

Role of Institutions in Economic Development

Political and Economic Institutions have an important role to play in economic growth and development of a country. Institutions strongly affect the economic development of countries and act in society at all levels by determining the frameworks in which economic exchange occurs. They determine the volume of interactions available, the benefits from economic exchange and the form which they can take. There is wide-ranging evidence that institutions matter a great deal in determining the level of economic development of a country. The contribution of institutions for economic development is obvious and based on the functions, the modern institutions can be divided into four categories as follows:

First, institutions create markets; By protecting property rights, guaranteeing sanctity of contract, and providing law and order, they create an environment in which business and private investment can flourish. Thus, the judiciary, bureaucracy, and police are key institutions in facilitating the development of markets.

Second, institutions regulate and/or substitute for markets; The need for these functions arises so as to prevent market failures and/or to achieve other social objectives such as income distribution. Free markets do not deliver what is socially desirable. For example, banks and other financial institutions need to be regulated to ensure that they do not take on excessive risk, which can lead to socially costly bank runs or collapses. The private sector may not deliver education and water to the most needy because they cannot afford to pay for these services. Thus proper institutions are required to regulate the market.

Third, institutions, such as the central banks or fiscal, stabilize markets by ensuring low inflation and macroeconomic stability and helping to avoid financial crises.

Finally, institutions legitimize markets through mechanisms of social protection and insurance, and importantly, through mechanisms for redistribution and managing conflict. For the economic development, both economic growth and distribution are important. Institutions like pension schemes and other social policies can be considered as market legitimizing institutes.

The most interesting evolution has been the market-regulating/ownership role of institutions. For much of the post-war period up to the 1980s, most countries sought to address market failures by the state substituting for markets: hence power, education, telecommunications, and water were provided by the public sector. proportions were placed on the terms it could operate under, including the scale of operation, what

products could be produced, how much labour could be hired, where plants could be located etc.

Institutions conducive to economic development reduce the costs of economic activity. The costs include transaction costs such as search and information costs, bargaining and decision costs, policing and enforcement costs. They lower transaction costs by providing common legal frameworks (e.g. contracts and contract enforcement, commercial norms and rules), and they encourage trust by providing policing and justice systems for the adherence to common laws and regulations. They ensure greater self-expression and allow the free flow of information and greater sharing of resources through democratic institutions. The welfare state is an example of an institution which pools resources to limit the negative effects of business cycles on incomes and unemployment. Institutions conducive to development pool resources to provide the investments in education, health and infrastructure which lie at the basis of economic interaction and are necessary and complementary to private investment.

The protection of property rights requires an expanded role for state authority. Individuals and groups sacrifice a degree of freedom in order to ensure state protection; they accept levies and taxes to cover policing expenses, and state monopoly over the use of force for common security. However, there is a risk that states which have the power to enforce property rights may use that power to expropriate property too. Instead of reducing risk of economic transactions, this increases it. Thus property rights are by no means sufficient to spur economic growth, and must be balanced by institutions which limit the extractive capacity of state power. These typically involve independent parliaments and judiciaries. Democratic institutions of political representation strongly contribute to this process. The inclusive economic institutions will create the inclusive market and the market is fully bounded by the property right. If the economic institutions protect private property, it will increase the confidence of investors and get decisions on entering and improving the market. Trust is a part of social capital and by ensuring trust in the society, social capital can rise. Both higher social capital and good institutions promotes the image of the country in locally and internationally. This further leads to international investment inflows and boosts the country's development process.

Without ensuring the property right, the country will not be able to improve the capital formation, land and real estate development and investment in Research and Development. The Research and Development generate novelties and innovations contribute to economic development significantly. Cross-country analyses use indicators such as degree of protection of property rights, the rule of law, and civic liberties and find that they are strongly correlated to economic performance.

Thus institutions determine the extent to which those in power are able to expropriate the economy's resources to their private advantage. Unequal institutions which allow

the dominance of powerful elites over economic exchange strongly limit development by reducing the capacity of individuals to access resources, expand production and increase their incomes. A comparative analysis of development trajectories of countries indicates that institutions which benefit elites and allow their appropriation of resources and products have perpetuated underdevelopment. Efficiency in the court system, enforcement of contract laws and restricting the power of political leaders is essential in securing the property rights. Political institutions are needed to take necessary intervention to protect the relationship between institutions and economic development, independence and un-biases in the law enforcement

Greater equality and functional economic institutions are also seen as the cause for the successful development countries compared to countries where high inequality has concentrated power in the hands of restricted elite, and governments have failed to adequately invest in infrastructure and public welfare. The unequal land ownership system in many countries has been a fundamental cause of its underdevelopment. There are evidences that it limits the development of greater rural employment and higher rural incomes. Similarly, institutional capacity to exploit domestic primary resources is indicated as the key to the success of some countries like Botswana and Mauritius.

The outcomes of institutions have effects which lie deep in the socio-economic fabric of societies. Informal institutions too lie at the basis of an economy. They include public agencies, trade unions, community structures and professional associations. They make up the fabric which determines the response to laws and government decisions. Most often they shape these outcomes themselves.