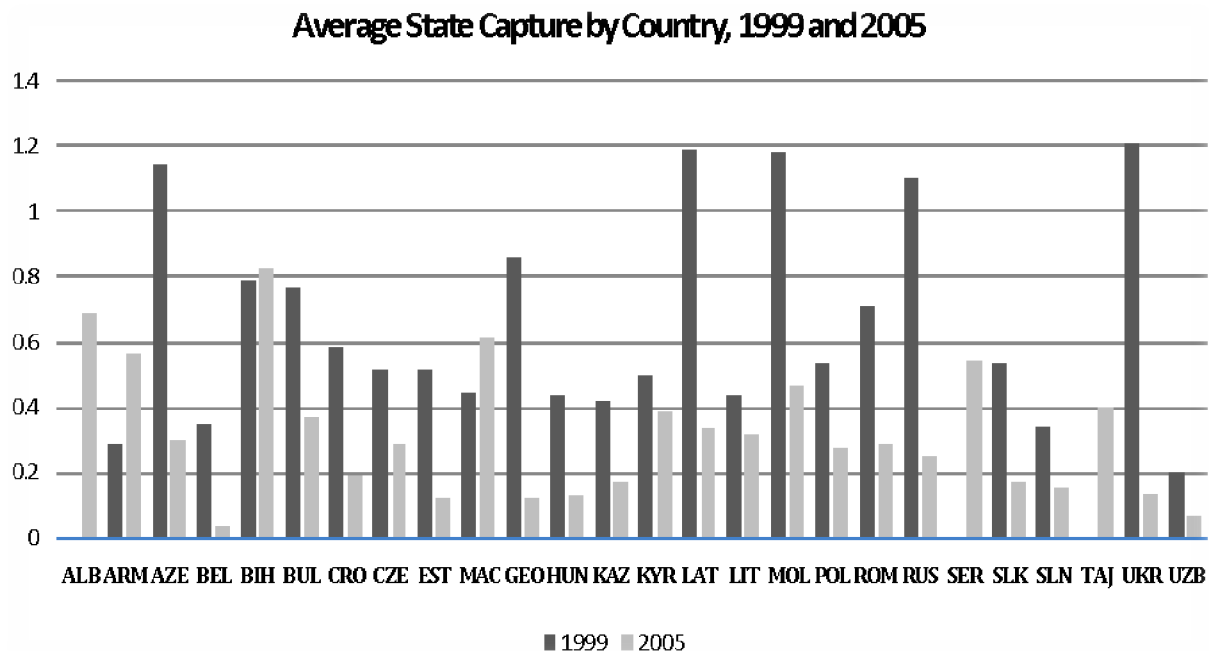
In this chapter, I explore further this surprising lack of statistical significance of the political and institutional variables, by constructing different indicators of institutions and testing them (as well as other political variables). I am particularly interested in how variables that proved important in my case study, such as banking reforms and political change might affect state capture and its variations.

Variables

My main dependent variable is the impact of state capture on firms in transition (state capture in short). Specifically, I am interested in the BEEPS question asking firms to what extent the sale of Parliamentary votes on laws to private interests has had an impact on their business. The choice of answers varied from “no impact” to “very significant” or “decisive” impact, with intermediary answers of “minor”, “moderate”, and “significant” impact. This measure of state capture is a reasonably close approximation of the concept of institutional capture used in this work. Firms’ answers on the BEEPS state capture question overestimate institutional capture, because the question does not ask specifically about the sale of basic market laws, but rather about the sale of any laws that might have an impact on business, some of which can be very specific (e.g. short-term exceptions from regulations for specific companies). In spite of this slight mismatch between the central concept of my thesis and its statistical measurement, the existence of statistics, even perception-based ones, on an issue as hidden from direct observation as state capture presents a unique opportunity to investigate the possible causes of this key form of corruption.

The first important observation about state capture in postcommunism is that, with the exception of a few countries mostly in South-East Europe, it experienced a spectacular drop in a short time at the beginning of the second decade of transition.

Figure 4.1



The average state capture is highest in Bosnia at just over 0.8 (a value of 1 represents minor impact of state capture on business). However, the mean of state capture across countries was only 0.28 in 2005, down from 0.77 in 1999. In Russia, 61% of firms were affected by state capture in 1999, while in 2005 that figure dropped to 16%. In 19 out of the 26 countries surveyed in 2005 at least three quarters of firms declared no impact from state capture, compared to only 5 countries in 1999. The reasons for this substantial drop in state capture are the topic of this chapter.

My independent variables range from firm perceptions of various aspects of courts' performance and obstacles to doing business, to institutional country-level variables (Appendix 5).

Hypotheses

Firm-level variables

Hellman et al (2000a) suggested that the ability of the state to provide a sound legal system that protects property rights is a substitute to state capture. The BEEPS includes a number of variables of firm perceptions of the legal system. I have derived the following hypothesis regarding these variables:

H1: The higher firm perceptions that courts are protecting their property rights, the lower the perception of state capture.

H2: The higher the perceived ability of courts to enforce their decisions, the lower the perceived impact of state capture.

H3: The higher firms perceptions of judicial obstacles, the higher the perception of state capture.

In addition to the above variables, the perceived impact of state capture could be related to the availability of information about new laws, and to uncertainty about such laws and/or new policies. If firms do not know the law, or have a hard time obtaining information about it, they are more likely to think that such laws are kept secret because they have been captured by more powerful companies. Uncertainty about laws and policies could raise similar fears of state capture. These variables are important, because if they are significant they could suggest that firms are perhaps

unduly attributing what they perceive as lack of clarity of laws to the often vague concept of state capture. In other words, perceptions of state capture might be caused by lack of information about the law, rather than by actual illicit actions of certain companies.

