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Institutions and economic development: A focus on the new institutional economics

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Abstract
The main objective of this paper is to provide some insights into the literature relating to institutions and economic development, by explaining the main advantages of using such a framework, instead of adopting other perspectives that attempt to explain economic performance without using institutions as a determining element. Institutions, crucial for the analysis of how agents deal with uncertainty, have been gaining increasing relevance on the economic research agenda. In this paper, we analyze the institutional literature that provides insights into different research fields, aiming to explain why this perspective obtains better results than others, in the field of growth and development economics. In particular, we stress the relevance of New Institutional Economics as an adequate framework for a broad understanding of development issues. This study has shown that the relevant literature has already proved that institutions are essential for understanding and explaining economic performance. The existence of positive transaction costs and the subsequent importance of institutions were the latest inspiring discoveries that have motivated some economists to dedicate their research to uncovering the particularities and implications of considering transaction costs in several different areas of the economy.

Keywords: Institutions; Institutional change, Economic Development, New Institutional Economics

Introduction

Institutions have increasingly come to be referred to as the main reason to explain why we observe different economic performances in different countries (Rodrik, 2007). Many authors have pointed out that differences in technology, physical capital or human capital may be the probable causes for those distinct trajectories (Meier, 2001). However, as a close analysis of the literature examined by this paper shows, there is much more lying beyond these causes that may enable growth and development; e.g., at the institutional level.

Institutions have been studied for a long time as major determinants of individual behaviour that may contribute to the performance of the economy. The most systematic studies began with old institutionalists such as Thorstein Veblen and John Commons, who, from different perspectives, alerted us to the essential role institutions have in defining agents' actions (Rutherford, 2001).

As Ronald Coase, a new institutionalist, argued in 1937, in his seminal paper "The theory of the firm", the uncertainty intrinsic to agents' engagement in business relationships leads to the emergence of the so called transaction costs. In other words, the more complex markets and societies are, the more probable is it that agents will engage in some opportunistic behaviour against each other. This is only possible because they do not deal with each other on a daily basis, thus having the chance to misbehave without being punished. Hence, transaction costs encompass information asymmetry costs, bargaining costs, enforcement costs and other similar costs (Coase, 1937). Thus, these transaction costs and the consequent need for coordination, so that agents receive higher benefits from their collective actions and do not suffer from free riding or individualistic actions that prevent increasing gains, necessitate the creation of institutions (Gagliardi, 2008).

Hence institutions are a key feature in the analysis of how agents deal with uncertainty and externalities of their activities, as they can assist in solving these problems. They are the environmental support in which agents take shelter and which defines how they can behave and what they may expect from others' behaviour. They offer the guidelines for interaction within society (North, 1990). More importantly, the kind of institutions that exist and the way they are organized and structured are essential i order to explain distinct economic performances. From this general understanding of how important institutions can be in the development and growth of economies, many researchers have started studying institutions in order to explain why some economies are more highly developed than others (Shirley, 2005).

Some empirical examples of distinct economic development trajectories were referred to as puzzles that were not easy to solve. The introduction of institutions in the analysis has provided some new insights for an understanding of those types of divergences. One example is the case of the two Koreas: before their separation in the 1950s they had similar development levels, but after 60 years they are now at opposite extremes in terms of levels of development. Other examples are the ex-colonies, which faced different fates after decolonization. Some achieved higher levels of wealth and development while others became the poorest countries in the world (Acemoglu, 2009). Many studies have been undertaken, using some of the above examples, in order to understand whether institutions indeed have an impact on economic performance. Several empirical studies have proved the existence of close connections between institutions, growth and development (e.g., Knack and Keefer, 1995; Clague, *et al*., 1999; Keefer and Shirley, 2000; and La Porta, 2008).

