

## INSTITUTIONAL RESULTS AND THE COURSE OF DEVELOPMENT

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*Abstract: Irrespective of the manner in which these are defined, institutions are correlated with growth, development, prosperity and welfare. Powerful and efficient institutions which belong to the sphere of natural, everyday life, in accordance to the spirit of the law, form the basis and dynamic of the process by which economic performance is obtained. In the present analysis, we deal with two important sets of complementary institutions which are indispensable to the economic growth process: the first set comprises such institutions as property rights, appropriately defined and protected, contracts and formal guarantees, etc.; the second set comprises those institutions which reduce uncertainty in social interactions and encourage trust.*

*Keywords: institutions, development, trust, property rights.*

### I. Introduction

The relationship between formal, informal institutions and economic growth constitutes a widely debated subject within social sciences. Irrespective of the manner in which these are defined, institutions are correlated with growth, development, prosperity and welfare. In the present analysis, we deal with *two important sets of complementary institutions* which are indispensable to the economic growth process:

- *the first set* comprises such institutions as property rights, appropriately defined and protected, contracts and formal guarantees, etc.;
- *the second set* comprises those institutions which reduce uncertainty in social interactions and encourage trust.

### II. The importance of property rights for economic growth and development

The importance of protecting property rights in the economic theory dates since Adam Smith's time. Smith stated that „the first and greatest purpose of every government system is to maintain justice: to prevent the members of society to use another person's property or to take something that did not belong to them”(Smith, 1978, p.5). In the neoclassical economy, property rights are completely and objectively defined in the absence of transaction costs. For these reasons, it is considered that the right of usage of resources will be automatically allocated to the agent which offers the greatest usage value. The zero transaction cost scenario belongs to the theoretical field. In reality, these costs exist, they are positive, and the adjustment of prices on the market can not take place instantly, as the neoclassical economic theory suggests. The existence of *market imperfections*, materialized in incomplete resource revaluation situations, together with an inefficiency in allocating them can lead to imbalance and represent a consequence of neoclassical theories anchored to everyday life. These basic suppositions of the neoclassical paradigm were attacked by R. Coase (1960) in his famous

article *The Problem of Social Cost*, which created the theoretical foundation of the institutions' importance revitalization in economy. Coase's discovery that, on the contrary, transaction costs are important, led to an interest in understanding and explaining institutions. In the Coasian frame, company and private property are the result of efficiency processes of human action. Transaction costs trigger the increase of the importance of property rights, introduce the problem of economic organization and turn the political institutions structure into a key to understanding economic growth. The rather late introduction of transaction costs in the economic theory is due to the fact that most economic theories implied the completeness of information and transaction costs are, one way or another, associated with the expenses for obtaining information related to the exchange (Eggertsson, 1999, p.55).

As Benham appreciates, „in our real world, transaction costs determine property and ownership rights, the commercial exchange dimension, specialization and production. If transaction costs fall, property rights will be more clearly defined, more goods and services will be traded, the positive effects of specialization will increase and great economic advantages will be obtained”(Benham A., Benham L., in Joan M. Nelson , 1998, p.38). The purpose of institutions is to reduce trade costs so that the participants in the economic game could take advantage of the arising opportunities, in other words, they maximize the common wealth of the parties involved. This is done if property rights are well defined and easy to transmit. Where property rights are not well defined and appropriately protected, individuals will direct their investment towards activities which can bring them immediate benefits. In the absence of a clear establishment and application of these, markets will be incapable to reflect the sum of costs and benefits resulted from a transaction within a trade, thus generating externalities. It therefore results that externalities are associated with market imperfections when the economic activities performed on a market do not reflect transaction costs and do not efficiently attach property rights. Moreover, the state machine must be capable to efficiently protect and defend them or otherwise it „is possible that those resources value less in relative terms, be used without the necessity to compensate the owner or other consumers who, in relative terms, put more value on them. If property rights are not easy to transmit, the market can not manage resources successfully because the owner, whose property right is difficult to transmit, will see himself often forced to inefficiently use his natural resource before transmitting it to others, without any compensation" (Soto, 2011, p.161). Therefore, many of the natural resources allocation problems are the consequence of the inappropriate definition and protection of property rights and not of the inefficient functioning of the market.

The quantification of the first set of institutions can be performed by relying on the *Private Property Index*. It is built on the basis of ten variables which are divided in three categories: *Legal and Political Environment (LP)*, *Physical Property Rights (PPR)* and *Intellectual Property Rights (IPR)*. Registered scores are presented on a scale from 0 to 10, where 10 represents the highest level of property rights protection. The below figure shows that the *Property Rights Index* values reach the highest levels in countries such as Finland or Austria.