H4: The easier it is to obtain information about laws, the lower the perception of state capture.

H5: The more firms perceive uncertainty as an obstacle to doing business, the more they feel affected by state capture.

I also expect the companies I have defined as captor firms (Appendix 1) to consider the impact of state capture as higher than other firms, because this high impact is presumably why they would want to engage in state capture to begin with. While firms that are likely to think state capture affects them negatively, captor firms are more likely to consider themselves positively affected by state capture.

H6: Captor firms are more likely to perceive that they are affected by state capture.

Objective firm-level variables, such as size and origin, have also been found to be significant in some previous regressions of state capture. Unfortunately, these variables are only available for the 2005 data. Based on previous findings from Hellman et al (2000a), I hypothesize that:

H7: Large firms are more likely to be affected by state capture than small and medium firms.

H8: New private firms are more likely to be affected by state capture than state-owned or privatized firms.

Economic variables

Economic variables are control variables in my model. I expect higher income countries, and countries whose economies are more open to foreign influences to be less likely to experience state capture. The expectation about wealth is based on the broad observation that corruption in general declines with the level of development. Foreign investors are also expected to look for countries where they are protected by relatively developed legal systems and less favoritism to incumbent firms, and thus less state capture.

H9: The higher the GDP per capita, the lower perceived state capture.

H10: The higher Foreign Direct Investment (FDI), the lower perceived state capture.

Institutional variables

The key variables for my research are institutional. Based on my case study research, I expect banking reform to have contributed to the reduction in state capture, by eliminating access to soft financing, which was key to state capture attempts.

H11: The higher the EBRD index of banking reform, the lower the perceived state capture.

I also consider alternative measures of economic and institutional reform, such as a broader index of EBRD reform, which includes banking, securities and competition policy reform, as well as large scale privatization and enterprise restructuring, and a measure of the quality of financial and commercial laws in 2002 (for regressions referring only to 2005). I expect higher values of any of these indexes to lead to lower perceptions of state capture. One reason why it might make sense to include more aggregate indexes, rather than having all the specific reforms included in the regression is that these reform measures are often highly correlated, making statistical interpretation problematic.

A special class of institutions considered here are political institutions. In previous World Bank research, the political variables used (government tenure measured by years in office, and the proximity of a legislative election) were not significant influences on state capture. I consider alternative variables, such as the World Bank governance indicator on political voice and accountability, as well as an index of parliamentary powers that differentiates between presidential and parliamentary regimes, and transition-specific measures of democracy from Freedom House's Nations in Transit, which focus on the electoral process, media and civil society. I expect all of these variables to have negative relationships with state capture, due to the dampening effects of political competition and electoral accountability on state

capture. I also check, however, Hellman et al.'s (2000a) hypothesis that the relationship between democracy and state capture is an inverted U shape. This suggests that the positive effects of democracy on reducing state capture happen later in the democratic consolidation process, while the initial effect of democracy is one of allowing more pressure from vested interests on the state, and therefore more state capture.

H12: The more democracy, the less state capture.

H13: At low levels of democracy, the more democracy the less state capture; at higher levels, more democracy reduces state capture.

Methodology

The BEEPS data used for this chapter represents more than 10,000 firms in 26 countries in Eastern Europe and Central Asia in 1999 and 2005. I have complemented this data set with country-level variables, mainly institutional and economic performance variables from the EBRD, whose effect on state capture I am interested in. The multilevel nature of the data necessitates the use of hierarchical or multilevel modeling techniques to account for country-level effects. The substantive motivation for multilevel analysis is to provide a single comprehensive model that combines multiple levels of analysis, while the statistical motivation is to avoid incorrect standard errors caused by the non-independence of individual-level observations (Steenbergen and Jones 2002). Thus, this model allows for firm-level observations to be influenced by

country-level variables. The standard errors in such a model are adjusted for clustering in the data.

My discrete dependent variable lends itself to a number of model specifications (ordinary least squares (OLS), multinomial logistic model, or a regular logistic model, once the variable is transformed into a 0-1 range). The OLS estimates are consistent in large samples in spite of the discrete nature of the dependent variable. I focus on the OLS models, given the ease of interpretation of the coefficients and comparability with previous research on state capture. In its previous analyses of the BEEPS, the World Bank uses OLS and verifies the results with ordered logit models, obtaining very similar results. They argue, however, that the OLS models “were most appropriate” (Gray et al. 2004: 59).

A disadvantage of the logistic model is that it suffers from loss of information, given that the four answer options to the survey question for my dependent variable are reduced to two. It is also not clear which answers should count as zero and which should count as one. If a company says there is minor impact on their business from state capture, it is not clear if this impact is negligible, or an important distinction from the “no impact” answers. I have, nonetheless, checked the results of logistic models (I present one here in Table 4.2), and in most cases the results are very similar (the significant variables do not change).

Results

The cross-country analysis of state capture reveals some interesting relationships. First, banking reform, which had an important role in eliminating the old managers' early advantages in the case of Romania, is statistically significant across the Eastern European sample, and across time, in reducing state capture (Table 4.1).