In view of these contributions, the research question we want to analyze is whether there is an advantage in introducing institutions and the institutional framework to explain economic performance and, if so, how this has been used in development economics. Moreover, we want to investigate which strands clearly emerge within this specific field, and what are the main models and theories proposed. Hence, we start with an overview of the main lines of institutional research in order to understand not only its sources and lines of thought, but also the way this stream has evolved through time, giving a broad understanding of the main research focus. Section 2 presents an overview of economic institutionalism. Then, in Section 3, some of the theories relating to development economics are set out and their proposals analysed within growth and development theories. That is, we will make a brief analysis of the neoclassical and evolutionist branches. Furthermore, we will propose and analyze the reasons why institutionalism is a better perspective and framework whereby to integrate theories of development than the other perspectives discussed in Section 3. In Section 4 we propose that New Institutional Economics should be the most suitable theoretical framework for growth and development economics. Finally, section 5 concludes the paper.

An Overview of Economic Institutionalism

Although institutions have been of general concern in the literature focusing on understanding society and the economy, only at the beginning of the 20th century was a more systematized approach conceived by some authors in order to understand the role of institutions and their impact at both social and economic levels. Two major strands emerge in this period – one linked to Veblen's ideas and another one closer to Commons'. The former is based on the definition that institutions are patterns of behaviour, "internal" norms, customs and traditions that agents form in a spontaneous way and which will regulate their behaviour. In contrast, the vision of Commons is to a large extent more legalistic. Although this author still agrees with the definition of institutions as rules that help governing agents' behaviour, he states that institutions have a legal source and are created by agents' design, not brought into being in a spontaneous way due to the agents' regular interaction (Rutherford, 2001).

After the 2nd World War these two approaches to institutions suffered a decline in interest mostly because they lacked the capability to offer tools and solutions to deal with the Great Depression (Rutherford, 2001). Hence, until the late 1960s, institutions lost the preponderance they once had, being replaced by mainstream neoclassical Economics. Only the emergence of the so-called New Institutional Economics (NIE) in the late 1960s and early 1970s restored institutions to Economics. However, it is important to acknowledge that another branch has also appeared among a new generation of economists who have tried to bring the ideals of Veblen and Commons to life. Geoffrey Hodgson is one of these theorists; he has worked in this branch by mostly using the ideals of Veblen through his evolutionary and Darwinian approach to institutions and institutional change (Rutherford, 2008). Still, we focus our analysis on NIE, since it seems to have met with more success in relation to Economics, and has put forward rather different perspectives which seem to have been more widely accepted and applied in the Economics field (Rutherford, 2001; Furubotn and Richter, 2005).

Coase (1937) played a crucial role with regard to core concepts within NIE, namely those of transaction costs. He first mentioned this concept in 1937, although only with his 1960 paper "The social cost problem" did it have a significant impact among fellow researchers in terms of placing institutions in the forefront of economic research (North, 1989). The recognition of their importance in managing transaction costs is in clear opposition to the mainstream view whereby institutions are mostly taken as given, without accounting for the fact that with positive transaction costs there are no perfect competitive markets. The acceptance of this new reasoning means that these mainstream models are necessarily flawed and do not resemble reality. The existence of positive transaction costs and imperfect markets is only one of the aspects that separate NIE in particular and Non Walrasian economic literature in general from mainstream Economics (Bardhan, 1989).

Other key divergent assumptions have to do with the nature of economic agents. In NIE they have bounded rationality, are heterogeneous and do not possess all the information available in the market. If agents are not completely rational, they will be unable to use optimization in their decisions. In fact, many of the strands within NIE assume no optimal behaviour (only adaptative rationality), although some authors try to use this approach in the sense that agents optimize within certain boundaries defined according to their rationality and availability of information (Rutherford, 1995). This is indeed a rather divergent vision of neoclassical Economics where perfect rationality, homogeneous agents and perfect information are almost always assumed in the models. There are still, however, some frameworks within NIE, particularly concerning the usage of mathematical tools, that are common to the mainstream.

One of the most prominent strands within NIE is dedicated

to the study of property rights. Besides Coase, other authors, such as Oliver Williamson, Harold Demsetz and Alchian are associated with this. Some of the first published papers dealing with this subject are Alchian (1961), Demsetz (1967) and Alchian and Demsetz (1973) (in Nelson and Sampat,
2001). Williamson is also a key author in this area, with some seminal papers published in 1975 (an extension of Alchian and Demsetz, 1973) and 1985 (Nelson and Sampat, 2001; Gagliardi, 2008). During this period, the main research themes were transaction costs in general and the nature of property rights and their enforcement in particular (Rutherford, 1995). The use of formal law was also a main concern that motivated building a framework where property rights were at the centre of the discussion, with Posner (1981; 1993) in Nelson and Sampat, 2001) a supporter of this formal legal approach.

