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Institutions and Economic Performance: A Review on the Developing Countries*

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Abstract

The aim of this study is to analyze the relationship between institutions and macro-economic performance in terms of developing countries. For this purpose, for a period covering the years 2000-2011 through the use of 23 institutional structure variables in the study, the relationship between the institutional structure and macro-economic performance is investigated in sampling countries where 38 developing countries take place by using the 'Panel Data Analysis' method. The results of the analysis reveals that institutional structure indicators such as the integrity of the law system, regulations on trade barriers, restriction of foreign investments, the share of the private sector in the banking system and employment-dismissal variables have a positive effect on the macro-economic performance of the developing countries. On the other hand, according to the analysis results, variables such as judiciary independence, government expenditures, transfers and subsidies, civil freedoms, the black market exchange rate, collective bargaining and military tutelage (political stability) have been seen to have a negative impact on the macro-economic performances of developing countries.

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Keywords: Institutions, Institutional Structures, Macro-economic Performance, Developing Countries

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1. Introduction

Institutions have an influence on the macro-economic performances of countries' by means of affecting transaction costs by decreasing uncertainty, directing economic activity to productive areas and by building trust and enhancing cooperation. The formation, functioning and development of institutions vary significantly among communities and those variations cause differences in economic performances of countries'; making some countries poor while making others rich.

Institutional economics relates the cause of poverty of third world countries to the lack of institutions solving low efficiency problems. Developing countries generally have low quality institutions and fail at supporting productive investments and protecting property rights. In this case, the society has to make institutional reforms and create good institutions in order to achieve economic development.

The aim of the study is to reveal the relationship between institutional structure and macro-economic performance for developing countries. For this purpose, first the relationship between institutions and macro-economic performance is tried to be explained, then by raising institutional structure features in developing countries, the relationship between the institutional structure and macro-economic performance for developing countries is studied empirically.

2. Institutions and Macro-Economic Performance Relationship

Institutions can be defined as habits that bring limitations to our actions through rules and organizations settled in social life, direct us on how we should behave, and lead social life (Yildirim, 2015: 5-6). According to definitions that try to explain the concept of institution, formal and informal rules existing in a society form the institutional structure of the society. In this sense, the institutional structure expresses thought habits, behavior, social habits, traditions, rituals along with laws, constitution, contracts and property rights (North, 2010: 11-12).

The trust factor that makes up the informal aspect of corporate structure of society forms the basis of social order, individual life and economic and political development through resulting effects in the form of growing business scales, industrial structure flexibility and increased social strength to external shocks (Gokalp, 2003). Trust increases the effectiveness of the economic and social system and makes it possible to produce more goods. The economic value of trust is understood better if a world without trust is imagined. For example, a very serious time will be spent to avoid a legal gap in business relations, and this will prevent development and entrepreneurship (Fukuyama, 2005:167). Low trust discourages innovations in the society (Knack & Keefer, 1997:1252). While entrepreneurs in a low trust society spend more time to accommodate a new technology or a new product, the exact opposite applies to high trust societies. This allows more investment in high trust societies and so the economy can grow faster. Accordingly, low level of trust in a society decrease productivity and deactivate economic decisions whereas in the presence of trust, basic economic activities revive, consumption and investment levels increase. Therefore it can be said that the trust factor has important effects on economic performance.

Confidence among the members of a society will reduce the transaction costs by reducing the necessity for formal arrangements. Decrease in the transaction costs will reflect positively on the economy. However in cases where individuals have low levels of trust against each other, formal regulations such as laws, contracts will be needed to compensate this lack of trust. Thus as a result of more frequent recourse to formal regulatory, transaction costs will increase. In addition, if issues rise during the implementation of those regulations, individuals will lose confidence in formal regulations in problems they might face during economic activity, therefore their courage to invest will be broken and they will narrow their scope of action during their economic activity.

There is a very close relationship between transaction costs and property rights. The relationship between the protection of property rights and economic growth is established by means of transaction costs. Property acquisition, preservation and transfer costs are defined as transaction costs. Reduction of transaction costs requires the protection