Table 4.1. Regression Results for State Capture
OLS Models of State Capture

	Model 1	Model 2	Model 3	Model 4
Institutional variables (country-level)				
Banking reform	-0.160* (0.068)		-0.287* (0.105)	-0.280* (0.097)
Parliamentary powers		0.810+ (0.444)	-0.103 (0.323)	-0.245 (0.316)
Political voice and accountability		-0.164* (0.070)	0.362* (0.113)	0.366* (0.108)
Political voice squared				-0.042+ (0.024)
Firm perceptions variables (firm-level)				
Property rights protection			-0.004 (0.007)	-0.004 (0.007)
Ease of information about law			-0.016* (0.008)	-0.017* (0.007)
Courts' enforcement powers			-0.018* (0.007)	-0.017* (0.007)
Judicial obstacles			0.056* (0.017)	0.055* (0.017)
Uncertainty obstacles			0.022+ (0.012)	0.022+ (0.012)
Corruption obstacles			0.114* (0.014)	0.112* (0.014)
Captor firm			0.491* (0.059)	0.491* (0.058)
Control variables (country-level)				
GDP/capita			-0.032* (0.010)	-0.030* (0.011)
FDI			-0.026+ (0.015)	-0.026+ (0.015)
Constant	0.885* (0.219)	-0.084 (0.305)	1.208* (0.409)	1.295* (0.373)
N	7335	7335	7335	7335
adj. R-sq	0.022	0.007	0.210	0.211

+p<0.10, * p<0.05

Microdata from BEEPS 1999, 2005 (World Bank and EBRD); macrodata from the EBRD. Robust standard errors adjusted for clustering at the country level in parantheses.

The effect of banking reform on firm-level perceptions of state capture is relatively modest, but statistically significant. Increasing banking reform by one unit (.33

on the EBRD reform scale) reduces state capture by 23 percent. In terms of standard deviation, a one s.d. change in banking reform leads to a change of almost a quarter (22 percent) of a standard deviation in state capture (at the mean).

The significance of banking reform for reducing state capture across Eastern Europe corroborates my Romanian narrative, suggesting that state capture and clientelistic allocation of finance go hand in hand across sub-regions of Eastern Europe and Central Asia with different income and democracy levels. This lends credence to my argument that banking reform was a key element in changing the incentives of entrepreneurs towards market strategies, and away from dependence on the state. By stopping the flow of soft finance, banking reform forced economic elites across Eastern Europe to compete in the marketplace by focusing mostly on productive activities.

In general, substituting banking reform for an index of related reforms measured by the EBRD (including large-scale privatization progress, capital markets reform, and enterprise restructuring) also results in a significant relationship between the reform of market institutions and the reduction in state capture.

In terms of political institutions, democracy, measured here as political voice and accountability, does have a significant effect on state capture. While initially the relationship between democracy and state capture appears to be negative (Model 2), the inclusion of other variables changes the sign of political voice. A second democracy variable, representing the square of political voice, is significant and negative, suggesting a non-linear, inverted-U relationship, consistent with the findings of Hellman

et al (2000a) for 1999 data. Replacing political voice with the Nations in Transit democracy score yields very similar results.

The third political institutional variable, the index of parliamentary powers, is positively correlated with state capture in a simple model, perhaps because a strong legislature makes the buying of parliamentary votes more worthwhile. However, the coefficient of the index becomes negative and insignificant in the more complete regressions. Thus, the effect of a strong legislature on state capture does not appear to extend beyond the broader effect of democracy.

Several firm-level variables are also significantly correlated with state capture. Contrary to expectations, firms' expectations about property rights protection by courts do not significantly reduce their perceptions of the impact of state capture, suggesting that there is not a strong link between protection of property rights and state capture in firms' assessments. By contrast, firms perceive a significant relationship between state capture and the ease of obtaining information about law, the courts' enforcement powers, and general judicial, corruption and uncertainty obstacles to doing business. When legal information is difficult to obtain, courts cannot enforce their decisions, there is high uncertainty about policy, and the judiciary and administrative corruption are viewed as obstacles to doing business, the impact of state capture is perceived to be higher. This may suggest that firms' assessments of state capture are more a reflection of legal information issues, of fear of unexpected legal changes, of perceptions of administrative corruption, and of more innocuous judicial problems, rather than a

strong sense that laws are skewed in favor of certain businesses, while other businesses' property rights go unprotected. One last significant firm-level variable is captor firm. As expected, firms who admit that firms "like theirs" need to engage in state capture consider that the impact of state capture on their business is more significant, although they probably view this impact as positive, unlike the majority of the rest of the companies.

Finally, the economic controls used here are also significantly and negatively correlated to state capture, showing that state capture declines as countries become more prosperous and open to foreign investment.

To verify the robustness of these results, I have also run a logistic regression (Table 2), with the dependent variable as a state capture dummy variable, constructed as equal to 0 when state capture is zero, and equal to 1 for all other values of state capture.

Table 4.2. Logistic Regression Results for State Capture

	Odds ratio	Robust standard errors	z statistic	p-value
Institutional variables (country-level)				
Banking reform	0.4242231	0.1193245	-3.05	0.002*
Parliamentary powers	0.624331	0.6244093	-0.47	0.638
Political voice and accountability	3.13527	1.04915	3.41	0.001*
Political voice squared	0.8312259	0.0903496	-1.7	0.089+
Firm perceptions variables (firm-level)				
Property rights protection	1.036507	0.0287009	1.29	0.195
Ease of information about law	0.9262176	0.0242784	-2.92	0.003*
Courts' enforcement powers	0.9460159	0.0267872	-1.96	0.05*
Judicial obstacles	1.179103	0.0578884	3.36	0.001*
Uncertainty obstacles	1.025347	0.047533	0.54	0.589
Corruption obstacles	1.453954	0.0691174	7.87	0*
Captor firm	3.90146	0.520971	10.19	0*
Control variables (country-level)				
GDP/capita	0.9014463	0.0374439	-2.5	0.012*
FDI	0.9140329	0.0528684	-1.55	0.12

N = 7335

Pseudo-Rsq = 0.1722

+p<0.10, * p<0.05

Microdata from BEEPS 1999, 2005

(World Bank and EBRD); macrodata from the

EBRD. Robust standard errors are adjusted for clustering at the country level.