Evolutionary theory has also produced contributions in the institutional field, following the seminal work "An evolutionary theory of economic change" by Nelson and Winter (1982). This analysis is much closer to the Veblen theory and proposes a research frame, either in formal or in appreciative terms, very far from the formalized neoclassical methods that some of the previously mentioned authors have been using. Some other NIE economists have been working on more government-related issues which are associated with the public choice field. This author undertakes research mostly within the theoretical framework of collective action, analysing how agents may misbehave by becoming free riders or by forming coalitions that would influence institutional design (Rutherford, 1995; Furubotn and Richter, 2005).

In this particular field, generally identified as political governance theory, the design of institutions (referred to above) is not only due to pure interactions between agents, but is also obedient to strong determination to change rules and some economic structures directly through their own particular power. Within this framework the government plays an essential role in designing and offering solutions to collective action problems. This line of reasoning has given rise to another research field that is today acknowledged as very important both for Economics and for political science – the functioning of political institutions. This area has become increasingly more important since mathematical modelling has provided numerous tools to recreate the interactions between groups of agents and simulate how they fight for power relating to institutional decisions (Acemoglu, 2009).

Finally, it is possible to identify a more historical and general approach to NIE. Here the proposal is to employ most of the methods used in the other approaches mentioned above and try to explain the evolution of institutions in countries, using historical arguments. The main procedure corresponds to analyzing the evolution of a country during the last few centuries and trying to understand what has failed or has succeeded in its development path within the institutional framework. The most important economist in this field is North, who claims that the intervention of the state in the design of institutions plays a major role in the success or failure of one country to develop. His general analysis and effort to prove this point, for example in his book of 1990, along with the usage of elements provided by the other strands of NIE, makes this a more complete and structured framework within which to examine countries' development. Some other important works in this field are Haber in 1991, Libecap in 1989, Greif in 2005 and others (in Furubotn and Richter, 2005).

It is arguable whether by using "New Institutional Economics" as a query; many papers belonging to the field might have been missed within this search. In fact, one might consider that NIE, the term coined in the 1970s by John Williamson (Hardt, 2009), is too narrow to cover the argument. It may therefore be useful to use a more comprehensive query to clarify whether the exhibited trend is actually observed. For this purpose, we used a wider query, "Institutions", which collated 10,662 articles from 1871 to 2011, of which 9,755 were from 1989 to 2011. This query is much more generic and will thus include that institutions have become a crucial research field in the last few decades.

Theories of Growth and Development: Neoclassical, Evolutionary and Nie

From the above idea that institutions are crucial to the understanding of economic performance, we may argue that they are also key variables in understanding why economies attain different economic growth and development levels (North, 1990; Shirley, 2005; Rodrik, 2007). As we have seen above, institutions help reduce uncertainty in the relationships between agents, and thus reduce transaction costs, providing a better framework for agents to behave adequately (North, 1990). Thus, when agents face a more certain economic environment, knowing what they can expect from other agents, opportunistic behaviour is minimized, the mechanics of the economy become stable, enforcement of contracts is easily solved and coordination between agents is indeed possible. Moreover, institutions may be seen as sustaining growth through the support they offer to technology, physical capital accumulation, education and all processes linked with growth (Nelson and Sampat, 2001). Without some of these institutions agents will perceive activities in various countries as too risky and thus will not invest as much as they could. Hence, fewer motivating behaviours emerge as agents produce less, and trade with certain countries if, for instance, the enforcement of contracts in those territories is not efficient. If there are, for example, no traditions that praise hard work and or fight absenteeism, then it becomes very difficult for a country to attract investment, since potential investors know future returns. These are common arguments within NIE (North, 1989).

