IMPACT OF INFORMAL INSTITUTIONS ON ECONOMIC GROWTH AND DEVELOPMENT

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ABSTRACT

Achieving the long-term economic growth rate and development is the aspiration of all economic policy makers. Contemporary economic theory recognizes institutions as fundamental sources of economic prosperity. According to Douglas North (1991), institutions represent designed limitations that manage political, economic and social interactions. Precisely, *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* (North, 2003:13). Besides formal institutions, i.e. constitutions, laws, property rights, informal institutions encompass customs, traditions and codes of conduct. Although more attention in developed economies is devoted to formal institutions, many authors deal with informal institutions as objects of their research.

The purpose of this paper is to present institutions through the function of economic growth and development. Besides, the purpose is also to consider the relationship between formal and informal institutions. Informal institutions are thoroughly presented through a series of examples which define and analyze their impact on development outcomes.

JEL classification: E26, O17

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1. Introduction

Achieving high rates of economic growth and development is the desire of every modern economy. Because of that, the focus of contemporary economic theory is often directed towards the issue of poverty, the achieved degree of democracy and the achieved degree of economic rates of individual economies. Different theories explain the causes of various economic development and social stability. Lately, there have been two hypotheses (geographical and institutional) that explain why some economies achieve higher growth rates, while others stagnate or are on a downward trajectory. According to the geographic hypothesis, the underlying reasons for the differences in the development are exogenous differences in the environment, whereas the institutional hypothesis determines a social organization and is focused on institutions as the rules of the game. The importance institutions have has increased, providing the reasons for the difference in economic growth and development of certain areas. Institutions are usually defined as the humanly devised constraints that structure political, economic and social interaction of people. There are formal (constitutions, laws, property rights) and informal institutions (customs, traditions, codes of conduct, etc.) whose rules have been changing throughout history in order to reduce uncertainty in the process of economic exchange (North, 1991). Economic institutions significantly affect economic incentives in society and the achievement of certain economic outcomes, that may be formed through formal or informal institutions. Through formal institutions, individuals may, e.g. because of the structure of property rights, be encouraged to invest in human and physical capital, and thus improve the achievement of certain economic outcomes.

By increasing human and social capital certain communities reach a more efficient use of the institutional framework (Glaeser *et al.*, 2004). Institutions are increasingly becoming the result of various studies (Farrell & Héritier, 2003; Hodgson, 2006; Casson *et al.*, 2008). However, the observation of the institutional framework is most frequently focused exclusively on formal institutions. In addition to formal institutions, a significant impact is achievable through informal institutions as well. There are numerous ways in which institutions are defined. One of the definitions implies that institutions are established and embedded social rules governing social interactions. Also, it is necessary to specify that institutions differ significantly from the rules, agreements, organizations or habituation. When classifying institutions into formal and informal, we refer to the impact non-legal rules and unclear standards have on formal institutions. Thus, legal or formal institutions that do not have strong "informal" supports are unsupported legislative declarations rather than real institutions (Hodgson, 2006). A much broader definition implies under institutions the rules of the game or humanly devised constraints that shape human interaction (North 1990). Institutions help to reduce uncertainty in decision making and behavior. Furthermore, in the world without institutions we would not know how to behave in mutual human interactions. Therefore, institutions may be deemed success factors in achieving their daily business activities and effective problem solving. However, with the exception of a stimulus to certain behavior and decision making in the economic domain, they also affect the political and social activity (North, 2003). Economic development can be achieved through institutions by different economic and social conditions. In doing so, it can be said that the hypothesis on the impact of institutions on economic development is presented by affecting humans. This position is focused on supporting the rule of law, investment in machinery, human capital, and an improved version of technology (Acemoglu *et al.*, 2003).

Formal institutions and their influence are discussed more often, and in relation with formal institutions, the impact of informal institutions is often neglected and marginalized. However, positive examples of synergy of formal and informal institutions have also been recorded. The classification of formal and informal institutions was developed by Douglass C. North, who uses two criteria by which a distinction between the institutions is made: i) the degree of formalization of institutions (written and unwritten), and ii) their emergence and change (Theurl & Wicher, 2012). The classification of institutions is most frequently done based upon the criteria of content coverage in four different categories of institutions: i) political, ii) legal, iii) economic, iv) cultural/social institutions (Theurl & Wicher, 2012; according to Acemoglu & Johnson 2005:949).