The results are almost unchanged when compared to Model 4 from Table 4.1.

The same institutional variables are significant, and the direction of their relationships with state capture is the same (odds ratio smaller than 1 means a negative relationship, while odds ration larger than 1 stands for a positive relationship). Among the firm-level variables, uncertainty obstacles is the only one that becomes insignificant, from a significance level of 10% in the OLS model. The FDI control variable also becomes

insignificant. In spite of these slight differences, the logistic model's results largely confirm the results of the OLS model.

To identify possible differences in the determinants of state capture within Eastern Europe, I examine the effect of country-level variables by sub-region next. Due to the loss of degrees of freedom when using fewer country clusters, micro-level variables have been left out of these regressions.

Table 4.3. State capture regressions on country-level variables by sub-region
OLS regressions of state capture

	Central Europe and the Baltics		South-East Europe		Former Soviet Union (except Baltics)	
Political voice and accountability	0.088	(0.143)	0.171	(0.162)	0.690*	(0.196)
Parliamentary powers	3.062*	(1.137)	-0.962*	(0.241)	-0.380	(0.646)
Banking reform	-0.309*	(0.114)	-0.099	(0.058)	-0.288+	(0.156)
GDP/capita	-0.030*	(0.007)	-0.040*	(0.006)	-0.068+	(0.032)
FDI	-0.003	(0.006)	-0.055*	(0.007)	-0.052*	(0.017)
Constant	-0.681	(0.614)	1.765*	(0.236)	2.015*	(0.604)
N	3410		2064		4633	
adj. R-sq	0.066		0.054		0.137	

+p<0.10, * p<0.05

Microdata from BEEPS 1999, 2005 (World Bank and EBRD); macrodata from the EBRD. Robust standard errors adjusted for clustering at the country level in parentheses.

While the effect of the economic variables on state capture does not change much when the sample is divided by sub-region, other variables are less consistent. Political voice and accountability is still positively correlated to state capture, but is only significant in the former Soviet Union (and the squared variable is insignificant). Banking reform, paradoxically, is only significantly correlated with state capture in Central Europe and the Baltics and the former Soviet Union. Perhaps the most interesting effect,

however, is that of parliamentary powers, which has a strong positive correlation with state capture in Central Europe and the Baltics, but a significant negative relationship to state capture in South-East Europe. This could mean that in more advanced democracies, like those of Central Europe, a strong parliament is perceived as a focus of attempts to illicitly influence laws, whereas in South-East Europe, the index of parliamentary powers picks up more the effects of democracy.

Table 4.4. Regression Results for State Capture by Year
OLS Models of State Capture

	1999		2005		2005	
Country-level variables						
Banking reform	-0.223+	(0.122)	-0.039	(0.052)	-0.029	(0.053)
Parliamentary powers	-0.293	(0.507)	0.253	(0.295)	0.273	(0.308)
Political voice and accountability	0.321*	(0.099)	0.075	(0.111)	0.070	(0.116)
Political voice squared	-0.055	(0.082)	-0.019	(0.019)	-0.018	(0.019)
GDP/capita	-0.043*	(0.018)	-0.016	(0.010)	-0.017	(0.010)
FDI	-0.024	(0.014)	-0.021*	(0.010)	-0.021*	(0.010)
Firm-level variables						
Property rights protection	-0.030	(0.020)	0.004	(0.007)	0.002	(0.007)
Ease of information about law	-0.053*	(0.017)	-0.017*	(0.007)	-0.017*	(0.007)
Courts' enforcement powers	-0.027	(0.020)	-0.007	(0.006)	-0.006	(0.006)
Judicial obstacles	0.092*	(0.032)	0.059*	(0.013)	0.057*	(0.014)
Uncertainty obstacles	0.109*	(0.023)	-0.014	(0.012)	-0.017	(0.012)
Corruption obstacles	0.193*	(0.030)	0.078*	(0.013)	0.082*	(0.013)
Captor firm	0.285*	(0.055)	0.582*	(0.076)	0.584*	(0.075)
Foreign					-0.020	(0.030)
Government-owned					0.026	(0.044)
Privatized					0.007	(0.048)
Startup					0.027	(0.039)
Firm with government contracts					0.000	(0.001)
Influential firm					0.053	(0.034)
Firm with growing sales					-0.005	(0.014)
Firm with dropping sales					0.013	(0.026)
Small					0.009	(0.036)
Large					0.041	(0.032)
Constant	1.108*	(0.352)	0.191	(0.383)	0.124	(0.402)
N	1705		5630		5457	
adj. R-sq	0.209		0.184		0.188	
+p<0.10, * p<0.05						

Microdata from BEEPS 1999, 2005
 (World Bank and EBRD); macrodata from the
 EBRD. Robust standard errors adjusted for clustering at the country level in parantheses.

Splitting the data by year (due to the availability of more firm-level variables in
 2005) renders many of the country-level variables insignificant, especially for 2005.

However, some of the firm perceptions variables, such as the ease of obtaining

information about the law, judicial and corruption obstacles, and captor firm, retain their significance and signs. Surprisingly, none of the objective firm characteristics are significantly correlated with state capture. There appears to be no significant differences on the impact of state capture reported by firms of different sizes, balance sheets, ownership and origins in 2005. This might be due to the fact that there is much less variation in state capture in 2005 than in 1999.