However, there are different perspectives on growth and development proposed by other strands in Economics that do not include institutions, at least as the main reason, in the explanation for divergences in economic development. One of these is neoclassical theory. According to this branch of Economics, the explanations for growth and development rely on institution-given growth models and also on a few structural change models (the Lewis model is a traditional example (Todaro, 1997)). These models are based on assumptions that typify the economy and agents in very specific ways, as already referred to above. That is to say, they define rational homogeneous agents that make their decisions by maximizing their profits and utilities. The external conditions are given (usually there are complete markets and all institutions are well defined) so that they only have to react to and explain market prices, supply and demand values and any eventual exogenous shock. Main neoclassical theories explain economic growth through the accumulation of capital, labour and or technological knowledge as opined in Solow model in 1957, the Ramsey-Cass-Koopmans model and all the subsequent extensions, or the new endogenous growth models that rely on human capital accumulation and on the generation of ideas as main sources for growth (Acemoglu, 2009).

Within these analyses, the main explanation for the low levels of growth is the lack of a minimum level of endowments that makes sustained output growth possible, and which leads the economy to an equilibrium typified by a reasonable welfare level. This limitation may lead the economy to a poverty trap situation (low output equilibrium) from which countries cannot escape unless there is some external element (the government or other entity) that operates the necessary provisions of endowments or the essential changes to obtain them. This is a claim usually criticized by economists due to its negative proposition that countries condemned the poverty trap fate unless some external aid is provided. Moreover, the demand for lower governmental intervention, only that strictly necessary to enhance the conditions for growth, is one of the strongest claims, as according to these theorists the excessive power of the state and its intervention prevents economic efficiency and restrains investors from investing in that country (Todaro, 1997). However, this may be counterbalanced by the endogenous growth theory that grants a role for the state to provide conditions for human capital to flourish (Todaro, 1997). Despite this, some authors argue that less developed countries are held in an unpleasant poverty situation only because they are not able to coordinate the allocation of resources due to the “heavy hand” of the state (Todaro, 1997).

According to these theories, there is no scope for other explanations than those of misallocation of endowments that are insufficient to be used in a suitably efficient way in these countries. Any reference to external variables, such as institutions, infrastructures, culture or imperfect markets is usually rejected as they are considered subsidiary questions that do not play a vital part in these theories’ analysis. These theories clash with the so called evolutionary theory. As we already know, this theoretical approach has some links to the NIE, as some of these last strands closely follow the evolutionary doctrine – as Nelson and Winter (1982) proposed. Within this approach Economics is broadly understood by using the evolutionary analogy, based on variety, replication and selection. In the centre of this analysis is the firm, which is the element that causes the economy to move forward.

These changes do not occur in the same way, but represent a variety of decisions that are more or less efficient depending on the effects they have on the level of profits attained (uncertainty is faced by firms according to their decisions). This process, known as selection phenomenon, defines firms as autonomous which prevail in the market and which disappear due to economic mishap (Nelson and Winter, 2002). Moreover, there is no equilibrium level in the sense of a continuous flow of innovation that keeps firms and the economy moving in new directions. Thus the evolutionary process comes from the interaction between innovation and selection resulting in an environment in which only the most efficient firms prevail, given scope for better routines to be used, which means more efficient production and hence more output and more wealth.

Also important within evolutionary Economics can be the role of the entrepreneur (Nelson and Winter, 1982). Since Schumpeter, the entrepreneur has been conceived as the element that drives the innovation process by imposing “development from within” (Schumpeter, in Foster and Metcalfe, 2012). Hence, the entrepreneur plays a crucial role which involves taking risky actions by investing in some specific innovation that may or may not succeed. It is through his/her initiative that technology advances and the necessary economic transformation and creation of new products and routines emerge, allowing for efficient production. Besides these theoretical frames, there is another approach that takes some procedures from these latter two, but extends and analyses growth and development issues differently as far as the NIE perspective is concerned. This proposes set-up where, due to the existence of transaction costs that may restrict the role of the entrepreneur, for example, institutions play the central role in defining the fate of countries. Contrary to neoclassical theories, it does not take institutions as given. It claims that they are the reason why some countries can develop, as their institutional framework fosters efficient agents’ behaviour, while others face difficulties as their institutions do not prevent abusive behaviour and inefficient methods, so that investment is discouraged and agents are restrained from making agreements with each other in a systematic way. This denies some benefits that specialization brings, since the more specialized agents are, the more are agents exposed to others, as they need to buy and sell products constantly (North, 1990).

