



## THE ROLE OF INSTITUTIONS IN ECONOMIC PERFORMANCE

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**Abstract.** The purpose of the article is to survey the significant literature on the role of institutions – formal and informal constraints that affect investment in physical and human capital – in economic performance and propose a new, comprehensive definition and classification of institutions, as well as to develop a conceptual model to illustrate the interaction between institutions and socioeconomic development. The literature shows that institutions played an important role in facilitating technological progress and leading the world into the modern economic regime. Moreover, quantitative research proves that institutions significantly impact socioeconomic performance around the globe.

**Keywords:** institutions, institutional economics, institutions and growth, economic development, industrial revolution.

**JEL Classification:** O17.

### Introduction

There is a wide discussion on the causes of differences in economic performance around the world. As Rodrik *et al.* (2004) put it: “it is hard to think of any question in economics that is of greater intellectual significance or of greater relevance to the vast majority of the world’s population”.

A significant body of literature has argued that institutions are the fundamental cause of differences in economic development. Institutions are formal and informal constraints that affect investment in physical and human capital. They consist of not only formal, state-order rules, but also informal, private-order beliefs, norms and conventions. Institutional economics goes beyond the scope of traditional micro and macro analysis. It argues that the efficient operation of the market requires more than setting the right prices and allocating resources in the right proportions.

The aim of the study is to survey the significant literature on the role of institutions in economic performance by looking at economic history and quantitative data and to offer a new, comprehensive definition and classification of

institutions, as well as to develop a conceptual model that illustrates the interaction between institutions and socioeconomic development. The object of this particular study is economic, political and value institutions. The methods of the study are: logical and comparative analysis of the literature, synthesis and deduction.

### 1. Institutions and economic development

Institutional economics stresses the crucial role of institutions in economic performance. It has been argued that such factors as innovation, economies of scale, education, or capital accumulation are not the causes of growth, but represent the growth itself, and that political and economic institutions are the fundamental cause of differences in economic development.

At the end of the 20th century, economic thought has returned to the analysis of the institutional environment. This shift has been influenced by the collapse of communism, the transition from socialism to capitalism in post-soviet

countries and China, as well as the persistent underdevelopment in the Third World.

It has been acknowledged that the market will not function effectively unless the institutions (both public and private) form an environment that fosters productive action. Horwitz and Boettke (2005) characterise it as a “move from the government directly orchestrating economic activity to providing the fertile conditions for bottom-up development”, in which “the role of the economic policymaker moves from engineering economic development to cultivating economic development”.

Institutions are defined as “the humanly devised constraints that shape human interaction”, “the rules of the game in society” (North 1990). They are the “non-technologically determined constraints that influence social interaction and provide incentives to maintain regularities and behaviour” and “are complemented by self-enforcing constraints generated through interactions within these rules” (Greif 1998).

North (1993) explains that institutions consist of formal constraints (rules, laws, constitutions), informal constraints (norms of behaviour, conventions, and self-imposed codes of conduct), and their enforcement characteristics. Greif (2000) defines institutions as “a system of social factors – such as rules, beliefs, norms and organisations – that guide, enable and constrain the actions of individuals, thereby generating regularities of behaviour”. Hall and Jones (1999) define social infrastructure as “the institutions and

government policies that determine the economic environment within which individuals accumulate skills, and firms accumulate capital and produce output”.

Institutions affect investment in physical and human capital, as well as the organisation of production (North 1990). In order to reach a high level of output per worker, the social infrastructure should provide an environment that supports productive activities, encourages capital accumulation, skill acquisition, invention and technology transfer (Hall, Jones 1999). Figure 1 outlines the role of institutions in economic development.

The crucial importance of institutions lies in the costliness of transactions. Transaction costs consist of the costs of measurement, costs of protecting rights and costs of enforcing agreements. Efficient economic institutions reduce transaction costs by decreasing information costs and risks, e.g. by decreasing uncertainty about the quality of products in the market, reducing the risks of confiscation and increasing contract enforcement (North 1990).

