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Exploring the Contribution of Institutions to Economic Development

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Abstract

Institutional structures and rules of behavior are a necessary condition for economic activity to flourish because incentive and price signal in a market economy cannot function properly without them. There are at least five main types of market-supporting institutions that are necessary, if not sufficient, conditions for rapid economic progress: property rights and legally binding contract; regulatory institution; social insurance institution; institutions for conflict management, and institutions to secure macroeconomic stability. Poor countries are often characterized by a lack of trust and the rule of law; weak institutions to mitigate risk and to manage social conflict; no clearly defined system of property rights: an inadequate regulatory apparatus to curb fraud and anti-competitive behavior; and a lack of clean government.

Key Wards: Institutions, Institutional Structures, Macroeconomic, Economic Development

Introduction

Growth and development cannot take place in an institutional vacuum. Economic maturity and the growth of markets require an institutional framework that allows transactions to take place in an orderly manner and in which agents know that the decisions they take and the contracts they make will protected by law, and enforced. Savers, investors, consumers, entrepreneurs, workers and risk-takers of all kinds need a framework of rules if rational, optimizing decisions are to be made. They also need some guarantee of economic stability and certainty, which can be provided only by good governance and sound economic policy-making.

Without property rights and the rule of law, the incentive to invest, on which economic growth ultimately depends, is very weak.

It is not easy to bring about institutional change. There is a collective action problem which limits potential gainers from bringing about change in opposition to vested interests, including the free-rider problem and the bargaining problem of distributing the gains.

It is not easy to measure institutional development and its impact on economic performance because institutional development itself is endogenous to economic development. An exogenous measure of institutions is required.

The Role of Institutions

The inability of societies to develop effective low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary under development in the Third World', because the absence of secure property and contractual rights discourage investment and specialization. A similar broad definition is humanly devised behavioral rules that govern and shape the interaction of human beings, in part by helping them to form expectations of what other people do'. At a more formal, precise Level, institutions can be defined in terms of the extent of property rights' protection; the degree to which laws and regulations are fairly enforced; the ability of the government to protect the individual against economic shocks and to provide social protection, and the extent of political corruption.

When economists undertake empirical work on the relation between institutional structure and economic performance it is of course necessary to have quantitative measures of the important institutions being discussed and evaluated. Lumping all institutions together in a single index of 'institutional quality' would obscure the different channels through which institutions work.

The reason why institutional structures and rules of behavior are a necessary condition for Economic activity to flourish is that incentives and price signals, so vital to a market economy, cannot function properly without them. 'Markets require institutions because they are not self-creating, self-regulating, self-stabilizing, or self-legitimizing'. Which institutions are important and which are not will differ across space and time according to the history of a country, its geography, stage of development and its political aspirations, that is, what sort of society its people want. In small rural communities where everyone knows each other, the scope for cheating, fraud and not honoring contracts is limited. Transaction costs associated with the costs of information, negotiation, monitoring, coordination and enforcement of contracts are low, and communities survive by adhering to norms of behavior; but economic development is limited through a lack of specialization. In contrast, in large, modern, industrial societies, where transactions are impersonal, there is widespread scope for opportunistic behavior. Transactions (therefore production) costs may be very high without institutional structures there is a consensus among development economists that at least five main types of market-supporting institutions are necessary, if not sufficient, conditions for rapid economic progress.

Property rights and legally binding contracts: market-creating institutions regulatory institutions: market-regulating institutions

Institutions for macroeconomic stability: market-stabilizing institutions.

Social insurance institution: market-legitimizing institutions.

Institutions of conflict management: market-legitimizing institutions.

Property Rights and Legally Binding Contracts

These are important because agents lack the incentive to invest and innovate if they do not have control over the return on the assets they accumulate. Intellectual property rights are particularly important to encourage invention. Control is more important than ownership. Formal property rights do not mean very much if there are not control rights; but control rights can spur entrepreneurial activity without clearly defined property rights.

Regulatory Institutions

Markets fail if there is fraud or anti-competitive behavior. Regulatory institutions are needed markets are to function properly. When markets are liberalized, a regulatory framework is also required to avoid the consequences of risky behavior, such as financial crises if the banking system is not properly regulated Institutions to compensate for capital market imperfections and coordination failures must also be an integral part of a 'regulatory' framework for promoting innovation and growth.

Institutions for Macroeconomic Stability

Monetary and fiscal policy institutions are necessary to provide an enabling environment in which private investment can flourish market. A good example of this is the way the state intervened to promote industrial development. All successful economies have an array of regulatory institutions that oversee different markets such as the product market, financial markets and the labour market. Developing countries may need more regulatory institutions because market failures are more pervasive than in developed countries economies are not self-regulating, and macroeconomic instability creates risk and uncertainty. The minimization of risk is vital if entrepreneurs are to take informed, long-term investment decisions. Financial markets are inherently unstable, which can have damaging real effects, and they need careful supervision. A central bank, a responsible banking system and fiscal prudence are all important ingredients of macroeconomic stability.

Social Insurance Institution

These are necessary if individuals are to accept change. In rural peasant societies on the margins of subsistence, change may spell disaster, but progress (particularly in agriculture) requires willingness to take risk. Insurance against unemployment, crop failures and price fluctuations for agricultural commodities are all important if traditional agriculture is to be transformed. Economic reforms of any type, particularly in the process of liberalizing markets, will meet resistance if not enough attention is paid to creating social security institutions to protect the vulnerable. Social stability and cohesion within a market economy in the process of structural change requires social insurance and safety nets.

Institutions of Conflict Management

In India there is a deep ethnic tribal and religious division. Social conflict damages economies because it diverts resources from directly productive activities, and creates uncertainty, which deters investment. To minimize conflict requires al full range a full range of institution-the rule of law, a fair legal system, a political voice for minority groups- which make it clear that the potential winners of social conflict will not benefit and potential losers will properly safeguarded.

The Role of Democracy

Most empirical work on the role of institutions in economic development has been conducted political instability and on the impact of political structures and the role of democracy. The challenge for any government, whatever its structure, is to provide leadership in resolving collective action problem which means a commitment to formulating and implementing development policies in the interest of all the people, to prevent groups going their own separate ways. Democracy can make this more difficult because politicians can succumb to vested interest groups and take short-term decisions.

On the other hand, dictatorships may have no interest in maximizing total output, and may allocate resources very inefficiently. Democracy makes life difficult for corrupt elites. In the discussion of democracy and growth it is also important to distinguish between democracy defined as free, multi-party elections on the one hand and civil and economic liberties on the other.

Conclusions

Democracies deliver more predictable long-run growth rates

Democracies produce greater short-term stability

Democracies handle adverse shocks much better

Democracies promote a fairer distribution of income

Democracies produce better outcomes in these ways because they produce superior institutions better suited to local conditions.

Several different measures of institutions have been used in empirical work, such as a measure of property rights and risk of expropriation: an aggregate governance index: an index of democracy, political rights and civil liberties: an index of political instability: an index of corruption: an index of economic freedom, and an index of social division institution versus geography, most of the empirical work on the role of institutions in economic development has been conducted on the influence of democracy and political stability on economic performance.

Democracies deliver more predictable long- run growth rates, produce greater short-term stability, handle adverse shocks better and promote a fairer distribution of income tan non- democratic states.

However, that the lessons of history are that many of the institutions that are agued to be important for developing countries today emerged after, not before, economic development was taking place- for example, democracy and property rights, contract law, company law, bankruptcy law and tax law. Message is that institutions should be allowed to evolve naturally, internally, and not be imposed from outside.

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