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## **INSTITUTIONS AS A FACTOR OF (REGIONAL) GROWTH AND DEVELOPMENT**

### **INSTITUCIJE KAO ČIMBENIK (REGIONALNOG) RASTA I RAZVOJA**

#### ***ABSTRACT***

*Regional differences have become a frequent problem in all countries regardless of their development level. However, there are significant disproportions between level differences of a specific country. Many European Union Member States are concerned with significant regional differences as well as differences at their national levels.*

*Determination of regional differences is usually performed according to economic criteria (e.g., GDP, unemployment rate of working-age population, revenues within local government, investments, extraction for education in GDP, foreign direct investments, etc.). However, taking into consideration just the economic indicators most of the time does not give a unique response when considering causes of the differences created. Therefore, the aim of the paper is to determine the institutional impact as a noneconomic indicator in growth and development differences – within-country and between-country differences. In this paper, institutions are considered to be comprised by North's definition (2003, 13), according to which "institutions are the rules of behaviour in a society, or more formally speaking, the restrictions on which man has figured out how to shape human interaction".*

*Focus on economic criteria of monitoring the differences is usually expressed by economic growth. But, development comprises a wide variety of indicators reflecting the welfare of a specific country. Examples of differences within and between a certain country (countries) are going to be the frame for displaying a de facto situation. Besides, as growth and development are sine qua non components of every country, research and contribution of institutions are a necessity.*

*Institutional performance of formal and informal institutions differs significantly.*

*According to the predominance of a specific institutional form, it is possible to outline different guidelines of institutional impact. The purpose of this paper, according to the institutional activity framework in a specific country, is to record the influence on economic development of a specific territory (region) or economy as a whole.*

**Key words:** *formal institutions, informal institutions, economic growth, economic development, regional disparities*

## SAŽETAK

*Regionalne razlike ustalile su se kao učestala problematika zemalja svih razina razvoja. No, značajne su disproporcije stupnja utvrđenih razlika u pojedinoj zemlji. U mnogim zemljama unutar Europske unije prisutne su značajne razlike među regijama, a identična kretanja su zabilježena i na nacionalnoj razini.*

*Utvrdjivanje regionalnih razlika najčešće se vrši prema ekonomskim kriterijima (primjerice, BDP, postotak nezaposlenih u radno sposobnoj populaciji, prihodi unutar lokalnih jedinica, investicije, izdvajanje za obrazovanje u BDPu, strana izravna ulaganja). Međutim, istraživanja samo ekonomskih pokazatelja često ne upućuju na jedinstven odgovor oko uzroka postojećih stvorenih razlika. Ciljem rada se, stoga, nameće utvrđivanje utjecaja institucija kao neekonomskog čimbenika na stvaranje razlika u rastu i razvoju unutar i između zemalja. U ovom radu se pod pojmom institucije podrazumijeva definicija Northa (2013:13) prema kojoj se „institucije odnose na utvrđena pravila ponašanja u određenom društvu, ili formalnije rečeno, restrikcije temeljem kojih se oblikuju ljudske interakcije“.*

*Usmjerenost ekonomskim kriterijima praćenja razlika obično izražava ekonomski rast. No, razvoj uključuje širi spektar pokazatelja ujedno prikazujući i blagostanje pojedine zemlje. Primjeri razlika – između i unutar - pojedinih zemalja bit će okvir za prikazivanje de facto stanja. Osim toga, s obzirom da su rast i razvoj cine qua non komponente napretka svake zemlje, proučavanje i doprinos institucija nalaže se kao potreba.*

*U načinu djelovanja institucija, značajno se razlikuje okvir formalnih u odnosu na neformalne institucije. S obzirom na prevlast vladavine pojedinog institucionalnog oblika, moguće je izvesti različite smjernice utjecaja institucija. Svrha rada je, s obzirom na institucionalni okvir djelovanja u pojedinim izabranim zemljama, evidentirati postojanje utjecaja na ekonomski razvoj pojedinog područja ili gospodarstva u cjelini.*