Nie: A Suitable Framework for Economic Growth and Development

To understand the relevance of NIE as an adequate framework in which to explain growth and development, we must first regard the premises of NIE and consider how they correspond more closely to reality. The heterogeneous agents’ hypothesis, for instance, is very important because each person has different preferences and cognitive abilities, and reacts differently when facing the same event. Thus, different people involve different outcomes that jointly lead to a specific one that can vary depending on which group of people is affected. This is what social realm is all about and why we cannot effectively predict economic outcomes, although we may have the ability to determine tendencies. If there are different groups of agents with different beliefs and different experiences taking economic decisions together, then the “equilibrium” attained may differ from other groups’ decisions.

According to Gagliardi (2008), there are three main approaches to the study of institutions in the ambit of economic development: a “historical perspective”, a “comparative institutional analysis” and “imperfect information theory”. The first strand, the “historical perspective”, argues that the reason why some countries are mired in poverty is due to their historical path that has undermined their institutions and produced an institutional structure that has become hard to transform – path dependent institutions. Thus, the past of each country becomes a key factor in tracing the reason why they have ended up with such kinds of institutions which are historically specific. It follows that the argument of path dependence is very important in this framework and explains why countries meet with different economic fates.

In addition, still following the line of this path dependence hypothesis, North (1990) advocates that only through changes in policy is possible to reverse the situation, although many argued to know exactly how such changes can be made and what actions are the most suitable for achieving such a purpose (Gagliardi, 2008). From the initial studies of North, many different explanations emerge as causes for underdevelopment. According to Shirley (2005), there are four main explanations for this situation: "Colonial Heritage", "Colonial Heritage Plus", "Political Conflict" and "Beliefs and Norms". North is closer to the first, although he also draws conclusions from the last one.

As regards "Colonial Heritage", the main assumption is that different colonial powers established different types of institutions in their colonies. For instance, La Porta (2008) argues that differences between common law (Anglo-Saxonic) institutions and civil law (France) institutions led to better institutional bases in some countries (common law group) than in others (civil law group). However, this argument was contested because if for some colonies it is a fact, for others, mainly African, Caribbean and Asian countries, the theory does not offer solutions (Shirley, 2005). A similar situation occurs in the example given by North (1989; 1990), when he compares Spanish and English colonies. He also considers that Spain had a more centralized government that did not favour the development of markets supporting institutions as in the case of England, where there was more colonial autonomy.

As for the second explanation, "Colonial Heritage Plus", there are some similarities to the first one, but here the great debate is whether colonisers brought to the colonies the best institutions available or if they pursued purely exploitative behaviour towards their colonies. This is argued by Acemoglu, *et al* (2001) and tested in Acemoglu and Johnson (2005). The main arguments are that in locations where colonial powers benefit from good weather, soil, lack of disease and land conditions, they were able to establish large communities. Where there were huge quantities of natural resources and a sufficiently large population to exploit, colonies were established just to exploit the wealth of that specific area. The institutions created were only those necessary for the maintenance of power and the extraction of as many resources as possible from the native population. In other colonies, where larger colonial populations settled, institutions were shaped in a more favourable way as migrants wanted to assure (and secure) their rights and properties, and where their customary behaviour would not be affected by damaging laws and policies. These are the main reasons why countries such as the USA and others were established on the grounds of good institutions, while others, such as most African and Latin American countries, maintained a poor institutional basis (Shirley, 2005). Engerman and Sokollof (2005) also support this view, although they argue that institutions are dependent on the endowments that were available in each country when the colonies were established. Both views have been contested, since they seem to miss some crucial points in terms of the Colonial Heritage explanations. They do not give relevance to the kind of colonial power established in those areas but only focus on the natural endowments of those areas and their impact on the institutions established there. Moreover, they can only explain some specific cases, such as the emergence of the USA (Shirley, 2005).

The third explanation, "Political Conflict", is in respect to the lack of political conflict as the source of poor institutions. Here the conflicts correspond to situations in which, to fight some common enemies, elites unite and forge alliances so that together they are able to win the conflict. These alliances comprise concessions of power and laws that favour some elites and make previous institutions change to accommodate those concessions. Some examples are the concessions the English king made to English the nobles and merchants in order to receive the financial and human support needed to expand the empire. These alliances changed some previous statuses, decentralizing some of the previously exclusive power of the king by, for instance, giving more power to the parliament. Thus, these conflicts enabled the appearance of certain institutions.

