Institutional factors of economic growth

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Introduction

During the previous period, differences in economic development were predominantly based on neoclassical optics, based on different factors (land, labor, capital), and unequal pro-active effects of individual factors (technical progress, innovation, education). Currently, there are several shortcomings of these economic growth models. Institutional economists point out that the neoclassical approach is not an appropriate tool for analyzing and shaping a policy that would stimulate long-term development as it deals with the functioning of markets, thus not with the way markets evolve.

The predominance of positive economy methodology and the emphasis on using the mathematical apparatus to investigate the economic reality (as well as the construction of models and their simplicity) lead to predictive models not being able to cover all the problems of contemporary development, and above all to encompass their complexity. The modeling of the models concentrates on the analysis of several variables which are considered crucial for the elimination of bottlenecks in the development of the economy as well as for the promotion of economic growth which can lead to a reassessment of the pro-factor influence of the investigated factor. When exploring economic development it focuses on technological development and recently on investment in human capital, but ignores and underestimates the structure of incentives, the incentive structure embedded in the institutions. An example is the influence of capital on economic growth which has become the decisive factor of Solow’s model (Solow, 1957). Solow’s verification, however, showed that more than 85% of the output per employee was not due to increase in capital investment but due to other factors that shifted production upward and attributed to technological change (Wight 2011). In its original form, neoclassical theory provides a mathematical model of a static world without conflicts. The neoclassical analysis of economic performance over time is therefore based on two erroneous assumptions: first, that it does not matter on the institutions, and secondly, that time does not play a role (North, 1994).
It follows from the above mentioned that the definition of an institution by North is understood to be the rules of the game in society that allow the not only economic, but also political and social interests. This approach is generally accepted by the scientific community but there is still a lot of variability in terms of how to correctly define the individual components of the institutional environment and its internal structure. The fact which institutions are important and which not, differs depending on the development of the country, its political ambitions, the social attitudes of the population. There is no set of institutions that will suit all countries but there is a consensus that at least five main assumptions of institutional structures which are needed are aimed at: protecting property rights and law enforcement, securing a regulatory market framework, securing macroeconomic stability, quality of social insurance, and to reduce costs. In the frame of this, those are institutions which either create conditions for the functioning of the market and ensure its stability or solve its failure. If they are not developed, the development of the country is not sufficient (Rodríg, 2007).

As we have mentioned in the terms of degree of formality the institutions consist of formal and informal institutions. While formal institutions represent everything that is codified, informal institutions arise spontaneously in the course of historical development. The notion that formal institutions have a greater impact on the institutional quality of a company because of its enforcement may not always be correct. Informal institutions as part of the institutional framework are equally important to the institutions as formal ones, since the success of formal rules depends on the success of their informal acceptance (Tridico, 2011). This means that the sequential nature of institutional evolution reflects the interdependence of formal and informal institutions; the institutional quality depends not only on the quality of formal institutions but is also largely conditional on their implementation, the enforceability of their performance, e.g. its informal application. Informal institutions bear in themselves a link to long-term cultural development, the evolution of traditions, customs, predominant ethics and morals of society.

Formal institutions must therefore respect the need for gradual change of informal institutions, since informal institutions are unable to adapt immediately and in a short period of time to changes in formal rules, they have encoded regional specificities, different absorption capacities of formal institutions. Furthermore, incorrectly set formal rules can severely distort the informal behavior of the company in the sense of a decline in social responsibility, morale, tolerance of the growth of an unseen economy, etc. Institutional complementarity (Amable, 2003) should ensure the coherence of the economic and social system, e.g., changes in informal institutions should not lag behind the pace of formal change. This means that if the formation of formal institutions does not take into account the informal institutions aspect, it may not bring positive effects in relation to economic development.

As a result, the notion that the mechanical transfer of formal rules from a successful economy to a lesser-performing economy automatically translates into growth
in performance shows that it is incorrect. An example of the negative impact of the non-interconnection of formal and informal institutions can be the transformation of Central and Eastern European countries where the replacement of original formal institutions by new ones in the relatively short time did not produce the expected effect but manifested itself in institutional failure in the form of increased corruption, rent-seeking, etc. For the main cause of such deformed behavior, Stiglitz (1999) considers institutional “blitzkrieg”, e.g. underestimating the importance of gradually changing behavioral rules. Williamson (2000) describes the interconnection of formal and informal institutions with the concept of anchoring respectively integration, while pointing to the fact that the more informal institutions have, they are more deeply integrated into society and need more time to change. This means that lower-level institutions (customs, traditions, mentality, religion, etc.) respond to societal changes much more slowly and longer than higher-level institutions that set formal rules, affect the functioning of public administration and the legislative framework. However, each higher level carries the former institutional equipment.