**Ključne riječi:** *formalne institucije, neformalne institucije, ekonomski rast, ekonomski razvoj, regionalne razlike*

## 1. Introduction

In contemporary economics, institutional economics has been put in the centre of interest of many scientists<sup>216</sup> as a factor that may move the boundary of economic growth and

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<sup>216</sup> E.g., North, 2003; Acemoglu, Johnson & Robinson, 2005; De Soysa & Jütting, 2006; Voigt, 2007; Casson, Della Giusta & Kambhampati, 2010. For more information on the impact of institutions on sustainable economic development, see: Mijiyawa, A. G. (2008): **Economic Growth Sustainability: Do Institutions Matter, and Which One Prevails?**, The Cato Journal, Vol. 28, No. 3, [http://www.isnie.org/ISNIE06/Papers06/05.2%20\(no%20discussant\)/Mijiyawa.pdf](http://www.isnie.org/ISNIE06/Papers06/05.2%20(no%20discussant)/Mijiyawa.pdf), (accessed 15 February 2014).

development (Nelson, 2008). The foundation of institutional economics rests on the view that leading institutions “skilfully” could result in significant progress recorded by economic growth rates and overall well-being of a certain nation shown by the level of development achieved. During the development of economic theory, views of the impact of exogenous factors on economic growth and development have shifted to the endogenous growth theories and impacts. Endogenous variables cover institutional activities intensified in the late eighties of the last century. According to Acemoglu, Johnson and Robinson (2005), institutions were singled out as one of three fundamental causes due to which there are differences between countries. In addition to institutions, the impact of geographical location and culture can also be singled out, but the biggest differences between countries are caused by the institutional framework activity. The authors also provide empirical examples of the impact of institutions on economic progress citing for example the division of Korea and the differences such a division led to. The colonisation of large parts of the world is also mentioned that started in the fifteenth century. There are also numerous other examples of differences conditioned by institutions, as pointed out e.g. by Barković and Lucić (2010); the examples in question refer to the north and south of Italy and the west and east of Germany. We have an interesting example of Switzerland, which is a country that despite its existence outside of the strong institutional framework and institutional activity of the European Union, and due to extremely powerful institutions it owns, it ranks high in developed countries. North (2003, 1) emphasizes institutions as *incentive systems that structure human interaction*. Furthermore, it is important to know institutions to be able to solve problems encountered on a daily basis effectively since everyday life situations are not imbued exclusively with economic activities, but also with political and social aspects, whose efficiency is evident from a successful combination of all the aforementioned spheres.

The definition of institutions and their activity is multidimensional, as can be seen from a number of different aspects of the notion of institution. The paper accepted the definition of institutions provided by Nobel Laureate North (2003,13), according to whose definition *institutions are the rules of behavior in a society, or more formally speaking, the restrictions on which man has figured out how to shape human interaction*. Although this definition offered by North is widely accepted, Voigt (2007) points out that many scientists under institutions imply a simplified definition of institutions encompassing them as determined by the rules of the game.

The paper is organised as follows. The chapter after the introduction focuses on clarifying the differences between formal and informal institutions and the impact on economic growth and development as well as cases and examples referring to the formal and the informal institutional activity. Chapter 2 provides an overview of the impact of formal versus informal institutions with reference to levels other than just national, i.e. focus on the regional level. Given that regions are becoming the central focus of economic policy makers in the implementation of some form of authority, it is necessary to determine the effect of the institutional framework at lower territorial levels as well. Chapter 3 gives concluding remarks about different institutional activities and the impact such activity has on economic growth and development. Thus, the conclusion provides a link of a single institutional framework to the degree of economic growth as a determinant of economic performance. In addition to the earlier demarcation referring to activities of formal and informal institutions, the issue of measuring the impact of institutions is also introduced - norms, morals, values and behaviours.