As uncertainty characterises the economic and political choices we make, we cannot fully rely on the rationality assumption, which presumes that individuals do what is in their interest and act accordingly. North (1993) explains that institutions evolve as a result of the learning processes of human beings – not just of individuals, but of societies. So institutions are endogenous, determined by the choice of society and a result of learning through time, which is

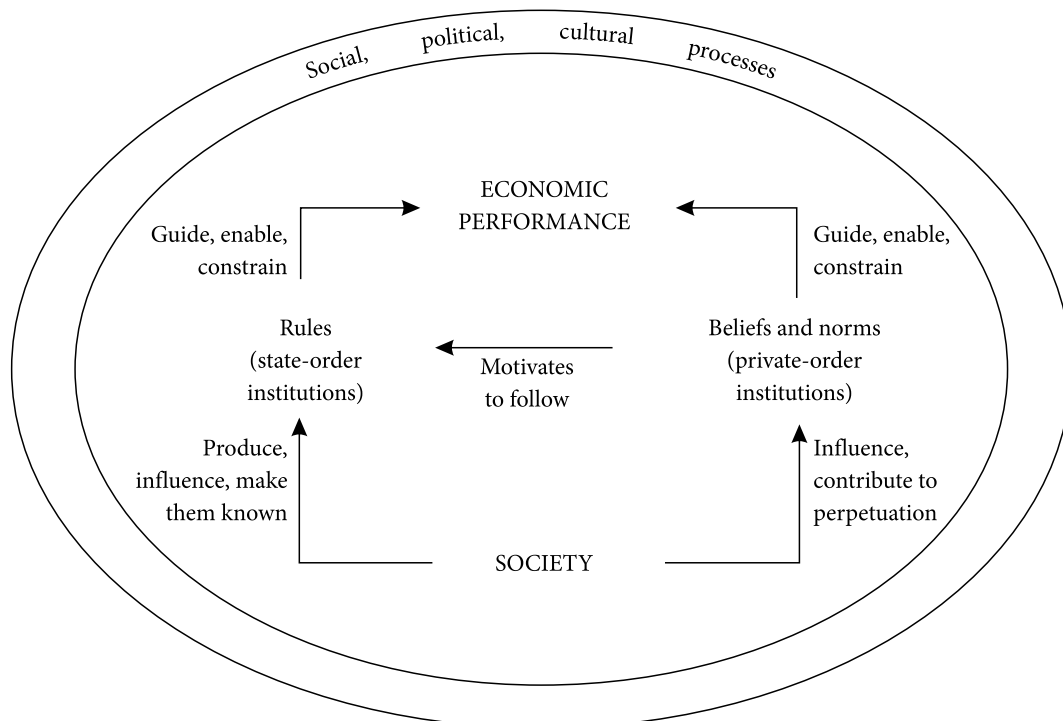


Fig. 1. Conceptual model of the interaction among institutions and socioeconomic performance (developed by the authors)

maintained through culture. Thus institutional economics stresses the importance of non-economic factors – history, culture, social and political aspects – in shaping institutions (Greif 1998). Rodrik *et al.* (2004) propose to „view institutions as a cumulative outcome of past policy actions”. Equation (1) shows policy (p) as a flow variable and institutional quality (I) – as a stock variable;  $i$  denotes the dimension of policy (e.g. fiscal, monetary, trade),  $\alpha$  – the impact of policy on institutional quality and  $\delta$  – the rate at which institutional quality decreases, absent countervailing action.

$$I = \sum \alpha_i p_i - \delta I . \tag{1}$$

Moreover, as knowledge is transferred between generations through the common culture, institutions are strongly influenced by path dependence. There is no guarantee that past experience will help solving new problems; thus societies might get stuck in underdevelopment. North (1994) argues that “in fact most societies throughout history got “stuck” in an institutional matrix that did not evolve into the impersonal exchange essential to capturing the productivity gains that came from the specialisations and division of labour that have produced the Wealth of Nations. (...) History demonstrates that ideas, ideologies, myths, dogmas, and prejudices matter; and an understanding of the way they evolve is necessary for further progress in developing a framework to understand societal change”.

## 2. Economic, political and value institutions

Based on the literature analysis, we define institutions as socially approved behaviour models that restrict the rationality of an individual and constrain or encourage specific behaviour, and assume that high quality institutions encourage an efficient use of limited production resources in order to fulfil the needs of society. Moreover, we classify institutions into three groups – economic institutions, political institutions and value institutions (Fig. 2).

Economic institutions should provide incentives for investment in human and physical capital. Economic institutions are characterized by the extent of the rule of law and the quality of the regulatory framework, as well as the level of corruption, because corruption distorts the operation of markets by limiting fair competitiveness.

The most important economic institutions are the structure of property rights and the presence and perfection of markets. The market, as the most decentralised form of organisation, ensures the most efficient allocation of resources, high-powered incentives and outstanding adaptability (Williamson 1995). Property rights provide incentives for investment in human and physical capital. Protection against expropriation serves as a powerful incentive to invest, especially in physical capital and assets that are more durable. Moreover, regimes that provide strong

support for physical and intellectual property rights attract high-technology industries and industries that benefit from specialized, durable assets.

