Institutions and economic growth theory

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Abstract
The determinants of economic growth have enjoyed a lot of attention in both theoretical and applied research. However, there is no unified theory to explain these determinants. In this paper I briefly summarized the essential characteristics of the main economic growth theories from a historical perspective, and emphasized the integration of institutions in the economic growth and their importance.

Keywords: economic development, institutions, institutional quality

JEL: B15, O43.

1 INTRODUCTION
"Why some countries are richer than others?" is a primary question that all economists tried to answer. "Theories and models of economic growth" is an epistemological approach in economics, an important source of human action, known as praxeology. Over time several models and theories of economic growth have emerged, with mixed results on the real economy. Economic growth has been and will be a desideratum even in our days. The concept of economic growth stated with the eighteenth century in the Anglo-Saxon world that created the economic liberalism and more.

Economic development is a complex phenomenon, at least through the discovery and understanding of its sources, albeit the clarifications from theories of economic growth.

The source of economic growth can be attributed to the division of labor limited to the market size (Smith), the capital accumulation (Marx), government spending and interest rate (Keynes), the emergence and maintenance of innovations (Schumpeter), savings and investment rate (Harrod-Domar), the efficiency of the private and public sector (Stiglitz), etc.

In the last four decades we can distinguish three main strands in economic growth theories: a neoclassical model based on Solow’s growth model who emphasised the importance of investment and savings, a theory of endogenous growth developed by Romer and Lucas who took into account human capital and innovation capacity and the neoinstitutional economic theory which emphasizes the role of institutions in economic growth.

In more recent times, Jeffrey Sachs offers another explanation to the degree of economic development taking into account 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.

2 The determinants of growth in economic theories – a historical perspective
Throughout the economic history the economists tried to thoroughly explain the sustained growth of labor productivity and material wealth taking into account an increasing number of explanatory factors.

The classical models of Adam Smith, Thomas Malthus and David Ricardo described the economic progress in terms of division of labor, limited land and increasing population, but they have failed or have underestimated the contribution of the technical progress.

At the beginning of the twentieth century, amid strong economic and social distortions that
culminated with the economic crisis during 1929-1933, John Maynard Keynes advocated a macroeconomic model, sustaining that national income increases in response to an increased aggregate demand. Keynesians have used new concepts related to growth, the multiplier and the accelerator effects.

After the Second World War, a theoretical synthesis of the macroeconomic and dynamic approach was made. Thus, growth theory has emerged as a component of modern economic science, with the great contributions of R. Harrod, E. Domar, R. Solow, Swan, Samuelson, Hicks, Kalecki, F. Perroux.

Neoclassical growth model explains how capital accumulation and technological change affect the economy. Robert Solow (and Swan), Nobel Prize winner for his contributions to growth theory, developed in the mid 50s a stable growth model, inspired by the growth models of Harrod and Domar. Solow neoclassical model tried to explain differences in development between countries in terms of efficiency of the inputs combination (human factors, capital and new technologies).

Following Solow's work more econometric models have been developed, in which technical progress and technology have been included in various forms, but it is considered exogenous in most cases.

Viewed as a whole, the neoclassical assumptions state that markets are competitive and without the state intervention, the optimal level of production and resource allocation is achieved.

In the mid '80s, a new growth theory emerged, promoted by Paul Romer and Robert Lucas, in line of traditional neoclassical growth model. The premise of this theory is that capital accumulation is usually associated with an accumulation of knowledge.

The new growth theory or endogenous growth theory brings important changes: technological progress is considered a product of economic activity because it internalizes technology in a functioning model of the economy and unlike the objects of physical nature; knowledge and technology are characterized by increasing returns. Ideas can be shared and reused indefinitely, increasing without limit and driving the growth process. The new theory reflects the transition from resource-based economy to the knowledge one, assuming that the emergence of new knowledge is a key source for growth, small events at the right time can change the trajectory of growth. Thus, the new theory contradicts the concept of general equilibrium unique and optimal, which implies a reduced capacity to forecast future results.

Also in the 80s, the dedicated analysis of economic development was strongly driven by the strong focus on long-term economic history (North, Thomas, 1973, Rosenberg, Birdzell, 1986, North, 1990). In these studies the authors highlighted the progress in technological and organizational knowledge during the industrial revolution, as the result of the gradual evolution of institutions conducive to capital accumulation and trade (individual freedoms, property rights, effective protection by the law of contracts and the limited power of the state).