## 2. Formal and informal institutions: impacts on economic growth and development

Achieving economic growth recorded by quantitative macroeconomic indicators, and then reaching qualitative indicators of well-being or quality of life, is surely one of the fundamental objectives of any economy. The impact of institutions on economic growth is possible and can be determined given the prevalence of formal or informal institutions. Thus, the ratio of representation of one or the other institutional framework can either improve or worsen the performance of the economy as a whole or certain parts of the national economy.

Numerous studies have confirmed the influence that institutions have on economic growth and development (North, 1991; Acemoglu, Johnson and Robinson, 2004; Acemoglu, Johnson and Robinson, 2005; Valeriani and Peluso, 2011; Ferrini, 2012). Some authors, such as Valeriani and Peluso (2011) believe the quality of institutions is an important component of the impact on economic growth and test it based on three institutional variables. In relation to economic growth, the domain of economic development has much wider impact and it is often very difficult to make a clear-cut distinction between them. Economic growth represents a quantitative component of economic progress usually expressed by GDP data, while development is a subjective component that in addition to quantitative indicators also includes well-being within a particular economy.

Voigt (2007, according to North, 1990) highlights North's classification of institutions in formal and informal institutions, and expresses his personal attitude that there are external and internal institutions, as well as economic and political institutions. Barković and Lucić (2010) point out that there are several classifications in institutional economics mentioning the following as a criterion: i) the degree of formality, ii) the hierarchy, and iii) an area they "govern".

The paper will be focused on a more detailed overview of institutional activity by the level of formality, i.e. formal and informal institutions (Table 1). De Soysa and Jütting (2006) point out that formal institutions usually base their activities on official entities (such as courts and police), while informal institutions refer more to self enforcing through mechanisms of obligation.<sup>217</sup> According to De Soysa and Jütting (2006; according to Helmke and Levitsky 2003; Pejovich 1999), informal institutions are defined as *a behavioral regularity based on socially-shared rules, usually unwritten, that are created, communicated, and enforced outside of officially-sanctioned channels*.

Table 1 Classification of institutions by the level of formality

Formal institutions	Informal institutions
Constitution, statutes, common law, regulations and other government decisions.	Tradition, customs, moral values, religious beliefs and all other standards of conduct adopted over time.
Formal rules are straightforward – they are specific and defined precisely.	Informal norms are ways of doing things.

Source adapted according to: Barković, I., Lucić, N. (2010): *Uloga institucija u ekonomskom razvoju: prirodni (povijesni) eksperimenti*, Pravni vjesnik, Vol. 26, No 2, pp. 69-87; North, D. C. (2003): *The Role of Institutions in Economic Development*, UNECE Discussion Paper Series No. 2.

North (2003) demonstrated the interaction of mutual influence of formal and informal institutions quite credibly by using the example of Latin American countries that took over the Constitution of the United States of America in the time of their independence (early nineteenth century), considering them extremely structured. However, given the very different

<sup>217</sup> Classification of institutions by the level of formality is shown in Table 1.

historical development of informal institutions of Latin American countries, the implementation of formal institutions has not been successful.<sup>218</sup>

In order to determine the degree of impact of institutions on economic development, Voigt (2007) proposes the necessity of measuring such impact. In addition to that, he also stresses the difficulties in measuring the impact of institutions and proposes some of the possibilities for their measurement. There are several basic assumptions regarding contributions of Voigt's studies to measuring the impact of institutions. They refer to the following assumptions: i) when measuring institutions, specific institutions that are covered should be clearly defined since otherwise measures remain too broadly defined and do not provide any meaning, ii) objective measures are preferred to subjective measures, iii) the impact of institutions is measured with respect to formally executed legislative specification (*de jure*) and as part of the impact realised practically (*de facto*), and iv) the ability to measure the institution does not imply the possibility of creating and measuring institutions at will. By examining Table 2, we get a clearer picture of the need for measuring institutions. The dark cell presents the most effective combination of measurements, while the cell shaded gray requires most resources, but it is necessary to take them into account since only knowledge of the data of these two cells enables their comparison.<sup>219</sup>