Classification of institutions by category defines legal, political, economic, and social institutions. Legal institutions are the most common types, as they penetrate through government all social interactions regardless of their level (state, public administration, private sector). They cover a wide range of institutional environments, protection of property relations, quality of the legislative framework, law enforcement. Political institutions define the electoral system, the activities of political parties; determine the competencies and scope of individual state actors. Economic institutions show a significant degree of overlap with legal institutions as they provide conditions and rules for market and state functioning; they formulate regulatory frameworks, quality of business environment, and so on. Social institutions generally identify themselves with informal institutions - reflecting forms of population interaction, social capital and social networks in society.

Assessing the quality of institutions and assessing of their impact on the economy

A large number of indicators are used to measure the quality of institutions but there is no generally accepted system and a uniform methodology for assessing its impact on the economy. Due to the interconnectedness of institutions it is difficult to assess the impact of each particular institution on overall economic performance. Therefore, the most common methodology for measuring the quality of the institutional environment is based on an assessment of the defined characteristics of each institution. Based on the empirical data analysis, economists propose the characteristics which have an impact on economic growth or the level of retirement such as state size, state of the legal system, contract protection, bureaucratic culture, corruption rate, protection of property rights. Since many institutions are the result of political processes, it must be clear that they are closely linked to the economic policies of the states. It is important to note that measuring the quality of the institutional environment is very challenging, thus there are only a few organizations in the world that are involved in assessing the quality of institutions. The quality of institutions is measured by:

- World bank (www.worldbank.org);
- World economic forum (http://www.weforum.org);
- Fraser Institute (www.fraserinstitute.org);
- The Heritage Foundation, created by Heritage Foundation and Wall Street Journal (www.heritage.org/index);
- Freedom House (www.freedomhouse.org);
- Legatum Institute (www.li.com);
- Transparency International (www.transparency-international.org);
- Word Justice Project (WJP) (www.worldjusticeproject.org);
- Property Rights Alliance (www.propertyrightssalliance.org) and other institutions.

Their common denominator is effort to cover the greatest possible amount of such institutional characteristics which frame the growth performance of the economies and at the same time allow the assessment of the dynamics of institutional changes and the position of the country in the international comparison. Institutional quality indicators are generally constructed as composite indicators that combine the information of a number of empirical knowledge based on the so-called hard and soft data which can bring some degree of subjectivism to values of their results. Here is a brief introduction to selected organizations dealing with assessing the quality of institutions.

World Bank

Since 1996, the World Bank has undergone institutional analysis within the framework of the well-known “Governance Matters” project (until 2002 the institutional quality assessment was carried out at two-yearly intervals, from 2002 yearly onwards). The World Bank assesses governance based on six aggregated sub-indices (democracy, political stability and the absence of violence, government efficiency, regulatory quality, law enforcement, and corruption control), resulting in a composite index of quality of governance as their arithmetic mean. Within democracy the quality of political, civil and human rights, the scope of freedom of expression, assembly, electoral rights are assessed. The indicator of political stability and the absence of violence is the result of a survey of the probability of destabilizing the country by unconstitutional or possibly violent means and the impact of such changes on the development of the country. In the framework of the government’s effectiveness assessment, the quality of public services, the competence of bureaucracy, the degree of its political independence and the quality of its economic policy are monitored. The sub-index of regulatory quality reflects the scope of the regulatory burden and assesses the government’s ability to formulate and implement a policy that supports the private sector. The legal order in an aggregated way reflects confidence in the social legal
system and its acceptance by the public. It evaluates the extent of crime, the efficiency of courts and police, the risk of violence, the protection of property rights, and the enforcement of law. Corruption control is an indicator that monitors the perception of the use of public power, assesses the extent to which public power is used to gain private benefit.