The opposite is marked by Romania, Croatia, Poland and Malta which register the lowest score. Some of the representative characteristics of the above mentioned countries are the weak government and difficulties in building strong institutions able to support the market and protect property rights. Equally important is the fact that in such societies, the state is

either too weak and incapable to protect against property theft or too strong, himself turning into a threat against property and personal independence.

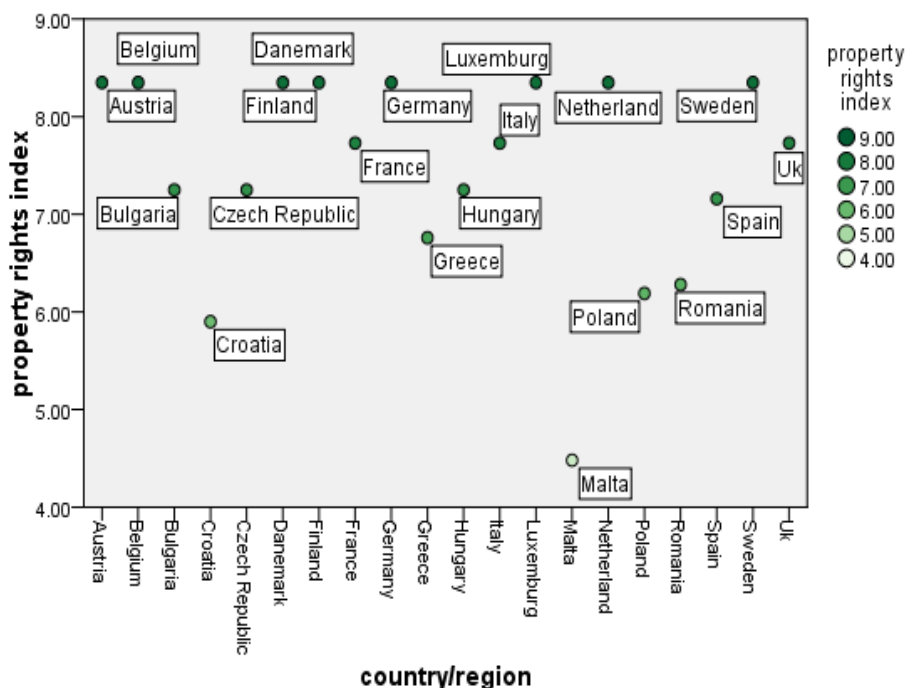


Figura 0.1 Property Rights Index

### III. Trust, transaction costs and opportunist behaviour

As Arrow rightfully states „each commercial transaction essentially contains elements of trust especially if it lasts for some time. It would be true to state that economic underdevelopment can be explained by insufficient mutual trust”(Arrow,1974, p.357). In this ideational context, a wide range of specialty articles studies stressed on the positive role of trust in economic development. Trust contributes to the economic growth and adequate functioning of the economy *due to the following reasons*:

#### a) Trust lowers transaction costs

R. Matthews' definition for the transaction cost is as follows: „it represents the cost of arrangements for closing a contract ex ante as well as the cost of monitoring and of ex post assessment, as opposed to production costs which are costs of the contract enforcement" (Matthews, 1986, p.106). These are the costs associated to discovering and announcing some commercial positions, negotiations, contracts as well as ensuring the integrity of the agreed contract terms. Moreover, the lack of some effective mechanisms able to protect property rights and to ensure the integrity of contract terms leads to the creation of a hostile environment to investment, innovations, etc. The higher the level of trust between partners, the lower the transaction costs of future interactions. These costs are inherent to the price system and may play an important role in making production decisions. If these transaction costs become too high as compared to the price, they may prevent possible exchanges from actually taking place. Fukuyama (1995) notices the importance of property right, law and

contract as fundamental elements in the efficient functioning of institutions on condition that all these are accompanied by trust, reciprocity and moral obligations. As the author stresses, „all procedures which substitute trust lead to high transaction costs. In other words, the prevalence of distrust in society is equivalent to the introduction of a supplementary tax on economic activity in all its forms, a tax which is absent in the societies where the level of trust is high (Fukuyama, 1995, p.148). Therefore, the protection of property rights and minimum impediments to exchange are the institutional characteristics which stimulate economic growth and development. This type of institutional arrangements allows us to follow a sustainable path which leads to economic performance.