Apart from the positive examples of synergy of formal and informal institutions, we are also familiar with some other different cases, whereby the outcome of the institutional framework itself is much worse. As an example, we can mention the situation in which there have been attempts aimed at implementing the policy of New Public Management, that might shake the established informal forms of influence, with the possibility of endangering social stability (De Soysa & Jütting, 2007). Within the framework of the definition, informal institutions refer to extension, argumentation and codification of formal rules that go beyond the official limits, socially punishable norms of behavior, including behavior, customs, adopted rules of behavior and tradition. In relation to informal institutions, formal rules and institutions refer to constitutions, laws, property rights, contracts, books of rules, legal provisions and regulations (De Soysa & Jütting, 2006). A stronger influence of informal institutions in relation to the rule of law commonly occurs in certain periods of crisis, such as war (Cousins, 1997; according to Thompson, 1991). Simply put, the institutions are formed according to the official rules, informal constraints and their enforcement characteristics. Formal rules are usually always very clearly defined assuming specific rules covering laws, constitutions and regulations and all other well-defined specific rules. Informal rules of behavior are much more complex and they include the way in which certain things are done, whereby the norms as part of an informal institutional framework become almost more important than formal rules of behavior (North, 2003).

The structure of the paper is as follows. The introductory part of the paper presents the role, significance and influence of institutions as one of the factors of long-term economic development. In addition to formal institutions whose meaning is supported by the economic literature and research, the central part of the paper considers the activity, effects and importance of informal institutions. This structure of the paper provides the conditions for drawing conclusions.

2. The impact of institutions on economic development

The literature of economics, just like the literature of other social sciences, speaks in favor of positive effects generated by institutions on economic development (North, 2003; Acemoglu, Johnson & Robinson, 2004; Chang, 2005; Williamson, 2009). Economic theory that emphasizes the importance of economic development often considers the institutions to be the engines of economic development. The geographical position of a country is an additional element that may participate in the initiation of economic development and the effects of the geographical position oppose the effects of the institutional framework. The impact of the geographical position on economic development is confirmed by the fact that most of the areas around the equator are characterized as less developed, and they are condemned to a small amount of agricultural activity and production. When considering the effects of geographical location in relation to the role of institutions, it is necessary to point out that economic development of the country is observed through the natural effects, while the impact of institutions is analyzed through the man-made effects.

Some institutions, as well as well-defined and secure property rights, the rule of law, and political constraints, are of great importance in ensuring economic development. In doing so, the way in which the meaning of institutions is formed is often exempted (Williamson, 2009). The inability to establish a uniform rule under which it is possible to achieve economic development stems from the limitations of establishing a uniform definition of institutions. However, several different formats and functions of institutions are found in the service of achieving economic development. Chang (1998) identifies three basic functions by which economic development is affected by means of an institutional approach: i) coordination and administration, ii) learning and innovation, and iii) redistribution of income and social cohesion (Chang, 2005). Some suggestions that may be used for achieving economic development are achievable through mapping of formal rules to informal, but in the existing institutions (Williamson, 2009; according to Boettke *et al.*, 2008).

When talking about specific examples of some of the effects of institutions on economic development, the examples of South and North Korea, West and East Germany, and the differences between institutions and economic development in the north and the south of Italy are pointed out (Barković & Lucić, 2010). By 1945, North and South Korea were part of the same history and culture. Thus, North and South Korea were ethnically, culturally, geographically and economically homogenous. After the changes, North Korea adopted a socialist model that was followed by the abolition of private property and capital. On the other hand, South Korea adopted a model of private ownership and management. An example of significant differences created by institutions can be found in the paper written by Acemoglu *et al.* (2002) on the African country Botswana. In comparison to other African nations, the presumption for success of this country through the exercise of long-term economic growth lies in good institutions (Acemoglu *et al.*, 2002). Furthermore, a reference to good institutions relates to: i) enforcement of property rights for a broad cross-section of society that would enable a variety of individuals to have incentives to invest and take part in economic life, ii) constraints on the actions of elites, politicians and other powerful groups such that these groups cannot expropriate the income and investments of others in the society, creating in this way a highly uneven playing field, and iii) creation of equal opportunities for the whole population to enable simple investments, especially in the segments of human capital and participation in certain productive economic activities (Acemoglu *et al.*, 2003).