The last explanation, "Beliefs and Norms", relies on the reasoning that each country has inherent beliefs, norms and customs that could render a "fertile land" better or worse for good quality institutions. On the one hand, some argue that these informal rules may in themselves prevent the establishment of some institutions due to their strong prevalence in people's minds. One example is the Protestant incentives for production, entrepreneurship and other qualities linked to the ideals that made the industrial revolution possible (Shirley, 2005). Others, more restricted in their analysis, refer to these rules as elements that may stimulate better learning and implementation of new institutions or that may prevent them, depending on whether they come into conflict with each other or not. The main flaw in this analysis is that apparently there are no solutions for systemic beliefs that prevent institutions to arise, thus condemning less fortunate countries to even greater poverty. The change in beliefs seems as a hard task that can be accomplished through investments in education which leads to multiplier effect for the entire human development concept. (Shirley, 2005).

Within these hypotheses is an ultimate assumption: path dependence. The meaning of path dependence is that future and present outcomes are intimately connected with past events. It can be said that today's institutions have links to previous ones and to the events that originated them. This is significant because new institutions organised the kind of event that was the source of their emergence. This implies that when those institutions follow a certain path, such a trajectory influences the country's performance for the following periods, unless some adjustment changes the course of events (North, 1990). Thus, path dependence is very important, as it may determine whether countries diverge or converge. Taking one of the examples above, as a result of the colonial period, today's developing countries have different kinds of institutions that have defined their post-decolonization paths. Some were able to achieve convergence, as was the case with some former colonies of the United Kingdom, while others diverged, as in the case of former Spanish colonies (North, 1989).

Finally, the last strand proposed regarding the study of institutions in the context of economic development is the "Imperfect Information Theory". The reasons behind this maintain that institutions are the pieces that solve the jigsaw of the missing markets and preclude the emergence of complete markets by minimizing imperfect information. This corresponds closely to the perspective referred to above within the main strands of NIE, but now specifically applied to the field of Development Economics. The most important research within this field aims at an understanding of how institutions emerge in developing countries to overcome missing markets. The first study involved sharecropping in developing countries, an institution created to overcome risky investments (Bardhan, 1989). These types of institutions that emerge rather spontaneously are the solution for undeveloped countries that are sometimes disregarded as unimportant by reformers. Moreover, very often reforms end up causing disillusionment by forgetting how important these institutions can eliminate a mechanism within the economy that is the key element which has maintained economic conditions that propels inefficiency (Bardhan, 1989).

Conclusion

The main purpose of this paper has been to provide some insights into the literature concerning institutions and economic growth and development, by asking what the main advantages of using such a framework are, instead of adopting other perspectives that attempt to explain economic performance without using institutions as a determining element. We have shown that the relevant literature has already proved that institutions are essential for understanding and explaining economic performance. The existence of positive transaction costs and the subsequent importance of institutions were the latest inspiring discoveries that have motivated some economists to dedicate their research to uncovering the particularities and implications of considering transaction costs in several different areas of the economy.

There are studies on the historical level, on the law level, on agent to agent interactions, on evolutionary perspectives, on applications with game theory, and on the political level that explain the emergence of institutions and consequently the reduction in transaction costs. All these theories were then applied to the study of growth and development in order to furnish insights into how countries experience different conditions at an institutional level that either enable them to develop or prevent them from doing so, and if the latter is the case, how the negative conditions may be overcome. This understanding of the importance of the institutional quality, need to be fully introduced into other frameworks, such as the neoclassical and the evolutionary models. Hence, we argue that these approaches should be complemented by an institutional framework to improve and strengthen the rigour of economic development. Also in the developed world, the level of compliance to the implementation of institutional quality ethic is very high hence they are developed as they are which need to be followed by the developing countries all over the world. The discussions above informed researcher that new institutional economics involves in the contributions of these theories and operates within a specific institutional frame, which brings about comprehensive and more valid approach in the explanation of the reality of the development in the world.

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