World economic forum (WEF)
Since 2005, the Global Economic Forum has provided its National Competitiveness Reports (GCR) with assessments of the quality of national economy institutions. The reports are compiled according to the WEF methodology, based on the Global Competitiveness Index (GCI). The Global Competitiveness Index consists of three sub-indices that express the main competitiveness factors. The sub-index values are presented with fixed 12 synthetic pillars, the first of which expresses the quality of the institutions as one of the main factors of the competitiveness of the economy. Under the first pillar of the Institution, a total of 21 indicators are assessed: 1.01. Property rights, 1.02 - Intellectual property protection, 1.03 - Diversion of public funds, 1.04 - Public trust in politicians, 1.05 - Irregular payments and bribes, 1.06 - Judicial independence, 1.07 - Favoritism in decisions of government officials, 1.08 - Efficiency of government spending, 1.09 - Burden of government regulation, 1.10 - Efficiency of legal framework in settling disputes, 1.11 - Efficiency of legal framework in challenging regulations, 1.12 - Transparency of government policymaking, 1.13 - Business costs of terrorism, 1.14 - Business costs of crime and violence, 1.15 - Organized crime, 1.16 - Reliability of police services, 1.17 - Ethical behavior of firms, 1.18 - Strength of auditing and reporting standards, 1.19 - Efficacy of corporate boards, 1.20 - Protection of minority shareholders’ interests, 1.21 - Strength of investor protection.

Fraser Institute
In the Fraser Institute project the emphasis is placed on capturing the widest possible range of factors which underpin institutional quality. It focuses on analyzing world development indicators of more than 120 countries in 5 spheres: the size of the state, the legal system and property rights, access to finance, free trade, credit regulation, labor relations and business. Since 1986, the quality of institutions has been expressed by a specially designed Fraser Economic Freedom of the World (EFW) index. The EFW index, in addition to assessing the conditions for securing the freedom of choice of the individual, assesses in particular the quality of the competitive environment, the quality of legislation in terms of law enforcement and the protection of property rights, and the quality of the regulatory framework. The positive fact is that the EFW also assesses macroeconomic stability that frames the freedom of decision-making of individual subjects. In summary, the Fraser Institute evaluates the quality of economic and political approaches in the socio-economic, legal and cultural spheres and their impact on economic growth and development. The information base is extensive: state financial statistics, international financial statistics of the World Bank and the IMF, household surveys.

Heritage Foundation
The Heritage Foundation project has an identical mission, e.g. to examine the impact of economic freedom and the quality of institutions on the development of the country. Since 1995, the assessment has also been expressed by the Economic Freedom Index (Index of Economic Freedom). The status of economic freedom is assessed in 186 countries around the world based on 10 indicators at four levels:
- the rule of law in the field of property rights protection, law enforcement and non-corrupting environment,
- the quality of government, particularly in terms of fiscal responsibility,
- the regulation and creation of a quality business environment, and
- the level of openness of markets (free trade, freedom of investment, financial freedom).

The Index of Economic Freedom values are based on analysis and expert assessments of data from interviews and press reports published in the media.

Freedom House
The project provides a rating based on the Freedom House Index (FHI). It is based on the analysis of indicators of country development in two areas:
- political rights (electoral systems, political pluralism, functioning of the government),
- freedom of citizens (freedom of speech and belief, freedom of association and right to association, rule of law and human rights, economic rights, including the strengthening of property rights and recognition of equal opportunities, freedom from dependence on employers, trade union leaders, officials, etc.).

In order to designate the quality of institutions, economists use generally accepted definitions to designate institutions as "good" and "bad". "Good" refers to those institutions which help to reduce transaction costs, increase public confidence and support long-term investment in the economy. "Bad" institutions are those which increase the cost of doing business, reduce incentives for honest behavior, and hinder the development of competition and investment. The main criteria for separating "bad" institutions from "good" institutions are their negative impact on entrepreneurial activity and economic growth.

Economic literature identifies the following causes of "bad" institutions: authoritarian political regimes; strong social inequality; elite and bureaucracy; institutional weakness of the state. The political elite of such regimes creates the "extractive institutions" instead of "inclusive institutions" which are characteristic for democratic countries (Acemoglu D., Robinson J., 2012). Such institutions allow the political elite to redistribute wealth in their favor and limit the impact of the broad mass of the population on the current policy, and the "extractive institutions" create private benefits for elites by reducing the well-being of the whole society. As a rule, in such an extraction state, the elite and the working population are separated by cultural barriers which prevent them from mixing. The elite increase its income either at the expense of a working population or because of a valuable natural resource commonly used by violence, confiscation of assets.
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and political power. "Inclusive institutions", on the contrary, allow the distribution of political power between different organizations and individuals more evenly, make the elite more responsible for society, and create incentives for entrepreneurship and business development. An even distribution of political power leads to sustainable economic growth, as large groups of people have the opportunity to influence political decisions which have a positive impact on their well-being. In an inclusive state, the elite is not separate from society, it includes the best, ready to work for everyone else. The countries which have moved earlier on to the path of the evolution from first to second type of institutions are now not only rich, but also have a more equal distribution of income and wealth among their citizens (Acemoglu D., Robinson J., 2012).

