The Importance of Institutions to Economic Development

https://www.e-ir.info/2012/09/19/the-importance-of-institutions-to-economic-development/

LUCA FERRINI, SEP 19 2012

Cross-country empirical analyses, in combination with micro-level studies, provide strong support for the overwhelming importance of institutions in predicting the level of development in countries around the world (Hall and Jones, 1999; Acemoglu, Johnson and Robinson, 2001). Protection of property rights, effective law enforcement, and efficient bureaucracies, together with a broad range of norms and civic mores, are found to be strongly correlated to better economic performance over time. This essay aims to explain why institutions are important to economic development and to provide evidence for the arguments made. It argues that institutions support economic development through four broad channels: determining the costs of economic transactions, determining the degree of appropriability of return to investment, determining the level for oppression and expropriation, and determining the degree to which the environment is conducive to cooperation and increased social capital. Evidence is derived from the literature, from comparison of countries, and from examples at the micro level.

In the words of North (1990, p. 4): "Institutions are the rules of the game in a society, […] the humanly devised constraints that shape human interaction. […] They structure incentives in human exchange, whether political, social or economic". Institutions comprise for example contracts and contract enforcement, protection of property rights, the rule of law, government bureaucracies, financial markets. They also, however, include habits and beliefs, norms, social cleavages and traditions in education (so-called informal institutions). Formal institutions typically tend to be the crystallization of informal institutions (North, 1990), as social norms in the realms of gender, class and caste, for example, determine rules of political participation and representation, methods of economic exchange, and inclusion of different groups in society (Pateman, 1988).

In a landmark study of new institutional economics, Rodrik, Subramanian and Trebbi (2002) assess the relative importance of institutions, geography and integration (trade) in determining the differences in incomes between the world's most developed countries and the poorest ones. They find that institutional determinants "trump" all others. It is not a new intuition that for the prospering of economic activity institutions matter. Adam Smith had already noted this is surprising detail, referring to the importance of a justice system, private property rights, and the rule of law (*The Wealth of Nations*). Aron (2000) surveys the studies which correlate indices of development to institutional ones: 7 find a positive correlation with property rights and enforcement, 10 with civil liberties, 10 others with political rights and democracy, 4 with institutions for cooperation (e.g. clubs and associations), and 15 find a negative correlation of development with political instability. The paragraphs below explain why institutions appear so important to economic development.

Institutions conducive to economic development reduce the costs of economic activity. The costs include transaction costs such as search and information costs, bargaining and decision costs, policing and enforcement costs (Coase, 1992, p 197; Dahlman, 1979, p. 149). They lower transaction costs by providing common legal frameworks (e.g. contracts and contract enforcement, commercial norms and rules), and they encourage trust by providing policing and justice systems for the adherence to common laws and regulations. Communities in LDCs typically rely on kinship or ethnic and religious ties for trade. Norms and networks of common language and religion may be enough to ensure compliance with agreements on economic exchange; collective punishment and social reputation may be enough to ensure the enforcement of (often informal) contracts even in the absence of a third party. Greif (1993) describes the trade networks of Maghribi traders which permitted the sharing of information on dishonest traders and their collective punishment. To take advantage of opportunities for trade with different groups and increase the size of economic transactions, however, cultural ties are not enough. There is need for greater information about trading partners, and for institutions which ensure agreements on the details of exchange and compliance to the agreed conditions. These take the form of contracts, codes of conduct, standardized weights and measures, disclosure agreements, and enforcement through courts and policing. Where transaction costs are small, the private enforcement of contracts may still be preferred. But as economic relations develop and become increasingly impersonal, the role of a third party to enforce compliance to rules is increasingly necessary (Shirley, 2003, p. 2).

Such institutions increase the security that the risk of incurring in an economic transaction is matched by the full appropriation of its eventual benefits. This includes the presence of individual private property rights. If property is protected individuals are more willing to invest and to incur sunk costs. Recounting the land-ownership system in Ghana, Pande and Udry (2005) are able to show that where individual perception of security of land tenure is low, investment in the land is significantly reduced, and output consequently drops. In fact, in the few cases in which land is obtained through commercial transactions (as opposed to the traditional informal system of land redistribution), there ceases to be any difference in levels of investment because security of tenure is assured. This increases output and thus is conducive to economic development.