Although good institutions include constraints on the actions of elites, politicians and other powerful groups and limiting effects of unequal conditions, different groups and individuals have different benefits from the effects of certain economic institutions, and that is achievable through the segment of political influence. Thus, it can be said that economic institutions determine the incentives of and constraints on economic actors, and shape economic outcomes (Acemoglu *et al.*, 2004). Also, those institutions that meet a predetermined function and purpose for which they were created excluding thereby other negative effects may also be considered good institutions. Good institutions can remain characterized as such, including those effects that go beyond the limits of functions they were designed for. Thereby the problem of measurability of the effects generated by the institutions is encountered. An example of the IMF, which is considered a good institution can be used as an example of the deviation of effects of that institution in relation to initial assumptions the institution should have performed. It was created to promote economic stability worldwide and help to achieve full employment in some economies. However, there have been examples where countries were pushed into recession, and the situations in which countries were encouraged to liberalize their markets that led to global economic instability. By observing this institution through a functional perspective, according to the segments of what it was envisaged for, it could no longer be claimed that it implies and is subject to the criteria of a good institution. However, it should be stressed that this way of seeing the institution as a good or a bad one is only one of the possible approaches to functional assessment of institutions (Stiglitz, 2000). Although the IMF is an institution (Blanco & Carrasco, 1999), sometimes it is put into the context of an organization. Organizations include households, businesses, government, established in accordance with certain preferences and goals, while institutions include formal and informal social constraints, i.e. certain rules of the game. Furthermore, when making a difference between organizations, economists usually speak about either individuals with their own goals or artificial structures serving the goals of members of a certain organization (Khalil, 1995).

In addition to effects produced by informal institutions, it is also necessary to mention the way in which certain rules are governed, and the way of governing, as well as institutions, can refer to both formal and informal (Table 1).

Table 1. Differences between Relation-Based and Formal Rule-Based Governance

Relation-Based Governance	**Rule-Based Governance**
Relying on private and local information	Relying on public information
Complete enforcement possible	Enforcing a subset of observable agreements
Implicit and non-verifiable agreements	Explicit and third-party verifiable agreements
Person-specific and non-transferable contracts	Public and transferable contracts
High entry and exit barriers	Low entry and exit barriers
Requiring minimum social order	Requiring well-developed legal infrastructure
Low fixed costs to set up the system	High fixed costs to set up the system
High and increasing marginal costs to maintain	Low and decreasing marginal costs to maintain
Effective in small and emerging economies	Effective in large and advanced economies

Source of data: OECD (2007); according to Li & Park (2003). Available at: http://www.oecd.org/development/governanceanddevelopment/37790183.pdf, (8 February 2013)

There are significant differences arising from the two governance mechanisms which contradict governance based on trust in persons and governance based on trust in rules. Informal governance mechanisms are based on trust in persons rather than on a formal set of rules. In the given governance mechanism, there is a high degree of autonomy from economic and civil society and no strong formal state authority regulating the market, enforcing contracts and ensuring property rights. Although it is impossible to determine a unique orientation of governance in a particular country, it generally holds that in developed countries the economy and the state are dominated by formal rules, while developing nations are focused more on informal governance mechanisms. Singapore and South Korea are examples of countries where informal governance has significantly complemented or even entirely substituted formal governance (OECD, 2007).

3. Informal institutions

Various analyses and research studies (e.g. Seyoum, 2009; Puffer *et al.*, 2010; Beyer & Fening, 2012) place emphasis exclusively on the presentation of impacts and activities of formal institutions and the rule of law, property rights or patent rights. The impact of informal institutions was often entirely neglected in the above mentioned studies. Informal institutions also express their (huge) importance through the ability to slow down or speed up the process of economic development. But, in order to fully understand the impact of institutions on the process of economic development, it is necessary to observe the mutual interaction of formal and informal institutions. The rule that could be applied to development policies of specific countries refers to situations in which formal institutions that have been well-proven cannot be transferred easily to another country with different informal institutions. Therefore, it is essential that reforms of formal institutions be included in order to be compatible with local informal institutions, which are subject to change, but they change more slowly (Domjahn, 2012). There follows an example of the case of unsuccessful transfer of the formal institutional framework to some other economy. In the early 19th century, Latin American countries declared their independence and as part of their formal institutions they took over the US Constitution. Since completely different informal rules are valid in Latin America, there was no success in applying the Constitution which applies in the USA. Hence it is impossible to determine unique formal rules for each economy, given that informal rules governing economy are an important factor. According to Williamson (2009), achieving economic development is even more powerful through informal rather than formal institutions.