Table 4.5. Forms of corruption compared OLS models of corruption and state capture

	State Capture		Corruption frequency		Kickback frequency	
Country-level variables						
Banking reform	-0.287*	(0.105)	0.029	(0.113)	0.175+	(0.089)
Parliamentary powers	-0.103	(0.323)	-1.046+	(0.554)	0.556	(0.661)
Political voice and accountability	0.362*	(0.113)	-0.000	(0.132)	-0.245+	(0.141)
GDP/capita	-0.032*	(0.010)	-0.033+	(0.017)	0.019	(0.018)
FDI	-0.026+	(0.015)	-0.016	(0.013)	-0.002	(0.014)
Firm-level variables						
Property rights protection	-0.004	(0.007)	-0.102*	(0.016)	-0.051*	(0.017)
Ease of information about law	-0.016*	(0.008)	0.001	(0.018)	-0.005	(0.020)
Courts' enforcement powers	-0.018*	(0.007)	-0.010	(0.015)	0.004	(0.011)
Judicial obstacles	0.056*	(0.017)	-0.007	(0.028)	0.027	(0.042)
Uncertainty obstacles	0.022+	(0.012)	0.020	(0.025)	0.032	(0.019)
Corruption obstacles	0.114*	(0.014)	0.386*	(0.019)	0.226*	(0.028)
Captor firm	0.491*	(0.059)	0.916*	(0.100)	1.666*	(0.086)
Constant	1.208*	(0.409)	2.598*	(0.473)	0.286	(0.443)
N	7335		7945		7953	
adj. R-sq	0.210		0.214		0.219	

+p<0.10, * p<0.05

Microdata from BEEPS 1999, 2005 (World Bank and EBRD); macrodata from the EBRD. Robust standard errors adjusted for clustering at the country level in parantheses.

My last analysis looks at how state capture compares to other forms of corruption, namely corruption frequency and kickback frequency, in its correlates. The

analysis shows that firms do distinguish between corruption and kickbacks on the one hand and state capture on the other. Both corruption and kickback frequency are significantly negatively correlated to firm perceptions of property rights protection, unlike state capture. This suggests that firms do not substitute the lack of property rights protection with state capture, as Hellman et al (2000a) argued. Rather, when property rights are inadequately protected by courts, firms buy this protection directly through corruption, but by trying to influence specific decisions rather than by trying to capture laws. This finding is consistent with my case study research on Romania.

Conclusion

The quantitative analysis of this chapter shows that state capture in Eastern Europe is closely linked to firm perceptions of other aspects of corruption and of the judicial system, as well as to country-specific institutional variables. At the firm level, the ease of obtaining information about new laws and the firms' assessments of judicial and general corruption obstacles are closely linked to the perceived impact of state capture. In contrast, I showed that firms do not see state capture as a result of the courts' inability to protect their property rights. This contradicts earlier suggestions by Hellman et al. (2000a) that state capture occurs when firms buy private protection of property rights in order to compensate for the judicial system's failure to publicly protect property rights.

Country-level variables are generally significant correlates of state capture. Prominently, banking reform, a key factor in the evolution of the Romanian market institutions, is also a significant factor in the drop of state capture across Eastern Europe. In my case study chapter, I suggest the likely mechanisms through which banking reform has reduced state capture, namely by contributing to a change in the economic elite that marginalized the old state enterprise managers, as well as by forcing the new entrepreneurs to move away from soft loans, and towards market-based profitability. While banking reform proved significant in reducing state capture across the region, it remains to be seen whether similar mechanisms to those present in Romania apply to other countries.

Finally, as initially suggested by Hellman et al (2000a), democracy has a complex effect on state capture. My analysis uses newer 2005 data to confirm that in the early stages of democratization, an increase in political voice and accountability can lead to a rise in state capture; this effect is reversed only later during democratic consolidation. Additional research, including qualitative analysis, is necessary for a better understanding of this inverted U-shape effect.

Chapter 5: Conclusion

In 2009, the economies of Eastern Europe have concluded twenty years of often-torturous double transitions towards democracy and capitalism. These transitions have involved not only massive economic policy change and political openings, but also wholesale institutional revamping in search for stable foundations for prosperity and freedom. This dissertation has delved into explaining the successful creation of these institutional bases for markets and democracy focusing on Romania, a transition laggard with particularly rough legacies of communist rule and inauspicious political beginnings. Few observers saw many prospects of improvement for Romania as late as 1999, and yet by 2007 the country had tripled its 2001 standard of living, achieved Western levels of inflation and unemployment, slashed its poverty rate to a tenth of its 1999 share of the population, and became an investment destination, with FDI inflows in 2008 more than ten times the value of the 1999 inflows (EBRD 2009). In 2009, Romania was hit hard by the global financial crisis, due to a sharp drop in exports, and to vulnerability of the foreign-owned banking system. However, the EBRD (2009) assesses Romania's prospects for growth in the medium term as favorable, suggesting that the country rests on stable institutional foundations.

The main aim of my dissertation has been to explain how this reversal of fortune was possible in the second decade of transition, focusing on the reform of market and democratic governance institutions, and on the influence of private actors, economic

and political, on the reform of these institutions. Market governance institutions, such as bankruptcy, capital markets, and concessions laws have been thoroughly reformed, and are reasonably effective in practice, while democratic governance institutions, such as anti-corruption, civil service, and conflict of interest rules have been reformed on paper after many delays, but have yet to prove their effectiveness in practice.