Indeed, the quantitative analysis by Rodrik *et al.* (2004) confirms that institutions have a larger impact on physical capital accumulation than on human capital accumulation and productivity: in their 80-country sample, the impact coefficient on physical capital accumulation is about six times greater than on human capital accumulation and about 3.2 times greater than on productivity.

The literature also implies that the credibility of property rights is more important than their actual form. It points to the experience of modern China and Russia, where institutional quality scores much lower in Russia, with a regime of private property rights, than in China, where formal legal protection of property rights is lacking. This example stresses that de facto institutions are more important than de jure institutions (Acemoglu *et al.* 2005).

Political institutions should ensure political stability in order to encourage investment and at the same time have a decent level of political competitiveness to facilitate political action that brings benefits to the majority of society, not only to the political elite. Also, a professional and politically independent bureaucracy plays an important role, as it is more long-run-productivity-oriented than politicians because of job security and a need for reputation (Williamson 1995).

The most important political institutions are the form of government and the extent of constraints on politicians. They closely interact with economic institutions. The political institutions and the distribution of resources are the two main static variables in a causal relationship (Fig. 3).

Political institutions constitute the de jure political power; the distribution of resources in the society represents the de facto political power. Together, de jure and de facto political power determine political and economic institutions; and economic institutions, as already discussed, determine economic performance and the distribution of resources. Thus economic institutions are chosen for their distributional consequences.

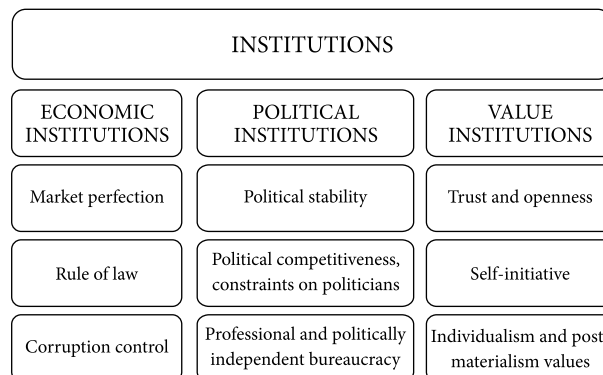


Fig. 2. Economic, political and value institutions (developed by the authors)

Which economic institutions emerge depends on who holds political power. So it is the differences in political institutions and the distribution of political power that determine the variations in economic institutions (Acemoglu *et al.* 2005). As North (1994) argues in his Nobel Prize lecture, “institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules”.

An egalitarian distribution of assets and a high degree of social mobility leads to a relatively equal distribution of economic resources, and representative political institutions become the *de facto* power in society. However, as political institutions are more durable than *de facto* political power, large changes in the distribution of political power are usually needed to alter them. Also, an institutional change that does not destabilise the current political situation is more likely to be implemented although it might not be the most efficient in terms of economic performance (Acemoglu *et al.* 2005).

Long-run efficiency and credibility do not come easily to politicians, because their primary goal is to stay in power for the short and medium term. As Williamson (1995) puts it, “if politicians with short horizons can seize assets or otherwise reward favoured constituencies now, and if a big (and certain) piece of a small pie is perceived to be better than a smaller (and uncertain) piece of a bigger but deferred pie, then credibility may get short”. He argues that a professional bureaucracy is more oriented towards long-run productivity because of job security and a need for reputation.

All else being equal, economic growth is good for those in political power, because it will increase income that they can tax or expropriate, as well as increase returns on their assets. However, new technologies and improvements in institutions might benefit also other groups in society that could potentially contest political power in the future. There is no outside third party that could enforce a contract between the current political power and their followers; the loss in political power cannot be compensated, at least not credibly. So the commitment problem in the allocation of political power leads to a basic trade-off between economic productivity and distribution (Acemoglu *et al.* 2005).

Acemoglu and Robinson (2006) call this a “political replacement effect”. Consequently, political power will tend to improve economic performance if: (1) the political power faces intense competition; (2) the political power has gained a high level of assurance against the commitment problem (e.g. by modifying political institutions to retain some power); (3) the level of human capital in the country is high, and thus the future gains of modernisation are higher; or (4) countries face external threats of invasion.