The relationship between the quality of institutions and the economy

Although the institutional environment is only one of the factors of economic performance growth, both the theoretical approaches and the conclusions of empirical works confirm that improving institutional quality creates better conditions for economic growth and development (Acemoglu et al., 2004) and higher institutional quality is accompanied by higher economic performance as well. Countries which have a good institutional framework and their economic system have been linked to institutional quality for long, are now achieving a higher level of economic performance. However, although economic performance often correlates with high-quality institutions, causal links are not one-way, which means that the quality of the institutions can also be the result of economic growth and not necessarily always just its cause. A higher economic level can change the moral values of society; make it more free, open, reliable, and responsible, which contribute to increasing institutional quality. This fact is confirmed by, for example, the development of countries with a high degree of institutional quality and the countries with low degree of institutional quality (Table 1).

| Table 1: Economic performance and institutional quality of selected countries (year 2017) |
|---------------------------------|-----------------|------------------|-----------------|
| Economy                        | GDP per capita US | Institutions score (1-7) | Economy                        | GDP per capita US | Institutions score (1-7) |
| Luxembourg                     | 10586.323        | 5.7                | Portugal                      | 21159.00          | 4.4                |
| Switzerland                    | 8063.738         | 5.9                | Czech Rep.                    | 20401.58          | 4.2                |
| Norway                         | 7539.466         | 5.8                | Greece                        | 18637.27          | 3.7                |
| Iceland                        | 7024.273         | 5.5                | Slovak Rep.                   | 17655.05          | 3.5                |
| Ireland                        | 6871.082         | 5.3                | Lithuania                     | 16730.63          | 4.1                |
| United States                  | 5979.020         | 5.3                | Latvia                        | 15550.44          | 3.6                |
| Denmark                        | 5663.600         | 5.5                | Hungary                       | 14209.44          | 3.5                |
| Australia                      | 5569.973         | 5.4                | Poland                        | 13381.23          | 3.8                |
| Sweden                         | 5292.13          | 5.6                | Croatia                       | 13271.38          | 3.5                |
| Netherlands                    | 4855.35          | 5.8                | Russia                        | 10955.79          | 3.7                |
| Austria                        | 4737.44          | 5.2                | China                         | 8643.11           | 4.4                |
| Finland                        | 4397.24          | 6.2                | Bulgaria                      | 7368.50           | 3.5                |
| Canada                         | 4509.461         | 5.4                | Georgia                       | 4085.83           | 4.2                |
| Germany                        | 4767.922         | 5.3                | Armenia                       | 3657.18           | 4.1                |
| Belgium                        | 4348.849         | 5.0                | Moldavia                      | 2694.47           | 3.2                |
| France                         | 3993.269         | 4.8                | Ukraine                       | 2656.01           | 3.2                |
| Japan                          | 3844.58          | 5.4                | Kyrgyz Rep.                   | 1207.78           | 3.4                |
| Italy                          | 3199.698         | 3.5                | Chad                          | 810.16            | 2.6                |
| Spain                          | 2835.881         | 4.1                | Benin                         | 770.80            | 3.5                |
| Slovenia                       | 2365.441         | 4.1                | Burundi                       | 312.46            | 3.2                |

Table 1 shows that those economies which have been deeper integrated into the EU, despite many persistent problems in the quality of institutions, are capable of achieving greater socio-economic development. This state is conditioned by the fact that the EU is constantly pushing for the improvement of the institutional environment which gradually changes the behavior of society and reduces the tolerance for negative social phenomena.

Finally, it should be recalled that the successful economic policies of the government can usually link formal and informal institutions to the motivation of the people to achieve success. The mentality of the nation, its customs, traditions and cultural maturity, standards of behavior, morality and ethics are reflected in the legislation of the country and the quality of formal institutions. If formal institutions and economic policies operate in line with the informal environment, the country is more likely to increase its economic level. The quality of institutions narrows the scope for trade-related risks, in general, there is a greater interest in investing in countries which protect property rights, have a high-quality legislative framework, high law enforcement, low bureaucracy, low corruption rates, regulatory burdens, criminality, and are capable of providing high-level public services.

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References