Table 2 Matrix of types of institutions and ways to measure

		Way to measure:	
		subjective	objective
Type of institution:	<i>De jure</i>		
	<i>De facto</i>		

Source: Voigt, S. (2007): *How (Not) to Measure Institutions*, <http://siteresources.worldbank.org/DEC/Resources/voigtfinal.PDF>, (accessed 6 February 2014)

In addition to differences appearing due to the dominance of either the formal or the informal institutional framework, the institutional framework may be a holder of various forms of social power. Acemoglu, Johnson and Robinson (2004) point out that economic institutions determine the incentives and constraints to economic holders and determine the final economic outcomes. For example, different groups and individuals realise the benefits of various economic institutions whose benefits are typically focused on groups with greater political power. Furthermore, the distribution of political power is determined by political institutions and the distribution of resources; and in accordance with the aforementioned, it follows that political institutions possess and allocate political power *de jure*, while groups with greater economic power possess more *de facto* political power. In addition to the differences and the desire for achieving power on the *de facto* and *de jure* level, effective performance of institutions can indeed provide the desired response in determining the question of differences between individual economies.

Given the different conditions prevailing in a particular economy, it is impossible to establish a unified scheme of the institutional framework activity. An authentic example of the transfer of the economic impact to the institutional framework are transitional processes conducted by

<sup>218</sup> For an overview of different standpoints referring to the interaction of formal and informal institutions, see: Marošević, K., Jurković, Z. (2013): **Impact of informal institutions on economic growth and development**, in: Barković, D., Runzheimer, B. eds.: *Interdisciplinary Management Research IX*, pp. 701-717.

<sup>219</sup> Only mutual comparison yields the objectivity of data.

various dynamics and scope, but also countries of Central and Eastern Europe covered by various degrees. Redek and Sušjan (2005) provide a review of the institutional framework activity in transition economies and establishing changes towards the capitalist system that followed in relation to the previously existing system. The authors focus on the analysis of the importance of the quality of institutions in economic performance in transition economies. By reviewing the status and trends within ten transition economies in Eastern Europe, Cernat (2001), for example, explores how institutional factors have an impact on economic growth. Results of this research confirm the former view and suggest a correlation between the quality of the established institutional framework and economic growth.

Significant differences that appear between countries are usually expressed by indicators of economic growth achieved or by a degree of economic development achieved. However, the differences that occur at national level - between economies - are considerably less than the gap that has been recorded between the regions of the national economy. Globalisation effects within the European Union have been achieved by developing regions as territorial units, and the creation of the single market has significantly contributed to the removal of borders and led to the establishment of the region as the basic territorial unit. Regional division harmonised with the *Nomenclature of Territorial Units for Statistics* (in French: *Nomenclature des unités territoriales statistiques*, NUTS) in all European Union Member States has resulted in easier management and comparison of the existing differences. Therefore, recording the difference at regional level has become imperative, and management in regions lagging behind has been adapted to specific requirements of the territorial area.