Furthermore, economic change is more likely to happen when: (1) the political power is in the hands of a relatively broad group of society with significant investment opportunities; (2) there are limited rents that power holders can extract from the rest of society; and (3) there are sufficient constraints and checks on those who hold political power (Acemoglu *et al.* 2005). Acemoglu and Robinson (2006) stress that new technologies and improvements in institutions are often blocked due to the fear of losing power, not the economic rents.

Also, the values of society impact the use of production resources. Higher trust promotes sharing knowledge and other resources, thus decreasing production costs and encouraging innovation; research has proven that innovative businesses are active in cooperation and sharing information (Malecki 2012). Higher initiative raises economic and social activity, leading to higher rates of employment, entrepreneurship and non-governmental activity. Individualism decreases the need to conform to common rules and norms, thus facilitating innovation and rational behaviour (Greif 2000). Last but not least, post-materialism encourages civic activity and political participation, thus promoting democracy and increasing the constraints on political elites (Inglehart, Welzel 2005).

### 3. Institutions in economic history

The role of institutions in economic progress has been widely discussed in economic history. The literature on the transformation of economy to the modern economic regime distinguishes three phases of economic development: Malthusian regime, Post-Malthusian regime and modern regime. The Malthus phase in economic development is

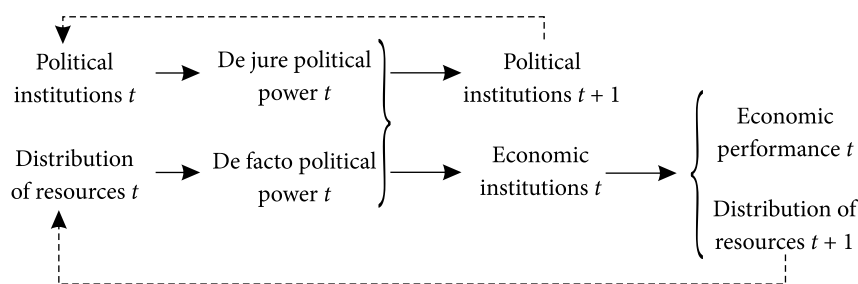


Fig. 3. Interaction among economic and political institutions (Acemoglu *et al.* 2005)

characterised by the absence of a long-run trend towards the growth of real wages, as an increase in real wages is counterbalanced by an increase in population. In a Malthus economy population growth is regulated by a preventive check (decrease in fertility) and a positive check (increase in mortality) in order to maintain an equilibrium. Thus more developed territories will be more densely populated, but the living standards will not differ. The reason for an income per capita close to the subsistence level is the fixed supply of the most important factor of production – land, as it generates decreasing returns to scale when technology does not improve (Crafts, Mills 2009; Galor, Weil 2000; Hansen, Prescott 1998).

The Malthusian regime was followed by the Post-Malthusian regime, in which rising income led to rising population growth rates. The income rose due to sustained technological progress (there is no consensus whether it was exogenous or endogenous), as land was gradually substituted with other factors of production. Colonisation may have played an important role in easing the constraints on land because of the inflow of grains and other commodities from the colonies and outflow of population to the colonies (Galor, Weil 2000).

The raise in population, technological progress and human capital eventually led to the modern regime, which is characterised by a steady growth in the level of technology and income per capita. The relationship between income per capita and population growth is negative, because the quality returns for each child substituted quantity and the opportunity costs of raising children grew. Empirical research shows that the pre-industrial economy in England ceased to be Malthusian from the mid-17th century, when the preventive and positive checks were no longer apparent, and the system returned to Malthusian equilibrium very slowly. The positive check in England was absent even from the mid-16th century. Changes in real wages ceased to be counterbalanced by changes in population at the end of 18th century. The demographic transition, which followed the industrial revolution, marks the beginning of the modern growth regime in the early 20th century (Crafts, Mills 2009; Galor, Weil 2000; Hansen, Prescott 1998).

So what role did institutions play in facilitating technological progress and thus overcoming Malthusian stagnation? Acemoglu *et al.* (2005) argue that as far back as the 14th century, the external shock of the Black Death resulted in the rise of the income and thus the de facto political power of peasant communities. An increase in their political power led to the end of the feudal regulations, which resulted in further changes in the distribution of resources in the society

The literature stresses that the Dutch economy in the 16th–17th century is acknowledged to be “the first modern economy”. It was characterised by access to effectively

functioning markets, division of labour, a government that respected and enforced property rights and a tolerant mentality, which allowed the attracting of talented immigrants. Adam Smith considered the Dutch economy to be the model economy. Britain took away the leading place of the Dutch economy after the Glorious Revolution in 1689. It introduced a representative assembly, a professional bureaucracy and fiscal institutions. In fact, these inventions were partly “imported” from the Dutch (Bogart *et al.* 2010; Persson 2010).