This difference in outcomes occurred because unlike in market governance, where a new economic elite had few incentives to oppose a sophisticated market framework after 1999, in the democratic governance domain politicians still had relatively strong incentives to oppose institutions that limit the discretion of office-holders in spite of robust political competition. These incentives were complicated, sometimes in unexpected ways, by the President-Parliament competition of 2005-2008.

My account of the reform of market institutions differs from the conventional view on the matter, which regards Romania as “a textbook case of the capture of a partially reformed economy by former communist cadres linked closely to the ruling political parties” (Vachudova 2005, 50). I argue that institutional capture of market governance laws has not occurred, due to the inability of the communist-era directocracy to entrench their early benefits from initial reforms. The slowness of privatization before 1997, combined with the political change of 1996, and the end to soft loans after 1998 achieved through banking reform, have resulted in a fall from grace of the old economic elite, and the rise of a younger elite, with different market skills and incentives.

This new elite is not necessarily clean of communist party and secret services connections, but most of these entrepreneurs were too young at the beginning of transition to have held important positions in the communist nomenklatura that would have allowed them the conversion of political power into economic power. These entrepreneurs are often lumped together with the directocracy in accounts of the Romanian reforms in an amorphous 'business interest' entity, which prevents an adequate understanding of the role of economic actors in institutional reform. Unlike the market-phobic and state-dependent directocracy, the new economic elite had quite adequate market and entrepreneurial skills, acquired in the process of managing their start-up firms, as well as by cooperation with foreign partners. Therefore, they did not need to oppose a sophisticated market governance framework. To the extent that they had an interest in continued legal loopholes, such as the lax banking regulations that made soft loans possible, these entrepreneurs were co-opted by the government into acquiescing with banking reform through such practices as de facto debt forgiveness.

Elite change in the Romanian economy has happened due to a combination of factors (political change, banking reform, and a particular sequencing of privatization policy) that is not easily replicable in other countries. Elite change is also difficult to measure in a consistent way across countries. This raises issues about the generalizability of my argument, questions that also apply to the my explanation of the contradictory role of political competition for democratic governance reform.

Nonetheless, my research on Romania can be expanded beyond this country in several ways. I have experimented with one such generalization in my quantitative chapter, and found that banking reform, a factor crucial to the Romanian case, has robust significance across the region. Another way to expand my case study is through small-N comparative studies. On the business side, there is some evidence that the economic elite in other countries, such as Russia, is somewhat similar to the new Romanian entrepreneurs (Guriev and Rachinsky 2004). Both elites contain many entrepreneurs who were quite young at the beginning of transition, and who showed they had the capacity to run productive companies. Both elites were faced with banking reforms in the wake of financial crisis in 1998. However, much of the improvement in market governance in Russia seems to be due to the return towards authoritarianism, and to the Russian state under Putin trying to bring business interests under its control.

On the democratic governance side, a comparison of the passage of reforms between Romania and Ukraine, also a semi-presidential democracy with recurring conflicts between the President and the Prime Minister, would be highly instructive for untangling the incentives of politicians and the effects of political competition.

Beyond these qualitative comparisons of the role of private interests in institutional reforms, there is the broader issue of the comparative performance of Eastern European countries in terms of compliance with international standards in market governance, such as the OECD principles in various areas of business law, as well as with best practices of democratic accountability. One of the most direct influences on

many of these institutional reforms in Romania has been the European Union, but other countries with much less certain prospects of joining the EU have engaged in similar reforms for reasons that need to be clarified by further research.

Finally, one important issue arising from my dissertation research regards questioning the quality of the institutional frameworks that Eastern European countries are emulating. The recent global financial crisis has brought under scrutiny the conventional wisdom on what constitutes good capital market or investor protection law even in the advanced economies where these laws were invented. It appears to be the case that independently of direct business influence, these laws have built-in 'neoliberal' biases in favor of business, by taking a very laissez-faire view of financial regulation that does not adequately protect the economy against financial crises. The building of a new global financial institutional infrastructure and the roles that business and politics will play in these reforms will be a fascinating topic of study for several years to come.

Appendices

Appendix 1: Compliance with international standards in market legislation in Eastern Europe

Law	High Compliance	Medium Compliance	Low Compliance	Very Low Compliance
Bankruptcy (2004)	Albania Bosnia Herzeg. Bulgaria Croatia Moldova Romania Serbia/Monten.	Armenia Belarus Czech Republic Estonia Kazakhstan Macedonia Poland Russia Slovak	Azerbaijan Georgia Hungary Latvia Slovenia Uzbekistan	Lithuania Tajikistan Turkmenistan Ukraine
Concessions (2008)	Albania Lithuania Slovenia	Bosnia Herzeg. Bulgaria Croatia Czech Republic Hungary	Belarus Estonia Georgia Kyrgyz Republic Russia	Armenia Azerbaijan Tajikistan

		Kazakhstan Latvia Macedonia Moldova Montenegro Poland Romania Slovak Rep. Ukraine	Serbia Turkmenistan Uzbekistan	
Corporate governance (2004, 2008, assessing Company law, Securities law, and Regulations of the stock exchanges in force in September	Poland Hungary Macedonia Lithuania Latvia Moldova Russia Kazakhstan Armenia	Czech Rep. Slovak Rep. Slovenia Serbia Albania Bulgaria Croatia Estonia Romania (2008) Uzbekistan Kyrgyz Rep.	Bosnia Herzeg. Georgia Turkmenistan	Belarus Ukraine Azerbaijan Tajikistan

