

INSTITUTIONAL QUALITY: CRITERIA, DETERMINANTS AND BENEFITS²

Abstract

Understanding human behavior and institutions mutuality, the economic and political implications of this interdependence, increased the importance of institutions and institutional analysis in economic theory. The institutional quality of the economic and political system is paramount to the welfare of nations. In the absence of appropriate institutions, individuals do not always have the ability to recognize what is socially beneficial. A central question in social sciences and history is, therefore, why societies evolve along different paths of institutional development and prosperity and why others do not adopt institutions that generate economic and social benefits.

Keywords: economic development, institutions, institutional quality

1. Introduction

The emphasis on the importance of institutions in economic prosperity goes back at least to Adam Smith (1776), but also the recent work of Olson (1982), Scully (1988), North (1990), Barro (1996), Barro and Sala-i-Martin (1995), Landes (1998), Hall and Jones (1999), and Acemoglu, Johnson, and Robinson (2001, 2002, 2006).

North has defined the institutions as “rules of the game” in a society, the formal and informal constraints on human interaction. In his opinion, “good” institutions are viewed as those who establish an incentive structure that reduces uncertainty and promotes efficiency - hence contributing to stronger economic performance (North, 1991).

Giving more specific shape to this broad concept of institutions, would be particular organizational entities, procedural devices, and regulatory frameworks. Such institutions affect performance primarily by fostering better policy choices. Examples include commitment devices such as central bank independence and balanced budget amendments; the existence and design of international trade agreements; and regulations governing the functioning of labor, product, and financial markets. (IMF, Growth and Institutions, 2003, p. 97).

Rodrik (1999, 2002) and Frankel (2002) (cited in IMF, Growth and Institutions, 2003), suggest that a full market based economy need institutions that will:

- Protect property rights, uphold the rule of law, and rein in corruption;
- Provide appropriate regulation of product, factor, and financial markets to counteract the sources or consequences of market failure;
- Support macroeconomic stabilization, including protecting the value of money and ensuring a sustainable fiscal stance; and
- Promote social cohesion and stability, including by guarding against extremes of poverty, reducing civil conflict, and muting the adverse consequences of economic dislocation and change.

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Good institutions accelerate business development and facilitate social interactions, thus giving the advantages in the division of labor and specialization of knowledge, a major source of prosperity.

2. Criteria for institutional quality:

Any institutional analysis is based on certain fundamental properties of the institutions.

The first evaluation criterion of the institutional quality is *universality*. Universality implies general, open, abstract social rules, or as Hayek said rules must be “applicable to an unknown and indeterminable number of persons and circumstances” (Hayek, 1973, p. 50).

A clear example of a universal rule is that “no one is above the law”. There are countless examples where this principle is violated: the granting of benefits and subsidies for certain sectors, industries and companies, promulgation “on the run” of emergency laws and ordinances, frequent changes in taxation, etc. The rules that are made for certain purposes, create economic and social tensions, and do not fulfill their regulatory and coordination role.

The second criterion stems from a major function of institutions, *the reduction of transaction costs, and uncertainty* in human interactions, thus providing a high level of security and stability in the economic and social relations. In this regard, institutions should be characterized by *credibility and stability, be transparent and easily knowable*.

Another criterion is adaptability or the institutions ability to anticipate changes and offer socio-economic incentives for agents, in order to facilitate adaptation to the new socio-economic conditions.

3. Determinants of institutional quality

There are numerous studies that associate institutional quality with growth, focused mainly on cross-country analysis through a series of indicators like the aggregate indicator of governance (including the degree of corruption, political rights, public sector efficiency and regulatory burden on business), legal protection of property rights and upholding the rule of law in this area, institutional constraints on political leaders. (Knack and Keefer 1995, Mauro 1995, Hall and Jones, 1999, Rodrik, 1999, 2003, Acemoglu et al (2000). Another series of studies focus on the historical evolution of institutions and way these have influenced economic development. (Engerman and Sokoloff (2000), North (1993, 1994), Jones (1981), Greif (1989, 2006)).

In these papers some of the authors also examine the determinants of institutional quality; some of these determinants are outside the economic sphere (geographic location, colonial origins, the tradition of the legal system, religion, ethno-linguistic fragmentation or endowment with natural resources), others belong to the economic politics area (distribution of income, openness, education and state power).

In their attempt to explain the development of institutions several authors (Rodrik, Subramanian, Trebbi (2002), Diamond (1997), Sachs and Warner (1995, 2001), and Gallup, Sachs, and Mellinger (1998), Acemoglu, Johnson, and Robinson (2001, 2002) and Easterly and Levine (2003)) attach the utmost *importance to geographical location and historical influences*. This vast body of literature emphasizes the influence that location, climate and natural resource endowment have on economic performance. For example, access to a seaport or distance from major trading centers, involve higher transaction costs and significant constraints on international trade and thus on prosperity.

A major contribution in this area is that of Acemoglu, Johnson, and Robinson (2001, 2002), that point the impact of various forms of European colonization between the seventeenth and nineteenth centuries, on the institutions of developing countries at that time.

They distinguish between settler colonies (USA, New Zealand, Australia, Canada) which allowed a better European migration and the formation of "good" institutions (protection of property rights, rule of law) enabling growth and investment and extracting colonies (mainly countries in Sub-Saharan Africa and Latin America) where the European migration was restricted due to climate, diseases and a naturally more hostile environment, here institutions were designed to ensure control of colonies and natural resources extraction. These authors argue that colonial origins had lasting effects in the formation and quality of institutions.

