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## **TRANSFORMATION OF INSTITUTIONS AS A CHALLENGE OF ECONOMIC DEVELOPMENT IN THE REPUBLIC OF MACEDONIA**

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***Abstract:** Economic institutions of a society depend on the nature of political institutions and the distribution of political power in the society. The new institutional economics is interested in the social, economic and political institutions that govern everyday life. In this essay, we will discuss that institutions, very broadly defined, are the fundamental cause of economic growth and development. We will also discuss the fact that our state of knowledge does not yet enable us to make specific statements about how institutions can be improved (in order to promote further economic growth). Nevertheless, we can use this framework in several ways. Solving the problem of development will entail the reform of these institutions. Unfortunately, not all aspects of good governance have the same impact on economic growth and for some of them this impact is faster than for some others. The statistical analysis shows that political stability, absence of violence (stb) and the strengthening of law enforcement (law) affect the growth at the same time, but it is not evident for other indicators. Our analysis reveals challenges for those who want to solve the problem of the impact of institutions on the development of Macedonian economy. A better development policy will be brought when we recognize and understand these forces better. Nevertheless, our country has been undergoing political transitions, reforming their institutions, and moving onto more successful paths of economic development.*

***Key Words:** institutions, economic development, governance, reforms.*

### **1. Introduction**

To develop more satisfactory answers to questions, such as: why some countries are richer than others, or why some countries grow much faster than others, we need to look for

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potential *fundamental* causes, which may be underlying these proximate differences across countries.

The term 'new institutional economics' was established by Williamson (1975). NIE, which began to develop as a self-conscious movement in the 1970s – it traces its origins to Coase's analysis of the firm (Coase, 1937), Hayek's writings on knowledge (Hayek, 1937, 1945) and Chandler's history of industrial enterprise (Chandler, 1962), along with contributions by Simon (1947), Arrow (1963), Davis and North (1971), Williamson (1971, 1975, 1985), Alchian and Demsetz (1972), Macneil (1978), Holmström (1979) and others. Its best-known representatives are Coase, Williamson and North. For overviews and commentaries see Eggertsson (1990), Furubotn and Richter (1991), Coase (1992), Werin and Wijkander (1992), Pejovich (1995), Drobak and Nye (1997);

The institutional environment forms the framework in which human action takes place. 'Institutions reduce uncertainty by providing a structure to everyday life', writes North (1990, p. 3). 'In the jargon of the economist, institutions define and limit the set of choices of individuals. Institutional constraints include both what individuals are prohibited from doing and, sometimes, under what conditions some individuals are permitted to undertake certain activities. ... They are perfectly analogous to the rules of the game in a competitive team sport' (North, 1990, pp. 3-4).

As its older counterpart, the new institutional economics is interested in the social, economic and political institutions that govern everyday life. However, the new institutional economics eschews the holism of the older school. NIE follows strict methodological individualism, always couching its explanations in terms of the goals, plans and actions of individuals. Of course, NIE appreciates social phenomena like corporate culture, organizational memory, and so on. Still, NIE takes these as *explananda*, not the *explanans*. Of these sets of rules, the legal environment has received the most attention. Economists have long been interested in the economic effects of laws (for instance, the effects of a price ceiling on equilibrium price and quantity), but only in the last few decades has economics been applied to the design of legal rules and the legal system itself.

In this essay, we will discuss the fact that *institutions*, very broadly construed, are the fundamental cause of economic growth and development.. We will also argue that our state of knowledge does not yet enable us to make specific statements about how institutions can be improved (in order to promote further economic growth). Nevertheless, we can use this framework in several ways.

## 2. Legal, social, economic and political institutional environment

The institutional environment forms the framework in which human action takes place. 'Institutions reduce uncertainty by providing a structure to everyday life', writes North (1990, p. 3). 'In the jargon of the economist, institutions define and limit the set of choices of individuals. Institutional constraints include both what individuals are prohibited from doing and, sometimes, under what conditions some individuals are permitted to undertake certain activities. ... They are perfectly analogous to the rules of the game in a competitive team sport' (North, 1990, pp. 3-4). Unlike the rules in team sports, however, these guidelines often arise 'spontaneously', as by-products of individual choices, rather than deliberately through collective action (Hayek, 1967, 1973).

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Economists have long been interested in the economic effects of laws (for instance, the effects of a price ceiling on equilibrium price and quantity), but only in the last few decades has economics been applied to the design of legal rules and the legal system itself. Beginning with the early literature on the efficiency of the common law (Rubin, 1977; Priest, 1977), economics has been used to study not only the character and effects of law but the mechanisms by which legal rules change. NIE has been particularly interested in contract law (Llewellyn, 1931; Macneil, 1974, 1978; Langbein, 1987) and property law (Alchian, 1961; Demsetz, 1967; Furubotn and Pejovich, 1972, 1974; De Alessi, 1980; Barzel, 1989).