2003)				
Securities markets (2007)	Bulgaria Croatia Czech Rep. Estonia Hungary Latvia Lithuania Moldova Poland Romania Slovak Rep. Serbia Slovenia Ukraine	Armenia Bosnia Herzeg. Macedonia Kazakhstan Kyrgyz Rep. Mongolia Montenegro Russia	Albania Azerbaijan Georgia Uzbekistan	Belarus Tajikistan Turkmenistan
Secured transactions (2004)	Bulgaria Romania Hungary Latvia Lithuania Slovak Rep.	Bosnia Herzeg. Poland Macedonia Ukraine	Estonia Kazakhstan	Armenia Azerbaijan Belarus Czech Rep. Croatia Georgia

				Russia Slovenia Uzbekistan Turkmenistan Tajikistan
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Source: EBRD <http://www.ebrd.com/country/sector/law/about/assess/index.htm>

Appendix 2: Top 25 Wealthiest Romanians (Source: Capital 2007)

Name	Age	Net worth in (million 198 9 USD)	Main sectors	Comments
Dinu Patriciu	39	3.1-3.3 billion	oil, media, real estate	architect; worked for architecture institute before 1989
George Becali	31	2.8-3 billion	real estate , soccer, auto industry, agriculture (poultry), construction	Starts real estate business after a land 'exchange' with the Romanian army, and some other suspicious land acquisitions from the state
Ion Tiriac	50	2.2 - 2.4 billion	finance, real estate, trade, sport	re-pat
Sorin Ovidiu Vantu	33	2.1-2.3 billion	finance, media, real estate	Involved in the collapse of the National Investment Fund in 2000
Micula	N/A	1.9-2.1		re-pats; returned from

brothers (Viorel and Ioan)		billion	food and beverage, tourism, media, real estate	Sweden in the early 1990s
George Constantin Paunescu (and family)	52	1.6-1.8 billion	Tourism, media, real estate, publishing, shipping	Believed to have ties with ex-securitate; worked in foreign trade before 1989; moved business and residence abroad after 1996
Iosif Constantin Dragan	72	1.5-1.6	propane distribution, publishing, real estate, transportation	re-pat
Zoltan Teszari	19	1.2 billion	communications	
Ioan Neculae	35	1.4-1.6 billion	foreign trade	various accusation of shady deals; was involved in oil refining business; London Stock Exchange listing of the chemical company in 2007
Camelia and Corina	10-	0.9-1	Media, trade, agriculture, industry,	daughters of Dan Voiculescu, accused of

Voiculescu	12	billion	real estate	collaborating with the former Securitate
Marius and Emil Cristescu	Less than 30	750-800	industry (Bega group), tourism	They started in 1990 as students with a small store on campus; their Bega group has 29 companies, mostly in industry, mostly bought from the state in direct privatization deals in the late 1990s
Adamescu family (Dan Grigore and Carmen Adamescu)	N/A	700-900	insurance, trade construction, real estate, tourism	Dan Grigore is a German citizen and Carmen Adamescu is a resident of Monaco
George Copos	36		industry: food, electronics, real estate, tourism	accused in Loteria file, former Vice-PM in Tariceanu government, PC; July 2008 accusations of capital market manipulation

Gabriel	22	600-700	offshore oil, oil	new in the top 300, bought
Valentin			industry tools,	offshore platforms in 2005
Comanescu			tourism	after credits from foreign and Romanian banks
Ovidiu Tender	33	600-620	insurance, pharmaceuticals, tobacco, oil prospecting	Controversial businessman involved in RAFO refinery deals
Stefan Vuza	19	400-410	electricity, green energy, aviation, real estate	
Ioan Neculaie	32	380-400	auto industry, construction, tourism, agriculture	contested ownership of Roman truck factory; exports trucks to the US
Fathi Taher	41	350	tourism, process equipment manufacturing	Lebanese; Griro (formerly Grivita Rosie), one of the oldest Romanian factories, has an impressive list of internatioanl clients

Frank Timis	26	320-350	natural resources around the world	lives in Australia
Josef Goschy	58	250-300	tourism	also lives in Germany
Robert (and Ionut) Negoita	18	250-300	trade, hotels, real estate	started with floor coverings firm in 1996; Robert became PSD member in 2003
Dimitrie Sturdza	51	250-300	cosmetics, accessories, real estate	re-pat, part of the Romanian royal family
Enrico Perini	22	200-250	trade, sanitary equipment production	Italian with double citizenship; came to Romania in 1992
Zinger Family	N/A	200	real estate, construction	also live in Tel Aviv, and do business in the US
Iosif Armas	23	200	transportation, tourism, trade, agriculture	took part in several privatizations; deputy on behalf of PSD 2000-2004, member of the

privatization commission in

Parliament

Appendix 3: Acronyms of Romanian Political Parties

CDR: Democratic Convention of Romania

DA: Truth and Justice coalition

FSN: National Salvation Front

FDSN: Democratic National Salvation Front (formerly part of FSN)

PDSR: Party of Romanian Social Democracy (formerly FDSN)

PD: Democratic Party (formerly FSN, now PDL)

PDL (or PD-L): Democratic Liberal Party (formerly PD)

PNL: National Liberal Party

PNTCD: National Peasants' Christian Democratic Party

PRM: Greater Romania Party

PSD: Social Democratic Party (formerly PDSR)

PSM: Socialist Party of Labor

PUNR: Party of Romanian National Unity

UDMR: Democratic Union of Hungarians in Romania

Appendix 4. Measures of corruption in Romania

	1999	2002	2007
Corruption Perceptions Index (TI)	3.3	2.6	3.8 (2008)
Corruption (FH)	4.25	4.75	4.00 (2008)
Control of corruption (WB) (percentile rank)	44.2 (1998)	45.1	55.6
Bribe Frequency (BEEPS)	51%	37%	23% (2005)
Rule of law (WB)(percentile rank)	46.7 (1998)	48.1	50.5
Judicial Independence (FH)	4.25	4.25	4.00

