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Formal and Informal Institutions and Economic Development – comparative research

In the Washington Consensus, which was adopted in the 1980's and 1990's by many developing and former communist countries, apart from capital inflows, deregulation, liberalization and privatization were considered to be of key significance. Openness and privatization strategies in the last 25 years have become worldwide processes covering many countries. This process has had many elements of universal significance, but there have also been many elements specific to a particular group of countries sharing a similar socio – economic structure and a certain position in the world economy.

In the period 2008-2014 I conducted research on development processes in the underdeveloped and medium developed countries in the Central and Eastern Europe, South America, Asia and Africa.[1] Several important conclusions can be drawn from that analysis:

- Undoubtedly reforms to the public sector and privatization prevented the establishment of other ineffective state-owned enterprises. Mere privatization, however, without the creation of a competitive environment and effective pro-market institutions could not fulfill the hopes which were placed on it.

- In many countries the institutional system turned out to be either inefficient (Latin America except for Chile, Asia) or non-existent (Africa).

- General insecurity and instability in such areas as property rights or copyright make economic subjects unwilling to get involved in long-term enterprises, resulting in a lack of necessary investment in fixed assets.

- The example of some countries (e.g. Indonesia, Argentina) shows that even positive economic parameters are not able to prevent financial and state crises. A political crisis, or rather a socio-political crisis, is as dangerous as an upset in the macroeconomic balance. It leads to the loss of those investment activities requiring confidence in the authorities in a given country. The fragility of this trust is particularly obvious in countries with widespread corruption, nepotism and so called "crony" capitalism. The market is ineffective where conditions are weak or where the necessary financial, social, legal or political infrastructure is lacking.

- The example of other countries (e.g. Argentina) shows that market reforms should be a natural consequence of the broadening of market freedom. This country is a good example of how market transformation has little effect if institutional reforms are not realized, if there are no competitive conditions and if corruption and nepotism are not limited.

- In the researched countries one can confirm the theory that effective institutional and legal systems are of key significance for development. These countries have weak state and legal institutions. Their distinct setback is the lack of structural reforms, huge income stratification, fragile investors' confidence and corruption. The thesis of lack of discipline, poor organization, low or inadequate education and knowledge of society can also be confirmed.

- Chile is a good example of an emerging economy with effective institutions (law abiding country, respect for property rights, no corruption) which is developing quite quickly.

- With the example of the researched countries it can be argued that a strong state is necessary particularly with respect to the formation of institutions and providing for their effectiveness.

A Nobel Prize winner Douglas C North (1993) wrote in the World Bank report that it was essential to motivate people, so that they would want to invest in better technologies, increase their capacities and organize effective markets. Such motivation is placed in institutions. What primarily differentiates rich countries from poor ones is the existence and quality of certain institutions. By this I do not mean governments creating new bureaucratic bodies, government agencies, commissions or institutions.

The institutions supporting the market do not have to be public and they do not even have to be formalized.

The most important tasks of institutions include: lowering transaction costs, the costs of launching new products and facilitating access to information. The institutional environment of the market acquires key significance when the issue of transaction costs is taken into account. It is known that the play of supply and demand depends on the level of social confidence and the transparency of functional conditions. These are influenced by the quality of the system, the moral principles and mentality of economic subjects. In other words, market effectiveness, and consequently, the level of transaction costs, depends on the institutions. Institutions and transaction costs are the two deciding factors of market effectiveness.

D. Rodrik from Harvard divides the system of market institutions into four basic categories:

- market – creating institutions, such as property rights, rights guaranteeing contract execution
- market regulating institutions – such as external effects, production scale, information about company activities, etc.
- market – stabilizing institutions – such as monetary and fiscal policy management, etc.
- market – legitimizing institutions, such as social protection, insurances, etc.[2]

According to the World Bank institutions can be divided into public and private ones. The public institutions include the legal and court systems, property rights, copyright, inheritance law, rights regulating and protecting competition as well as the "transparency" of government institutions and private enterprises. The private institutions include: trade chambers, loan and loaner registers, principles of inheriting land, mutuality of business partners, etc.