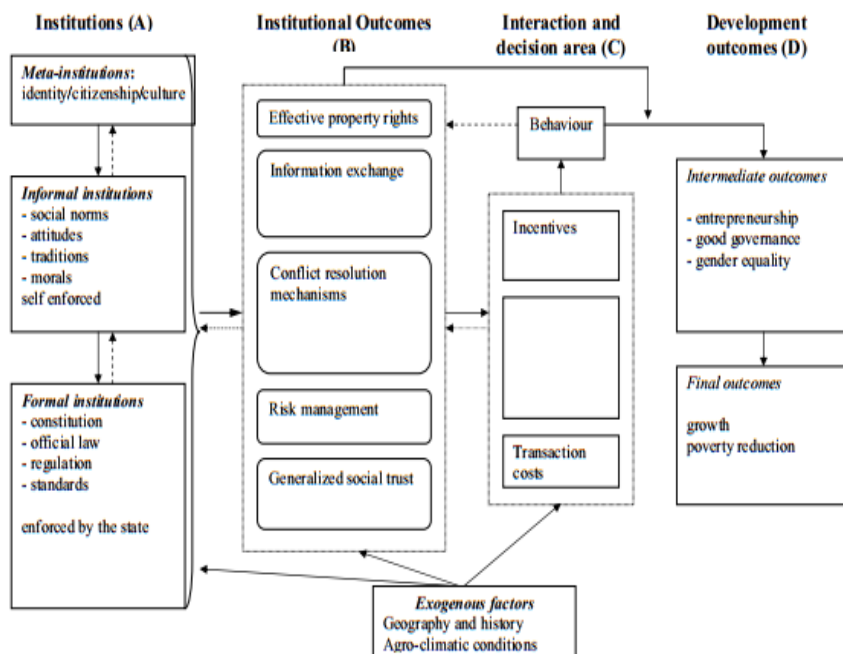
As already exemplified by various studies on the impact of institutions on economic growth and development, the identical direction of the impact is also expected to be recorded at lower territorial units, e.g., regions.

Given the significant differences between the formal and the informal institutional activity and their impact on economic growth and economic development, Figure 1 additionally clarifies the impact of both exogenous and endogenous variables. As pointed out by De Soysa and Jütting (2006, according to Hechter and Opp, 2001), the formal institutional framework does not act in isolation with respect to the informal institutional framework shaped in social culture, but the view of accepting such influence is neglected due to the difficulty of expressing the quantitative impact of informal institutions.

As outlined by *Applied Knowledge Services*, if the state has weak formal institutions, it is not uncommon for informal institutions to prevail over informal institutions and thus complement the specific functions expected from the state. Skoog (2005; according to Kasper and Streit, 2008) highlights an important role of not only the relationship between formal and informal institutions, but also of a dual relationship that exists between the holders of a certain type of the institutional framework (or human behaviour) and institutions. Mutual influence is reflected in the following way: the rules affect holders and restrict or encourage certain kinds of behaviour. Thus, a particular institutional framework stimulates human behaviour and activities. But, the institutional framework is also subject to constant change - and it is clear that people determine and govern the rules. Therefore, feedback confirms that the rules are made and determined by human behaviour. Holders should be brought into interaction with the institutional framework since institutional activity is always in interaction with the holders.

In addition to interaction at this level, numerous other influences are also possible. Figure 1 emphasizes possible interactions of institutions, institutional outcomes, interaction and decision areas and development outcomes. Indicators in institutional settings are visible in economic growth and poverty reduction. Institutional development can certainly have a positive effect on development outcomes, and according to Skoog (2005), institutional development includes institutional changes that promote sustainable economic, political and social development and a positive value. It is often identified with institutional changes, which is by no means identical – they involve a change or modification of existing rules or the creation of entirely new rules regardless of the final outcome of the change (positive or negative). However, the term institutional change applies to effective changes. There are two types of institutional changes - formal (consciously created and applied) and informal (spontaneous, occurring in unintended outcomes of individual and social interactions) - directed by activity of two types of institutions.

Figure 1 Effects of exogenous and endogenous factors on development outcomes



**Source:** De Soysa, I., Jütting, J. (2006): *Informal Institutions and Development – What do we know and what can we do? Informal Institutions and Development: Think Local, Act Global?*, OECD, <http://www.oecd.org/dac/governance-development/37790393.pdf> (accessed 11 February 2014)