Sources: World Bank Governance Indicators http://info.worldbank.org/governance/wgi/sc_chart.asp, Nations in Transit (Freedom House) <http://www.freedomhouse.org/template.cfm?page=17&year=2008> (1 best, 7 worst); Business Environment and Enterprise Performance Survey (BEEPS) <http://www.ebrd.com/country/sector/econo/surveys/beeps.htm> (percentage of firms paying bribes frequently, mostly, and always); Transparency International http://www.transparency.org/policy_research/surveys_indices/cpi (0 most corrupt, 10 least corrupt)

Appendix 5: Descriptive Statistics (BEEPS)

	Observations	Mean	Standard Deviation	Min	Max
Dependent variables					
State capture	10892	0.41	0.78	0	3
State capture dummy	10892	0.25	0.43	0	1
Corruption frequency	12267	2.47	1.53	1	6
Kickback frequency	11483	1.88	1.46	1	6
Firm perceptions variables (firm-level)					
Property rights protection	13218	3.51	1.38	1	6
Ease of information about law	13530	4.00	1.47	1	6
Courts' enforcement powers	12222	3.33	1.52	1	6
Judicial obstacles	12564	2.07	1.09	1	4
Uncertainty obstacles	13347	2.67	1.13	1	4
Corruption obstacles	12707	2.25	1.15	1	4
Captor firm	11274	0.10	0.30	0	1
Institutional and control variables (country-level)					
Banking reform	13060	2.84	0.75	1	4
Political voice and accountability	12827	-0.01	0.85	-1.82	1.2
Parliamentary powers	12827	0.62	0.17	0.25	0.81
GDP/capita	12828	4.49	3.89	0.17	17.85
FDI	12828	2.57	3.07	-0.067	11.63

Appendix 6: Measurement of variables (BEEPS)

Firm-level dependent variables (all from BEEPS 1999 and 2005)

(Note: Question and answer phrasing and coding differ slightly from 1999 to 2005. I have adjusted for these differences where necessary. Phrasing from 2005 used here.)

State capture: To what extent do private payments/gifts or other benefits to Parliamentarians to affect their votes had a direct impact on your business?" No impact: 0, Minor impact: 1, Moderate/Major impact: 2, Decisive impact: 3.

State capture dummy: same question as above; answers: No impact: 0, Everything else: 1.

Corruption frequency: Thinking about officials, would you say the following statements are always, usually, frequently, sometimes, seldom or never true? "It is common for firms in my line of business to have to pay some irregular additional payments/gifts to get things done in regard to customs, taxes, licenses, regulations, services etc.". Never: 1, Always: 6.

Kickback frequency: How often would a firm like yours make unofficial payments/gifts to obtain government contracts? Never: 1 to Always: 6.

Firm-level predictors (all from BEEPS 1999 and 2005)

Courts' protection of property rights: Do you agree with the statement: "I am confident that the legal system will uphold my contract and property rights in business disputes"?

Strongly disagree: 1 to Strongly agree: 6.

Ease of information about law: To what extent do you agree with the following statement: "Information on the laws and regulations affecting my firm is easy to obtain". Strongly disagree: 1 to Strongly agree: 6.

Courts' enforcement powers: How often do you associate the following descriptions with the court system in resolving business disputes? Able to enforce its decisions. Never: 1 to Always: 6.

Judicial obstacles: Can you tell me how problematic is the functioning of the judiciary for the operation and growth of your business? No obstacle: 1, Major obstacle: 4.

Uncertainty obstacles: Can you tell me how problematic is uncertainty about regulatory policies for the operation and growth of your business? No obstacle: 1, Major obstacle: 4.

Corruption obstacles: Can you tell me how problematic is corruption for the operation and growth of your business? No obstacle: 1, Major obstacle: 4.

Captor firm: How often would firms like your need to make payments/gifts to influence the contact of new legislation rules decrees etc.? Firms that answered sometimes, frequently, usually, or always were coded as captor firms.

Additional 2005 firm-level predictors

Foreign: Is the largest shareholder foreign? 1 if yes, 0 if no.

Government-owned: Is the largest shareholder government? 1 if yes, 0 if no.

Startup: Is the firm originally private? 1 if yes, 0 if no.

Privatized: Is the firm privatized (formerly a state-owned enterprise)? 1 if yes, 0 if no.

Firm with government contracts: What percent of domestic sales are to government agencies?

Influential firm: Did your firm seek to influence the content of national laws or regulations affecting it? 1 if yes, 0 if no.

Firm with growing sales: How have sales changed over the last 3 years? 1 if sales have grown, 0 otherwise.

Firm with dropping sales: How have sales changed over the last 3 years? 1 if sales have grown, 0 otherwise.

Large/small firm: Does the firm have few employees (1-49), medium (50-250) or many (>250)? Large if more than 250; small if less than 50.

Institutional country-level predictors

Banking reform: values from 1 to 4.33: an index of reforms from the EBRD transition reform indicators.

Political voice and accountability: values from -2.5 to +2.5: an index of various democracy sources from the World Bank's governance indicators.

Parliamentary powers index: values 0 to 1, from Fish and Kroenig (2009), available at:

<http://polisci.berkeley.edu/people/faculty/FishM/PPIScores.pdf>

Control variables (country-level)

GDP per capita: in billion \$, from the EBRD.

FDI: net inflows of Foreign Direct Investment in billion \$, from the EBRD.

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Curriculum Vitae

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