*b) Trust reduces incentives for opportunist behaviour*

The opportunist behaviour is considered a serious obstacle in the way of economic development. Different specialists in the field use convincing proofs which demonstrate the negative effects that corruption and the use of public positions have on economic growth. For example, Rose Ackerman's study stresses on the fact that corruption erodes the fundamental principles of democratic governance. Corruption generates negative effects and, for this reason, it is necessary for acts of corruption to be detected and punished. Starting from this perspective we intend to graph the situation of several European Countries regarding the level of trust and opportunist behaviour. In order to measure the *trust* variable, we use the data provided by *World Values Studies* and *Euro Barometer*. The *Control of Corruption* variable measures the perception of the extent to which public power is exerted for self-interest, including corruption at any level as well as the possibility of elites and/or private interests to „capture” the state. The data was provided by the World Bank reports for 2012.

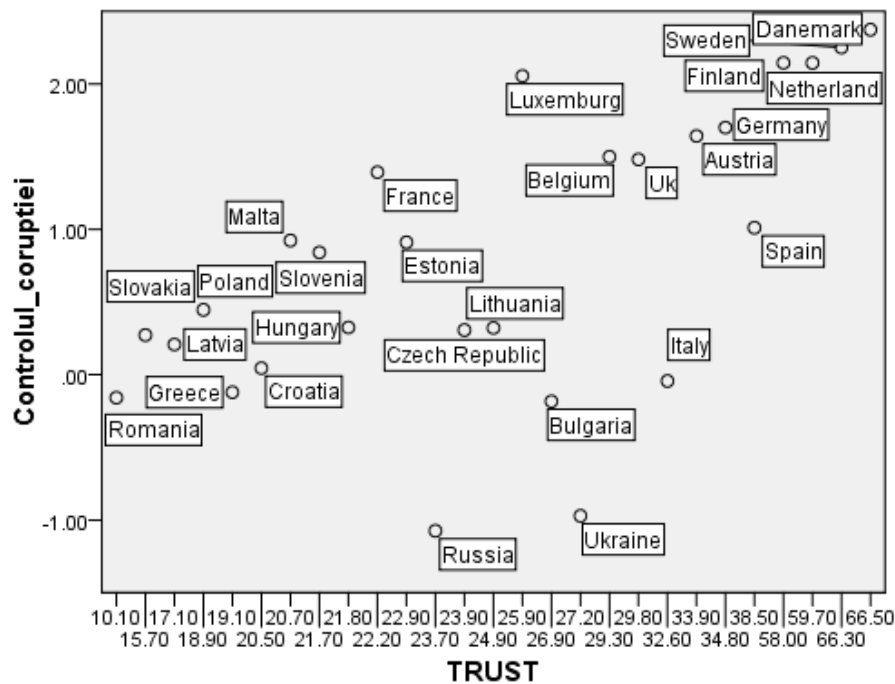


Figura 0.2 Control of corruption and trust

The graph shows that such countries as Finland, Denmark, the Netherlands, Sweden are associated with the highest levels of trust and corruption control. The economic agents' trust in formal institutions, legislative discipline, the decision making process transparency are just a few of the characteristics of the above mentioned countries. On the opposite, Romania and Bulgaria still bear the marks of the past. The great problem these countries have to face is the existence of an opaque decision making system as well as the lack of efficient monitoring, evaluation, and activity control mechanisms. Consequently, in the countries where institutions are weak and incapable to appropriately sanction predatory behaviour, where power abuse and bribery can not be stopped, the costs associated to corruption actions are high. According to the Global Report on Corruption (2012), published by Transparency International (TI), corruption practices constitute a destructive force which strangles economic growth. The costs that companies had to pay as a consequence of corruption practices led to the loss of customers' trust and of potential business partners. We consider that institutional fragility is a consequence of interpersonal trust as well as on the government's credibility in implementing formal rules. This is due to the fact that trust facilitates market exchanges extension, reduces the need of external constraints to respect contracts and social and institutional factors which affect it influence the rates of growth. Moreover, unstable legislative changes in accordance to certain interest groups, power abuse in law enforcement, the incapacity to protect property rights, all these lead to the creation of a corrupt competitive environment which slows down the rhythm of economic development.

### Conclusions:

In order to describe and explain the causes which form the basis of the gaps between nations, various authors in the specialized literature have fundamented their analysis on a different set of explanatory parameters. By using different conceptual and methodological points of view, they offered us original interpretations of the mechanisms which may lead to welfare. The institutional path to be followed in order to support the economy and discuss economic development must include: *first*, those institutions which encourage trust and *secondly*, powerful institutions capable to protect property rights which do not allow any possibility of state „*seizure*” by elites and/or private interests.

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