For the market to function properly there must be an effective legal – institutional infrastructure, the system must be transparent and property rights must be guaranteed. The better the guarantee of property rights and the better the system of debt execution, the easier it is for companies to do business for companies. Strong institutions are particularly important for smaller and weaker subjects. Corruption and poor debt execution are plagues resulting in increased transaction costs. Institutions providing for reliable contracts are a necessary condition for effective markets, underpinning the foundations of rich societies. Institutional stability is a condition for exchange in space and time. A lack of conditions for concluding reliable contracts is a primary cause of stagnation both in developing and in former socialist countries.

Economists agree that **competition** is the best stimulus for economic development. The role of the state should include competition protection and drawing up effective regulations in this area. It is the law that is the most important state institution supporting the market. The more effective it is, the lower transaction costs are for enterprises. An effective market economy should be the main drive of any development strategy but its final success depends on effective competition policy and an effective legal – institutional system. Deregulation, liberalization and privatization serve to achieve those goals, but their effectiveness is limited if they are not accompanied by complementary reforms.

At present economists dealing with economic development *generally agree with the following opinions*:

- Existing development models were rather short-term ones and as such they have often led to negative results. It means that a long- term perspective has key significance for economic development.
- Investments in human and social capital have fundamental significance for success in long-term development.
- Institutions determine developmental efforts, and current solutions in this field in developing countries are not sufficient or even anti-developmental. The adaptation of institutional system (it's worth remembering that the market itself is an institution) to meet the requirements of market economy has key significance.
- Cultural conditions of individual countries should be analyzed in more detail; in some case they seem decisive.
- An incentive system for both for individuals and the whole of society is essential as well as including these solutions into developmental policy;
- The private sector has key significance for economic development but the role of the state

should not be neglected (legal system should help competition, subsidies should develop necessary physical infrastructure and so on).

There is no agreement, however, among development economists in the following issues:

- Methods of reducing poverty and general economic growth acceleration;
- Role of state in initiating developmental processes (top-bottom interventionism or a bigger role for liberal individual choices even at a price of growing social inequalities).
- Role of political factors in developmental processes
- What is the best way of mobilizing social support for development of human capital in a given country, population programs, physical and information infrastructure development, formation of proper financial institutions, as well as for the issues of exchange rate policy, inflation objectives, international capital flow, etc..

Of course a question arises if the experience of other countries, particularly of medium developed ones, has relevance to Central and Eastern Europe. Undoubtedly, we deal with different economic, political, social, institutional and cultural conditions. It is not easy to transfer institutional systems from one country to the other, as in each country there are individual cultural circumstances. Nevertheless, in all analyzed countries there are striking experience similarities related to economy liberalization.

Firstly, privatization without effective competition does not fulfill the expectations which were placed on it.

Secondly, an effective legal – institutional infrastructure is necessary. A pro-market institution system seems to have a key significance for economic development. At the same time fundamental importance is attached to the effectiveness of institutions which create, protect and execute laws (which must be logical and coherent). The whole system of social institutions must also act effectively. In this area the state must be strong and efficient.

Thirdly, in the era of information society, the development of a knowledge – based economy has key significance.

Fourthly, corruption and nepotism, similar to the lack of political stability, lead to the loss of trust among investors.

Fifthly, cultural factors may play an important role in braking or accelerating development. Thus, the general education of society plays a fundamental role in overcoming cultural barriers.

Undoubtedly these conclusions may be fully relevant to our post communist situation. At the present level of economic development, particular significance should be attributed to the creation of a competitive environment, cultural factors (including mentality changes), to fighting against corruption and nepotism and the formation of effective pro market institutions.

In the implementation of those tasks in the post communist member states, the mature institutional system of the European Union (through the adoption of acquis communautaire) has already played a particularly positive role. Effective adaptation of the EU institutional system seems to be much more important than the financial assistance .

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