The existence of both formal and informal institutions is beyond question, but their natures differ significantly. Formal institutions are oriented towards public scrutiny and provide a framework of recognizable forms of the society as a whole, whereas informal institutions are harder to identify, partly because their rewards are less well articulated. However, success of informal institutions are usually certain specific behaviors determined by a particular social group (Alonso, 2009). Impacts of informal institutions are not subject to any measurement in the same scope as is the case with the influences created by formal institutions (Knowles & Weatherstone, 2006). Countries with a lower level of democracy are usually associated with the informal institutional framework, while countries with a high level of democracy are oriented towards ethics and political factors that are associated with the written rules. A poorly developed system of the rule of law is commonly present in countries with a lower level of democracy, and it is often set depending on the application of personal rules or community rules. Also, the influence of formal institutions may be weakened due to equalization of certain political factors with common practice examples (Bratton, 2007). By observing the mutual relationship between formal and informal institutions with respect to consideration of their political influence it is possible to notice a typology and a framework based on the model of the interaction of formal/informal institutions. The given model includes the following possible interactions: complementary, accommodating, competing and substitutive (Table 1). A common mistake occurs in relation to a definition and the content of informal institutions, whereby they are sometimes also considered as a category that includes all of those situations and behaviors deviating from the written and well-defined rules. For example, they are sometimes misinterpreted as weak institutions, mixed up with some other informal forms of behavior, and informal organizations, forms or concepts of culture. Examples of misconceptions are directed towards ineffectiveness of formal institutions, which is manifested by a poor application of predetermined rules. However, weak implementation of the formal institutional framework is not necessarily equivalent to the informal institutional framework. An example of the distinction between informal institutions in relation to other forms of informal behavior is focused on the situation, e.g. like removing a hat in church as a result of the activity by an informal institution, while removing a coat in the restaurant is an example of an informal form of behavior. Leaving a coat on during your stay at a restaurant is likely to cause feelings of uneasiness, but this does not lead to social disapproval or sanctions. Behavior in accordance with the informal institutional framework entails behavior corresponding to certain rules or instructions, and a violation of certain behavior results in certain external sanctions. Furthermore, there follows the distinction between informal institutions in relation to informal organizations. What is referred to within the given classification is the existence of differences between formal organizations (political parties) and formal rules as well as between informal institutions (the tribe, the mafia) and informal rules. In addition to the above examples, informal rules are embedded in the concept of culture, which also has an impact on the formation of informal institutions. The two opposing categories can be set when the question arises as to the functioning of formal and informal institutions. On the one hand, informal institutions can be seen as functional or those that offer solutions to certain social problems related to interaction and coordination, and those that emphasize efficiency and behavior of formal institutions. In addition to this dimension, the second dimension is focused on the effectiveness of relevant formal institutions, bearing in mind the level to which the rules and regulations that were implemented administratively are actually involved in the practice. A typology of informal institutions and the interaction of formal and informal institutions can be seen in Table 2 (Helmke & Levitsky, 2004).

Table 2. A typology of informal institutions

Outcomes	Effective formal institutions	Ineffective formal institutions
Convergent	Complementary	Substitutive
Divergent	Accommodating	Competing

Source of data: Helmke, G., Levitsky, S. (2004). Informal Institutions and Comparative Politics: A Research Agenda, Perspectives on Politics, American Political Science Association, Vol. 2, No. 4, pp. 725-740. Available at: http://www.wcfia.harvard.edu/sites/default/files/883__informal-institutions.pdf, (23 January 2013)

In the case when informal institutions complement formal institutions (complementary), they are striving towards the same goal (convergent) and are effective. As an example, we can take the introduction of an enhanced version of the anti-corruption law in a particular country. Thereby the creation of a useful outcome is taken as the final goal, understanding at the same time the anti-corruption law through the interaction of rules and laws, informal and formal institutions. The other existing form that may arise is when informal institutions adjust to formal institutions (accommodating), that is, they operate simultaneously with formal institutions and create an outcome that is not fully subordinate only to formal rules. Furthermore, there is a case when informal and formal institutions diverge, and the inefficiency stems from the fact that informal institutions compete with formal institutions. This situation occurs in cases where formal laws are poorly involved or completely ignored, and as an example we can mention here a case of poor countries where, although many laws protecting human rights may exist in the books, customary laws contravene these rights in practice. There is another possible relationship between formal and informal institutions, and it refers to the case when informal institutions can substitute for the lack of effectiveness of formal institutions. Like complementary institutions, informal institutions are designed to achieve what formal institutions aim to do, but they are ineffective or ignored by official sources. We may take as an example informal credit markets and insurance schemes which might be thought of as substitutes for formalized markets or state agencies that usually provide this type of services, and they are usually subsidized by the state agencies since most voluntary associations pose no threat to formal institutions. An assessment of the effectiveness of formal institutions in relation to informal institutions can be made on the basis of the relationship of effectiveness in relation to a degree of justice (De Soysa & Jütting, 2006). With the exception of the institutional framework, governance mechanisms in a particular economy can be considered in the same way (OECD, 2007).