Williamson & Kerekes (2011) emphasize the need for additional research into contributions of institutions to the process of economic development. Using culture as an indicator of informal institutions, we establish a positive and significant effect on property rights while formal institutions do not have a significant effect on the security of property. This fundamentally changes the view of the contribution of informal institutions to securing property rights, which enhances the development of developing countries. Even in his earlier

papers, Williamson (2009) highlights the necessary mutual interaction between formal and informal institutions in achieving economic growth. However, she stresses that the presence of informal institutions is a strong determinant of development and that the formal institutional activity can be successful only if they comply with informal constraints, which corresponds to the popular phrase “*Getting the Institutions Right*”. Looking at institutions with regard to the strength of formal and informal institutions, the author has made the division by four categories: i) strong formal and strong informal institutions, ii) weak formal and strong informal institutions, iii) strong formal and weak informal institutions, and iv) weak formal and weak informal institutions. Best results in terms of the progress of a country expressed by GDP were recorded in countries that have strong informal institutions, regardless of the strength of formal institutions (Table 3). The values in Table 3 are expressed as indices for formal and informal institutions. The larger the index in formal and informal institutions columns, the greater the strength of that institution in a particular country.

Table 3 Index of formal and informal institutions of selected countries

Country	Formal	Informal	Ratio
Austria	0.38	5.90	0.06
Belgium	0.46	4.24	0.11
Denmark	0.62	9.25	0.07
France	6.23	5.05	1.23
Germany	4.91	5.42	0.91
Greece	4.68	3.06	1.53
Italy	1.54	4.69	0.33
Netherlands	0.52	9.34	0.06
Norway	0.62	6.62	0.09
Spain	4.75	4.21	1.13
Sweden	0.96	10.00	0.10
Switzerland	5.09	5.88	0.87
Turkey	0.96	2.52	0.38
United Kingdom	10.00	3.89	2.57

Source according to: Williamson, C. R. (2009): *Informal institutions rule: institutional arrangements and economic performance*, Public Choice 139, pp. 371-387, [http://www.claudiawilliamson.com/Claudia\\_Williamson/Research\\_files/Williamson%20Public%20Choice%202009.pdf](http://www.claudiawilliamson.com/Claudia_Williamson/Research_files/Williamson%20Public%20Choice%202009.pdf), (accessed 13 February 2014)

Formal institutions govern political, legal, economic and social components and they are usually given in writing (i.e. a legal text or a constitution). On the other hand, factors that influence human behaviour that are not given in writing because they are conditioned by norms, values, habits and traditions belong to informal institutions. Since informal institutions are determined by social behaviours and beliefs, they form the basis of the creation of formal institutions (Dobler, 2009). Shikida, de Araujo Jr. & Sant’Anna (2011) also confirm the position mentioned earlier as to an increased contribution of informal institutions to defining better management, while Pitlik & Kouba (2013) are oriented more toward identifying the key components as determinants of an informal institutional framework that include stable cultural and social norms, agreements, moral values and other.

De Soysa & Jütting (2007) suggest ways in which informal institutions influence the development and causes of changes of the activity of informal institutions. People rely on informal institutions as drivers of prosperity in countries of different stages of development - that is, in both poor and rich countries. However, informal institutions are much more important in poor countries and in less traditional societies and communities where formal institutions are less developed - which suggests that formal rights and state power are rather less developed. Furthermore, identical informal institutions in different environments can lead



to completely different institutional and development outcomes due to different reactions with regard to the existing formal institutions. An example of the reverse influence are the governments, which as part of formal institutions, can extend their influence to informal institutions – the government sets the rules of the game.<sup>220</sup>

Although all the aforementioned research examples specifically refer to the national level, it is assumed that the impact of informal institutions achieves equally valuable and positive effects on economic growth on lower levels as well, e.g. a regional level. The next subsection gives an overview of attitudes and trends of institutional effects on economic development at regional level.