The impact of *different legal systems and their origin* on institutional development also enjoys considerable attention in the literature (La Porta et al (2000), Straub (2000), and Chong and Zanforlin (2000), Demirguc-Kunt et al (2001), Djankov, 2000). These authors argue that countries with French and socialist legal heritage have a poorer institutional arrangement than those with other legal traditions (British, Scandinavian or German).

In their opinion countries with French and socialist legal systems are characterized by a greater role of the state in the organization of economy and society, a greater burden of regulation and thus less flexible legal and economic institutions. On the other hand, the common law system is considered more flexible and dynamic, based on a greater recognition of economic freedom, limiting the role of the state in the economy and allowing the formation and development of better institutions.

Is also worth to mention the association that some researchers have made between *ethnic fragmentation, religion and institutional quality*. Ethno-linguistic diversity negatively affects institutional development; greater heterogeneity creates tensions between social groups, reducing cooperation, and creating a mismatch between formal and informal institutions. Easterly and Levine (1997), Alesina et al. (2003), Easterly et al. (2006) provide the evidence to support this hypothesis. Regarding religion and Landes (1998) supports Weber and points out that Catholic and Muslim countries, starting with the fifteenth century or even earlier, have perpetuated a culture of intolerance and xenophobia that led to obstacles in their development.

If geographical and historical factors would be the only determinants of institutional development and economic performance, it would be hard to reconcile the economic performance and institutional development of North and South Korea, or Vietnam or Singapore, for example. There is a vast literature demonstrating the influence of trade openness, strong competition, education and income distribution on economic development and institutions.

The level of economic development determines the availability of resources for building good quality institutions that reduce social costs. The positive relationship between the two variables was confirmed by previous studies (Chong and Zanforlinm 2000, Islam and Montenegro, 2002, or Rigobon and Rodrik, 2004, among others).

Income distribution - high inequality affects the predictability and legitimacy of institutions by creating differences between different social groups, leading to social conflicts, political instability and insecurity, reducing susceptibility to social cooperation and perpetuating rent-seeking activities and corruption. It also creates the possibility of "state capture" meaning the seizure of institutions by certain groups of power for serving their purposes. (Alesina and Rodrik, 1993, Alesina and Perotti, 1996; or Easterly, 2001)

Increased international openness encourages institutional quality by creating a more dynamic economy and therefore a demand for better institutions, discourages corruption and rent-seeking activities through greater competition and facilitates the process of imitation and

learning from the best practices found in other countries. (Rigobon and Rodrik (2004), Rodrik et al. (2002)).

Education is another determinant of institutional quality. In general, an educated population demands more transparent and dynamic institutions or create prerequisites for building them. The relationship between two variables was rarely considered in empirical research, an exception being Alesina and Perotti (1996), who confirm the positive impact of education on institutional quality.

The power of the state - a strong state is able to introduce and maintain an appropriate institutional framework required for business development and social cooperation. However the state powers should be limited and controlled by specific institutions of democracy, in order not to serve bureaucratic elites and interest groups.

An open Society - Karl Popper's dictum is another important determinant of quality of institutions. As Albert Hirschman (1970) shows there are three ways of resolving social conflicts: exit, voice and loyalty. For example citizens can protest, migrate or remain loyal to an oppressive political regime. Exit and voice restrict political behavior by voting and the freedom the press. In economic terms exit is associated with Adam Smith's invisible hand, the buyers and sellers are free to act through the market, constantly forming and destroying relationships.

The benefits of effective institutions

As already demonstrated, institutions *reduce uncertainty and transaction costs* so that people can interact with confidence and ease. Appropriate institutions reduce transaction costs, a crucial element for modern societies, which inevitably rely on a complex division of labor and continuous innovation.

Good institutions also provide *non-material benefits*, they create a sense of *security and facilitate the social contact*. (Kasper, Streit 1998) After all, people are not isolated individuals. They strive and work best in the company of others.

Effective rules *restrict the use of power and protect individual freedom*. Good institutions exclude undue coercion and provide limits on the exercise of individual freedom without infringing the freedom of others. Freedom is essential for motivation and creativity of an entrepreneur. Freedom derives necessarily from the rules of law, so the theory of freedom reveals, necessarily and systematically, the actual content of the law and legislation. Therefore, freedom is the rule of law. (Marinescu et al, 2011).

Institutions help to *maintain social harmony* (Kasper, Streit 1998). If different people with different aspirations pursue their own interests conflict situations are inevitable. Even with the best institutions, conflicts cannot be entirely avoided, but institutions offer solutions to these conflicts. Whether these are legal proceedings, material compensations or spontaneous informal sanctions, they are needed to keep peace and social harmony.

4. Concluding remarks

Theory suggests that many factors are responsible for institutional quality. In this paper we address the issue by reviewing the ample literature that link the institutional quality and economic development.

In this paper, we have singled out the three characteristics that, in our opinion, define institutional quality: universality, credibility and predictability, and adaptability. Subsequently, we investigated the determinants of institutional quality and the benefits of efficient institutions.

The determinants analyzed were separated into two groups, those referred to as the historical features of countries (geographic location, colonial origin, legal tradition, culture,

religion etc) that can be hardly influenced by government actions, and those related to the economic, social and political options (level of development, income distribution, education, trade openness, the power of the state).

The analysis suggests that at least some of the determinants of institutional quality are not out of the government reach; therefore there is room for better policies aimed at improving the quality of institutions.

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