The relationship between formal and informal institutions can also be defined through the strength of formal or informal institutions in a certain economy (Table 3).

Table 3. Strength of formal and informal institutions

(1) Strong formal Strong informal (Canada, New Zealand)	(2) Weak formal Strong informal (The Netherlands, Sweden)
(3) Strong formal Weak informal (Pakistan, Uganda)	(4) Weak formal Weak informal (South Africa, Turkey)

Source of data: Williamson, C. R. (2009). Informal institutions rule: institutional arrangements and economic performance, Public Choice 139: 371–387, available at: http://claudiawilliamson.com/Claudia_Williamson/Research_files/Williamson%20Public%20Choice%202009.pdf, (27 January 2013)

This classification of formal in relation to informal institutions is done based upon four distinct categories with respect to the strength. Thereby, the strength of an institution implies either well-developed constraints (strong institutions) or a lack of constraints (weak institutions). For example, the existence of a strong formal institution implies the presence of well-developed political constraints, whereas weak formal institutions indicate a lack of political constraints. Quadrant (1) represents the category with strong formal and informal institutions. Within this category there are strong political constraints and strong informal constraints. Quadrant (2) describes the existence of less developed formal institutions and a higher existence of informal constraints. Quadrant (3) describes the situation where strong formal but weak informal institutions exist. Countries attempting to adopt certain western style institutions currently not in place within the countries themselves fit into such institutional framework, and regardless of how well they performs, they are classified as having a strong formal institutional framework. Quadrant (4) represents countries with weak formal and informal institutions, whereby strong political constraints and strong informal constraints are lacking. The survey proved that regardless of the strength of formal institutions a country achieves higher levels of economic development if it has strong informal institutions. The best results in the realization of economic development were recorded in countries with prevailing weak formal institutions and strong informal institutions (see Table 3). Also, economic development is not necessarily determined by a mismatch of institutions, but the actual strength of formal or informal institutions.

4. Conclusion

The institutional framework in economic theory can be used as a framework to explain significant differences existing between individual economies. The effectiveness of the institutional framework, apart from the economic activity, is set by both social and political activities. To achieve successful and effective functioning of the economy it is necessary to integrate levels of these activities. Furthermore, institutions do not imply only formal rules and their firm footing in the legislative framework. Significant impacts are realized through less solid forms as informal frameworks of operation. An informal way of behavior is extremely important in everyday life and activities. Also, their importance in recent times has been increasingly recognized as an important determinant of economic progress.

Institutions imply a factor which causes deprivation of uncertainty issues enhancing thereby business activities and achieving long-term rates of economic growth. The prerequisite to implement the institutional framework is focused on the creation of good institutions. Good institutions include the enforcement of property rights, while ensuring the promotion of investment and general participation in economic life, limiting the action of certain powerful groups to ensure equality in society, and providing opportunities for easier investment, with a focus on specific segments of human capital and participation in relevant production activities. A successful institutional framework involves the interaction of formal and informal institutions, as well as the conditions to which the institutional framework applies. Playing a game can be used as an excellent example of the interaction of these institutional frameworks and enforcement modes. In this case you know the rules by which the game is played, but the course of the game need not be explicitly identified only by formal rules. It is important to indicate that the outcome of the specific situation may not be the rule in the next iteration. In addition, the implementation and success achieved by some level of a formal/informal framework of one economy does not necessarily bring success in other economies. In the paper, this rule was exemplified by an example of Latin America and the USA.

In this paper, special emphasis is placed on the importance and the place of the informal institutional framework when it comes to the impact on economic development. The hypothesis on the impact of informal institutions on economic development is thereby supported by secondary data in the empirical research. Economic development will occur if a country has strong informal institutions, regardless of the strength of formal institutions. The best results in the realization of economic development were recorded in countries with predominantly weak formal institutions and strong informal institutions (Table 3). Thus, it is confirmed that economic development of a certain economy is caused by activities of institutions, i.e. by the strength of formal and informal institutions.

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