## **2.1. Regional impact of formal and informal institutional framework**

Although the issue of the impact of institutions on economic growth and development in modern economy is significantly more prevalent in the scientific milieu as it used to be before, studies on the same issue are almost completely ignored at regional level. The same view is confirmed by Degirmenci (2011) claiming that the results of the impact of institutions on economic growth vary at regional level in relation to the national level of the same economy – regardless of the fact that economic regions include the same national space as well as the overall economy. Thus, although formal institutions are specific to the national level embracing in this way all formal institutions at regional level, their density and quality varies greatly in different regions. It is therefore crucial to include institutions in the generators of regional economic growth and regional development policies. In order to determine the current impact of institutions at the level of European regions, certain measurements of the impact of culture on economic development were carried out, such as research conducted by Tabellini (2005).

Ascani, Crescenzi & Iammarino (2012) emphasize a regional approach to development as a solution to regional specificity - the accepted norms, a combination of rules and social relations - which also represent the factors that create differences and gaps in the development of the region. A typical application of policies is top-down, but a bottom-up approach is considered a considerably better management policy in relation to top-down policies that have been frequently used so far. Decentralised management of power and resources is formed in this way, and the central management database is made up of regions as central territorial units. Therefore, decentralisation is an opportunity offered to heterogeneous regions to become the framework of economic growth adapted to specific requirements and needs.

Adapting to the specific needs creates the possibility of creating appropriate strategies. Rodriguez-Pose (2010) gives suggestions of the possible impact of institutions on regional development and the integration of institutions by means of regional development strategies. He identifies not exactly defined effective institutions in regional development strategies as a barrier to implementing institutions and ensuring economic growth. At regional level, he also highlights the problem with the ratio of the activity of formal and informal institutions and the strategies developed at national levels to suit all regions of a particular economy that are very

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<sup>220</sup> An example of mutual influence is the implementation of a specific norm that would be applied much easier and simpler by means of the decision and help by the Government, e.g. smoking in public places. For a more detailed view of examples of the effects of mutual influence of formal and informal institutions, see: Pejovich, S. (1999): *The Effects of the Interaction of Formal and Informal Institutions on Social Stability and Economic Development*, Journal of Markets & Morality 2, No. 2, 164-181.

difficult to implement. It is therefore necessary to adapt development strategies to the conditions of various regional institutions to ensure maximum effectiveness of their activity.

### 3. Conclusion

The impact on economic growth that can be achieved by the institutional activity is unquestionable. However, various forms of institutional activity lead to different rates of economic growth. Since in this paper the degree of formality is taken as a determinant of the division of institutions, the activity of formal and informal institutions and their impact on economic growth are studied accordingly. Although by its scope economic growth denotes a narrower component in relation to economic development, it is not a necessity, but it can be a good assumption in achieving economic development.

In order to determine the impact of institutions on economic growth, it should be measured. Measuring the impact of formal institutions is much simpler compared to the impact achieved by informal institutional activity. However, although it was recorded that informal institutions achieve a greater positive impact on economic growth, significantly less research is focused on the activity and measurement of the impact of informal institutions. Therefore, it is necessary to deepen and increase the number of studies focused on the study of the impact of informal institutions.

When it comes to the strength of formal and informal institutions, research results suggest a classification based upon four categories (strong formal and strong informal institutions; weak formal and strong informal institutions; strong formal and weak informal institutions; weak formal and weak informal institutions). Furthermore, such categorisation has confirmed the view outlined earlier referring to the need for placing informal institutions at the centre of research in promoting economic growth.

Institutional activity differs at national and regional level. As regions have become drivers of economic growth and development in economies, due to the effects of globalisation and the removal of national borders, the need has arisen to form and monitor institutions at levels other than national. Since strategies for institutional management mostly refer to national levels, it is very difficult to adapt them to the conditions prevailing in each region. It should be noted that in recent years authorities are trying to delegate powers to a lower territorial level in relation to the national, i.e. regional, and by bringing their own knowledge about a particular region economic power holders affect the spread of prosperity in regional areas.

Hence it is necessary harmonise institutional activity with the needs of the respective region. However, regardless of the difficulties and specificities of a given area, institutional management at regional level is an open opportunity of generating economic growth whose potential must not be neglected.

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