The protection of property rights requires an expanded role for state authority. Individuals and groups sacrifice a degree of freedom in order to ensure state protection; they accept levies and taxes to cover policing expenses, and state monopoly over the use of force for common security (Bates, 2001, p. 65-66). However, there is a risk that states which have the power to enforce property rights may use that power to expropriate property too. Instead of reducing risk of economic transactions, this increases it. Thus property rights are by no means sufficient to spur economic growth, and must be balanced by institutions which limit the extractive capacity of state power. These typically involve independent parliaments and judiciaries. Democratic institutions of political representation strongly contribute to this process (Rodrik, 2000).

Thus institutions determine the extent to which those in power are able to expropriate the economy's resources to their private advantage. Unequal institutions strongly limit development by reducing the capacity of individuals to access resources, expand production and increase their incomes. A comparative analysis of development trajectories of countries indicates that institutions which benefit elites and allow their appropriation of resources and products have perpetuated underdevelopment.

Countries which have undergone colonial domination tend to be plagued by such extractive institutions. These have outlived the gaining of independence on behalf of these countries, and their control has largely been taken over by local elites. There are countless examples of societal outcomes the cause of which can be traced to institutional arrangements of many decades before.

The unequal landownership system in Latin America (*latifundios*) has been indicated a fundamental cause of its underdevelopment. There is evidence that it limits the development of greater rural employment and higher rural incomes (World Bank, 2008, ch 6). ECLA, the Economic Commission for Latin America, has repeatedly flagged the importance of land reform in the process of poverty-reducing agriculture and rural development. A report by the United Nations Food and Agriculture Organization stresses that this is particularly urgent as population growth threatens to increase income inequalities, and technological developments in agriculture may serve the landowner elites to further consolidate their grip on land and agriculture, thus perpetuating the process of path dependency in the formation of institutions (UNFAO, 2006; see also Myrdal, 1992).

Greater equality and functional economic institutions are also seen as the cause for the successful development of Vietnam compared to a similar country as Nicaragua, where high inequality has concentrated power in the hands of a restricted elite, and governments have failed to adequately invest in infrastructure and public welfare. Similarly, institutional capacity to exploit domestic primary resources is indicated as the key to the success of Botswana and Mauritius in comparison to other developing countries for which primary resources have turned into a curse, i.e. Sierra Leone (diamonds), Angola, Equatorial Guinea and Nigeria (oil) (Birdsall et al., 2005, p. 138). The outcomes of institutions have effects which lie deep in the socio-economic fabric of societies. Banerjee and Duflo (2011) recount the finding by Abhijit and Lakshmi Iyer (2005) that in India the coexistence of two systems of land-revenue collection under the British colonization caused very different outcomes; under one system, the landlord was responsible for collecting taxes, and this strengthened his role, while under the other farmers themselves were responsible for the taxes. The regions where the second system was dominant, 150 years later (with the tax system long gone) exhibit higher agricultural yield, more schools and more hospitals, due to the development of more horizontal and cooperative social relationships among the inhabitants.

Institutions which are conducive to development ensure greater self-expression, allow the free flow of information and encourage the formation of associations and clubs. These form prosperous social relationships, which are conducive to greater economic interaction by increasing levels of trust and wider availability of information (Putnam, 1993). They allow greater sharing of resources through democratic institutions and the use of the state to reduce the risk attached to economic activity (Bardhan, 2006, p.5). The welfare state is an example of an institution which pools resources to limit the negative effects of business cycles on incomes and unemployment. Institutions conducive to development pool resources to provide the investments in education, health and infrastructure which lie at the basis of economic interaction and are necessary and complementary to private investment. Informal institutions lie at the basis of an economy. They include public agencies, trade unions, community structures and professional associations. They make up the fabric which determines the response to laws and government decisions. Most often they shape these outcomes themselves.

There is wide-ranging evidence that institutions matter a great deal in determining the level of economic development of a country. Cross-country analyses use indicators such as degree of protection of property rights, the rule of law, and civic liberties and find that they are strongly correlated to economic performance. This essay has described why institutions are so important for economic development and has provided evidence for the claims made. It has identified four broad channels through which the correlation can be explained. Institutions determine the costs of economic transactions: they spur development in the form of contracts and contract enforcement, common commercial codes, and increased availability of information, all of which reduce the costs of transactions, risk, and uncertainty. Institutions determine the degree of appropriability of return to investment: protection of property rights and the rule of law spur investment and thus increase incomes. Institutions also determine the scope for oppression and expropriation of resources by elites: unequal institutions which allow the dominance of powerful elites over economic exchange strongly limit development, as can be seen in the case of many ex-colonial countries. Lastly, institutions determine the degree to which the environment is conducive to cooperation and increased social capital; inclusive and participatory institutions increase the flow of information and the extent to which resources can be pooled to reduce risk and ensure sustained levels of wealth. This fits nicely with the finding of historical studies that high quality institutions today are rooted in greater equality, political competition and cooperative norms in the distant past. Institutions strongly affect the economic development of countries and act in society at all levels by determining the frameworks in which economic exchange occurs. They determine the volume of interactions available, the benefits from economic exchange and the form which they can take.