The differences between neoclassical and institutional economics come down to the fact that the first treated institutions as exogenous variables only. Langlois argues that "Veblen and his followers wanted an economics with institutions but without theory ... and many neoclassics want economic theory without institutions ..." (Langlois, 1986, p.5)

Criticizing neoclassics, North stated that: "By applying neoclassical theory to historical analysis, specialists in economic history focused on the decisions and constraints, which of course brought only benefits to the economic thought. [...] However, the constraints and decisions did not take into account limitations specific to the organization of human society, but technology and income. ...Even in the context of neoclassical theory, technology has always been an exogenous factor, so it did not really fit in to the theory ... The exception is the contribution of Karl Marx, who tried to integrate technological development with institutional change" (North, 1990, p.132)

3 Institutions matter

Institutions are formed to reduce uncertainty in human exchange. Together with the technology employed they determine the costs of transacting (and producing). It was Ronald Coase (1937 and 1960) who made the crucial connection between institutions, transaction costs and neo-classical theory; a connection which even now has not been completely understood by the economics profession. (North, 1992).

According to the Austrian school perspective of defining institutions, distinguish between designed institutions (pragmatic) that are intentionally designed and implemented by authorized actors (governments, parliaments, spiritual leaders or heads of the church) and organic institutions who arise spontaneously and evolve over time as a result of human action but not of human intention, as Hayek argued.
This definition of institutions does not mean necessarily that all institutions are accompanied by appropriate sanctions for ignoring them, on the contrary. The existence of penalties increases predictability of human behavior, creating coordination of individual actions and social order. Institutions incorporate and structure the incentives of human exchanges, whether political, social or economic. Establishment and functioning of institutions mean the shift from anarchy to order through the introduction and compliance with the rules or norms that guide economic and social life. Institutions are thus the prerequisite and product of the economic order and social life.

Institutions are the rules of the game of a society or more formally are the humanly-devised constraints that structure human interaction. They are composed of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self imposed codes of conduct), and the enforcement characteristics of both. Organizations are the players: groups of individuals bound by a common purpose to achieve objectives. They include political bodies (political parties, the senate, a city council, a regulatory agency); economic bodies (firms, trade unions, family farms, cooperatives); social bodies (churches, clubs, athletic associations); and educational bodies (schools, colleges, vocational training centers).(North, 1992)

What motivates these organizations to mobilize resources, inputs and to innovate? The answer is the rules (institutions) that govern market relations in a society and guide the player’s efforts.

Institutional Economics regards the action and human behavior as being guided by formal laws and property rights, but these, even the most developed market systems, form only a part of all the constraints that shape the people's choices. Of particular importance are informal institutions, ie culture, mentality, customs, changing them is not as easy as in the case of formal rules.

Reevaluating the role of institutions in supporting economic growth is arising from the existence of basic institutional arrangements such as private property, guaranteed contracts, the rule of law in a free society, things advocated by the Austrian school and classical liberalism.

North (1992) also states some essential characteristics institutional change and development:

- The continuous interaction of institutions and organizations in the economic setting of scarcity and hence competition is the key to institutional change.
- Competition forces organizations to continually invest in skills and knowledge to survive. The kinds of skills and knowledge individuals and their organizations acquire will shape evolving perceptions about opportunities and hence choices that will incrementally alter institutions.
- The institutional framework dictates the kinds of skills and knowledge perceived to have the maximum pay-off.
- Perceptions are derived from the mental constructs of the players.
- The economies of scope, complementarities, and network externalities of an institutional matrix make institutional change overwhelmingly incremental and path dependent.

We are therefore witnessing a return to the traditional arguments for economic development by considering the influence of institutional, legal and political factors.

Growth in terms of the institutional economics is based on explaining the availability and efficiency of resources through the influence of incentives and the constraints created by institutional and political environment. These incentives and constraints facing economic agents derive largely from existing institutions who can be effective or ineffective (North, 1990).

Institutions are made up of formal rules, informal norms and the enforcement characteristics of both and it is the admixture of rules, norms, and enforcement characteristics that determines economic performance. While the formal rules can be changed overnight, the informal norms change only gradually (North, 1992).

This means that economic theory will not postulate an adjustment mechanism that is independent and isolated from human behavior and the incentive structure in which the human action takes place. Growth theory, as developed in neoclassical theory, is almost irrelevant in explaining the historical and contemporary progress ...

In fact, the neoclassical economic growth theory not only ignores the historical empirical evidences, but fails to recognize that incentives matter - certainly a surprising position for economists whose theory is built around incentives (North, 1998, p.4).

4 Concluding remarks

An institutional framework that promotes economic progress offers incentives to remunerate productive efforts through lower taxation, laws that protect private property, fewer regulations, and the stability of prices.
Understanding the reciprocity of institutions and human behavior, and the economic implications of this interdependence, meant increasing the importance of institutions in economic theory. Thus, institutional arrangements and their development become key issues in the analysis of processes related to social interaction and coordination of individual actions through the market.

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Acknowledgement:
This work was supported by the project "Post-Doctoral Studies in Economics: training program for elite researchers - SPODE" co-funded from the European Social Fund through the Development of Human Resources Operational Programme 2007-2013, contract no. POSDRU/89/1.5/S/61755".