Norms and law are not necessarily substitutes, however. Law can shape the outcome of private bargaining by serving as a backup mechanism for resolving disputes that cannot be resolved privately. If the alternative to private dispute resolution is resolution in court, then the expected outcome at trial determines the parties' 'threat values' in bargaining. Bargaining typically takes place 'in the shadow of the law' (Cooter, Marks and Mnookin, 1982). Moreover, norms can help shape the law, if judges look to social norms as guidelines for legal decisions. The traditional account of the medieval law merchant illustrates this phenomenon. During the commercial revolution, merchants developed a system of private courts to resolve disputes among themselves. The rules of these courts became general merchant practice, enforced by the threat of ostracism. As the English legal system developed, judges began to hear commercial disputes once handled privately. In resolving these disputes, English common-law judges tended to enforce the merchant customs already in place. In this way the common law came to embody the principles that already existed, principles developed through private interaction among merchants. (On the law merchant see Trakman, 1983 and Benson, 1989). Today, many commercial disputes are resolved privately, through organizations such as the VISA Arbitration Committee (Solove, 1986; Cooter, 1994).

Economic development, then, is institutional development. 'The central issue of economic history and of economic development is to account for the evolution of political and economic institutions that create an economic environment that induces increasing productivity' (North, 1991, p. 98).

Political institutions have also received much attention in NIE. The rational-choice approach to politics, as outlined in public choice (Buchanan and Tullock, 1962; Mueller, 1979, 1989) and positive political theory (McKelvey, 1976; Riker, 1981; Enelow and Hinich, 1984), holds that political institutions can be explained in terms of purposeful human choice. This framework has been applied to constitutions, legislatures, executives, bureaucracies, courts and elections. Spatial models of voting, for example, show how different voting rules (such as, which party can set the agenda) affect the outcome. Among the better-known applications of the spatial model are studies of the committee structure in Congress, under which committees have agenda-setting power (Denzau and Mackay, 1983; Shepsle and Weingast, 1987). The rational-choice perspective is also used to explain the effects of political institutions on public policy, including macroeconomic policy, welfare policy, budgets, regulation and technology policy (see Weingast, 1996, for an overview).

### 3. Regulatory reform in Republic of Macedonia

#### 3.1. Institutional innovation

One of the most important institutional innovations is regulatory reform from the perspective of improving the business environment as a goal of economic policy, especially in crisis. In this respect the project identified the following specific objectives:

- Analyze the existing institutional arrangements and practices for regulatory reform;
- Develop recommendations for improving the regulatory reform and development action plan for implementation;
- Conduct assessment of the impact of the application of RIA specific laws that affect the business environment, both during their preparation and ongoing law enforcement;
- Strengthen the consultation process with the business community through the development of codes of Consulting and capacity building of stakeholders involved in it,

with the initiation of regulatory reform aimed at reducing the regulatory and administrative burden on businesses and citizens, as well as saving time and resources to effectively introduce and guillotine regulations, institutional mechanism for reviewing decisions of rules for their simplification.

Efficient implementation of the "Regulatory Guillotine" is aimed at improving the business climate and is part of the benchmarks for a date for starting negotiations for membership of the Republic of Macedonia to the European Union.

In the period 2006 to 2010, the Government implemented three phases guillotine of regulations, such as:

- First, simplification of the system of formalities;
- Second, reduction of customs burdens;
- Third, reducing the administrative burden.

The first phase of the regulatory guillotine measures included recommendations for changes, amendments or repeal of regulations (laws and regulations).

The second phase brought a package of measures that significantly contributed to the facilitation of the operation of firms, increased their competitiveness and accelerated cross-border flow of goods.

The third stage, in a transparent manner, met the requirements of the business community, in order to improve the business environment and remove the administrative barriers through further regulation of the legal framework, particularly legislation which is currently causing yield procedures or putting excessive demands for business entities.

Organizationally, each of the three phases of the guillotine took place in a different way, more formally defined structure in the first phase, up to one-iteration process with direct involvement of the business community in the third phase. Findings show that different approaches gave different effects in terms of representation, transparency and inclusion, but a common feature of all three phases of the guillotine is the incomplete implementation of the measures adopted by the competent ministries and authorities.

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### ***3.2. Regulatory impact assessment (RIA)***

Regulatory impact assessment - RIA is a systematic approach for evaluating the positive and negative effects of the proposed regulations and other measures. A key benefit from the introduction of policy-making process is a necessarily made analysis that serves as a support / justification of the proposed measure.