Bibliography

Acemoglu, D., Johnson, S., and Robinson, J.A., 2001. “The Colonial Origins of Comparative Development: An Empirical Investigation,” *American Economic Review*, 91, 5, December, pp. 1369-1401.

Aron, J., 2000. “Growth and Institutions, a Review of the Evidence.” *The World Bank Research Observer*, 15:1, pp. 465-90.

Banerjee, A. V., and Duflo, E., 2011. *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty* . Croydon: PublicAffairs.

Banerjee, A. V., and Iyer, L., 2005. “History, Institutions, and Economic Performance: The Legacy of Colonial Land Tenure Systems in India,” American Economic Review, American Economic Association, vol. 95(4), September, pp. 1190-1213.

Bardhan, P. (2006). “Institutions and Development”. In: D. Clark (ed.). The Elgar Companion to Development Studies, Edward Elgar Publishing, pp. 2-56.

Bates, R. H., 2001. *Prosperity and Violence: The Political Economy of Development*. New York: W.W. Norton & Company.

Birdsall, N., Rodrik, D., and Subramanian, A., 2005. ‘How to Help Poor Countries’, *Foreign Affairs*, July/August, pp. 136-152.

Chang, H-J., 2008. “Under-explored Treasure Troves of Development Lessons- Lessons from the Histories of Small Rich European Countries (SRECs)”, in M. Kremer, P. van Lieshoust and R. Went eds. 2009,*Doing Good or Doing Better – Development Policies in a Globalising World*. Amsterdam: Amsterdam University Press.

Coase, R. H. 1992. “The Economic Structure of Production.” *American Economic Review*, 82: September, pp. 713-19.

Dahlman, C. J. 1979. “The Problem of Externality.” *The journal of Law and Economics*, 22:1.

Greif, A., 1993. “Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders’ Coalition.” *American Economic Review*, 83:3, pp. 525-48.

Hall, R., and Jones, C. I., 1999. “Why Do Some Countries Produce So Much More Output per Worker than Others?” *Quarterly Journal of Economics*, 114, 1, February, pp. 83-116.

Myrdal, G., 1992. “The Equality Issue in World Development”. In: A. Lindbeck, ed. 1992, *Nobel Lectures, Economics, 1969-1980*. Singapore: World Scientific Publishing, 1992.

North, D. C., 1990. *Institutions, Institutional Change and Economic Performance*, New York, Cambridge University Press.

Pande, R., and Udry, C., 2005, “Institutions and Development: A View from Below”, *Yale University Economic Growth Center Discussion Paper No. 928*.

Pateman, C., 1988, *The Sexual Contract.* Polity Press.

Putnam, R., 1993. *Making Democracy Work : Civic Traditions in Modern Italy,* Princeton : Princeton University Press.

Rodrik, D., 2000. “Institutions for High-Quality Growth: What they are and how to acquire them”. Working Paper 7540, February.

Rodrik, D., Subramanian, A., and Trebbi, F., 2004, “Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development”, *Journal of Economic Growth*, 9(2), p.131-165.

Savoia, A., Easaw, J., McKay, A., 2010. “Inequality, Democracy, and Institutions: A Critical Review of Recent Research”, *World Development*, Vol. 38, No. 2, pp. 142–154.

Shirley, M. M., 2005. “Institutions and Development”. In Claude Ménard and Mary M. Shirley, eds.,*Handbook of New Institutional Economics*. New York: Springer.

UNFAO, 2006. “Land Reform”. [online] UNFAO. Avaliable at: <http://www.fao.org/sd/Ltdirect/landrF.htm> [Accessed 15 January 2012]

World Bank, 2008. *World Development Report, 2008*. New York, Oxford University Press.

—

Written by: Luca Ferrini
Written at: University of Reading
Written for: Marina Della Giusta
Date written: March 2012