Based on the meetings with the Secretary of the State, as well as RIA teams, also expert analysis of some implemented regulatory impact assessments, the following challenges were identified, whose overcoming will lead to the improvement of the RIA process in order to properly implement and achieve desired effects:

- inadequate understanding of the decision-making at all levels of the importance of regulatory impact assessment in the process of making the same at all levels and its pro-forma application for the preparation of the text of the regulation;
- lack of access defined in the implementation of the RIA process in all ministries;
- inadequate stakeholder involvement in the process and transparency effects of their involvement;
- setting tight deadlines for making regulations which do not allow proper implementation of regulatory impact assessment.

As a result, there were discussed the current problems faced by RIA teams and possible recommendations to improve the RIA process. Some of the aforementioned recommendations are as follows:

- Each ministry should have a sector whose primary responsibility will be implementing the RIA process (giving an adequate support lawmaker in the assessment of the regulatory impact of proposed laws / amendments to the laws)
- Appropriate training for RIA teams which will include more practical examples of conducted assessments. They should also require training and tools that can be used in the identification of the expected costs for all parties concerned.

It can be concluded that the identified challenges of the existing approach to the implementation of regulatory impact assessment in the ministries is in direct contradiction with its purpose and objective. It also represents a significant review of the conduct of RIA, responsible for providing conditions in individual ministries, also at the central level, as well as providing sanctions for non-compliance.

## **4. Impact of good governance in economic growth**

Attempting to analyze the impact of good governance in economic growth, the first problem that arises is that of definition, i.e. what do we mean by 'good governance'. It is a broad concept and in many aspects very difficult to measure, particularly in quantitative figures. For that reason, in the political-economic literature there is no clear definition of this concept. However, the purpose of this article is not to analyze the problematic aspects related to indicators that are used to express the level of good governance of a country. From this point of view, this article adopts the definition of the World Bank regarding 'good is defined as '...the manner in which public officials and institutions acquire and exercise the authority to shape public policy and provide public goods and services.' (World Bank, 2007).

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To have a clearer definition, nowadays, we mostly refer to the Kaufmann and Kraay (2008) classification, which classifies governance indicators in two groups based on two main criteria: (a) what they measure (b) on what sources and opinions they are based. Further, the first group of indicators includes two categories: (a.1) indicators who value the law enforcement or specific rules; and (a.2) indicators who value the concrete results of governance, specific politics or the outputs of this policy. Regarding the second group of indicators, which indicates where they are based, (sources, opinions, etc.), governance indicators are classified in two other categories: (b.1) indicators which result from evaluation of different experts, and (b.2) indicators which reflect the results of a sample's observation from groups of individuals and firms. Although both methods have their weaknesses, this type of classification is important for the analysis and the results presented below.

In this framework, the analysis of good governance for Republic of Macedonia is based on six main indicators defined by the World Bank, elaborated for the period 1996 – 2012.

1. accountability of governance,
2. political stability and the lack of violence,
3. governance efficiency,
4. legal framework,
5. law enforcement,
6. corruption control.

The first indicator is the “Voice and Accountability”. The variation of the evaluation of this indicator shows an improvement for in the period 1996-2016 for 0.92 percentile rank and governance score 0.16 positive. Political stability and absence of violence 3,12 and 0,10; government effectiveness 27,83 and 0.45; regulatory quality 30,77 and 1,09; rule of law 1,13 and 0,00 and control of corruption 14,37 and 0.31 respectively.

**Table 1. Governance indicators in Republic of Macedonia**

Indicator	Country	Year	Number of Sources	Governance	?	?	?
				Score (-2.5 to +2.5)	Percentile Rank (0 to 100)	Standard Error	
<b>Voice and Accountability</b>	Macedonia, FYR	1996	5	-0.39	37.50	0.24	
		2016	11	-0.23	38.42	0.12	
<b>Political Stability and Absence of Violence/Terr..</b>	Macedonia, FYR	1996	3	-0.48	29.26	0.41	
		2016	7	-0.38	32.38	0.22	
<b>Government Effectiveness</b>	Macedonia, FYR	1996	2	-0.64	28.42	0.18	
		2016	7	0.09	56.25	0.22	
<b>Regulatory Quality</b>	Macedonia, FYR	1996	3	-0.35	37.50	0.32	
		2016	9	0.44	68.27	0.18	
<b>Rule of Law</b>	Macedonia, FYR	1996	5	-0.31	40.70	0.20	
		2016	11	-0.31	41.83	0.15	
<b>Control of Corruption</b>	Macedonia, FYR	1996	3	-0.61	32.26	0.28	
		2016	11	-0.31	46.63	0.15	

Source: Kaufmann D., A. Kraay and M. Mastruzzi (2010). *The Worldwide Governance Indicators: Methodology and Analytical Issues*.

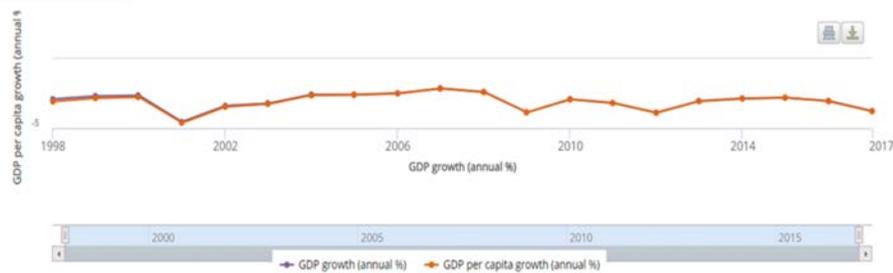
The Worldwide Governance Indicators are available at: [www.govindicators.org](http://www.govindicators.org)

Note: The Worldwide Governance Indicators (WGI) are a research dataset summarizing the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, international organizations, and private sector firms. The WGI do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources.

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The result shows an improvement for all periods of time (1996-2016), but of different degrees of intensity. The best results shows the indicator of 'government effectiveness' and the most bad results show the 'rule of law' and the 'control of corruption'.

Chart 1: Macedonia, FYR



Source: World development indicators

The presentation of governance indicators and growth rates note that while governance indicators have not been optimistic, the rates of economic growth (GDP) were satisfactory (at least until 2008). This indicates the fact that economic growth in Republic of Macedonia has not significantly been affected by the improvement of good governance, but normally by other factors. Among these, we may include: the primary reforms related to privatization, opening of these economies to international trade, changes in the structure of the economy, increasing demand in the unsaturated markets, etc.

## 5. Conclusions

Despite the relatively long duration of social and economic transformation, the improvement of governance indicators in the Republic of Macedonia during the analyzing period has been slow and below the average level of assessment. From six main indicators defined by the World Bank as indicators of good governance, two of these are still unsatisfactory ('rule of law' and 'control of corruption').

Not all aspects of good governance have the same impact on economic growth, and for some of them this impact is faster than for some others. The statistical analysis shows that political stability, absence of violence (*stb*) and the strengthening of law enforcement (*law*) affect the growth at the same time, but it is not evident for other indicators. Statistical analysis shows that some aspects of good governance can be better identified for their impact on economic growth, displaced in time. Governance accountability (*acc*) will affect economic growth in future periods, which means it has a slower future impact.

The Republic of Macedonia adopted several mechanisms that contribute to the fulfillment of the commitment to the regulatory reform. Fulfilling the commitment to better regulation began with introducing the concept of regulatory guillotine, and shortly after the introduction of mandatory regulatory impact assessment. Law-making process has been strengthened in the area of consultation with stakeholders, aimed at establishing web portal EN - single national electronic register of regulations.

Taking for granted the assessment of governance indicators, the analysis conducted in the paper shows that the impact of good governance in economic development of the Republic of Macedonia can be interpreted only in the long run – the impact is not clear from the overall evidence for the short period of 10 to 12 years.

For the Republic of Macedonia, the statistical analysis shows that there is no significant dependence of the improvement of governance indicators on the economic growth in the previous periods. Thus, the assumption is that the governance can be improved as a result of economic development in general, but for the analyzed period, 1996-2016, it is not precisely confirmed.

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### **TRANSFORMACIJA INSTITUCIJA KAO IZAZOV KA EKONOMSKOM RAZVOJU U REPUBLICI MAKEDONIJI**

***Rezime:** Ekonomske institucije društva zavise od prirode političkih institucija i raspodele političke moći u društvu. Nova institucionalna ekonomija je zainteresovana za društvene, ekonomske i političke institucije koje upravljaju svakodnevnim životom. U ovom radu pokazaćemo i da su institucije, koje su takođe vrlo široko tumačene, osnovni uzrok ekonomskog rasta i razvoja. Takođe, ukazaćemo da stanje našeg znanja još ne omogućava da damo konkretne tvrdnje o tome kako se institucije mogu poboljšati (kako bi se promovisao dalji ekonomski rast). Ipak, ovaj okvir možemo koristiti na nekoliko načina. Rešavanje problema razvoja podrazumeva reformu ovih institucija. Nažalost, nemaju svi aspekti dobrog upravljanja isti uticaj na ekonomski rast, a za neke od njih ovaj uticaj je brži od drugih. Statistička analiza pokazuje da politička stabilnost, odsustvo nasilja (stb) i jačanje zakona utiču na rast u istom periodu, ali to nije očigledno za druge indikatore. Naša analiza otkriva izazove za one koji bi želeli da reše problem uticaja institucija na razvoj makedonske ekonomije. Bolja razvojna politika će doći onda kada budemo prepoznali i bolje razumeli ove snage. Ipak, naša zemlja prolazi kroz političku tranziciju, reformiše svoje institucije i kreće se uspešnim putem ka ekonomskom razvoju.*

***Ključne reči:** institucije, ekonomski razvoj, upravljanje, reforme.*