The Napoleonic wars from 1803 till 1815 carried Napoleon’s codification of civil law across Europe. Napoleon’s civil law was debtor-friendly and procedurally slow, whereas his commercial code was creditor-friendly and speedier. Another innovation in law which happened at the same time was the liberalisation of the rules for creating corporations, especially corporations with limited liability.

Policy and institutions may have been crucial to the fact that the industrial revolution happened in England but not in China, where the level of knowledge may have been even higher. Max Weber contrasted the Western legal tradition with Chinese law, which was based on spiritual and magic practices, and concluded that the Western legal tradition led to the development of capitalism in Western Europe (Horwitz, Boettke 2005).

The Napoleonic wars also brought more political representation in exchange for fighting in the wars and as a result of the “constitutionalisation” of Europe. The wars encouraged the centralisation of fiscal systems in order to collect money for the wars and to service the governments’ debts. Before that, taxes were collected by using tax farming, but outsourcing tax collection had high overhead costs. Moreover, the first pension systems were invented for the maimed and the families of the dead (Bogart *et al.* 2010).

The expansion of markets had a significant influence on economic development. Urbanisation and international trade significantly increased the number of participants. Later on, the introduction of the telegraph and the commercial press provided cheap, fast and reliable information. The decrease in the costs of information and increase in law enforcement were crucial for lowering transaction costs. Trade interacted with institutional development. For example, Crafts and Mills argue that the Atlantic trade may have played a role in the development of capitalist institutions (Crafts, Mills 2009).

Furthermore, urbanisation and international trade changed the distribution of wealth in society. By the 17th century the growing prosperity of merchants and the gentry, based on internal and overseas trade, enabled them to field military forces capable of defeating a king, which led to changes in political power. Changes in political institutions induced major changes in economic institutions, strengthening the property rights of land and capital owners, as well

as spurred a process of financial and commercial expansion. Consequently, changes in economic institutions led to rapid economic growth, the Industrial revolution and further changes in the distribution of resources in society (Acemoglu *et al.* 2005).

Moreover, the “knowledge revolution” in the Enlightenment period and urbanisation, which fostered exchange of knowledge and innovation, are the “usual suspects” for the change in economic regimes (Crafts, Mills 2009). Glaeser *et al.* (2004) stress the primacy of human capital for economic growth and democratisation: “Each community faces a set of institutional opportunities, determined largely by the human and social capital of its population. The greater the human and social capital of a community, the more attractive its institutional opportunities”.

Last but not least, Acemoglu and Robinson (2006) stress the importance of the “commitment problem” and “political replacement effect”. Industrialisation was more likely to happen in states where traditional rulers and land owners had less fear of losing their political power and thus their economic rents. Due to the commercialisation of society and the rise of parliament and its control over the king, Britain was much more suited to further economic development than such absolute monarchies as Russia and Austro-Hungary. The landed aristocracy in Britain had become commercial farmers and therefore, by comparison to political elites in other European countries, did not oppose industrialisation.

By contrast, the rulers of Russia and Austro-Hungary feared that industrialisation could lead to revolution. Also, their economic rents were relatively high due to unreformed feudal relations. So Russia started to modernize only in fear of external threats after its defeat in the Crimean War, and Austria-Hungary only did so after the Revolution of 1848.

#### 4. Quantitative evidence

Numerous researchers have quantitatively analysed the role of institutions in economic progress. Thus Hall and Jones (1999) have analysed data on 127 countries and measures of the physical capital stock, primary languages spoken, distance from the equator, trade share, openness to trade, educational attainment, mining share of GDP, and an index of government anti-diversion policies. They found that differences in social infrastructure – “the institutions and government policies that determine the economic environment within which individuals accumulate skills and firms accumulate capital and produce output” – account for much of the differences in output per worker, because countries with good social infrastructure have high physical and human capital, as well as high productivity. Moreover, the analysis of Hall and Jones suggests that differences in social infrastructure are partly explained by the influence of Western Europe, because countries with a higher share

of European languages as primary language are characterised by higher measures of social infrastructure and higher output per worker.

Also, Rodrik *et al.* (2004) showed that institutional quality outweighs geography and trade. By using a large number of indicators of geography, integration and institutions in a sample of 80 and 140 countries to measure the effects of institutions, geography and trade on income, they found that institutional quality accounts for the greatest part of the differences in income. Rodrik *et al.* conclude that “once institutions are controlled for, integration has no effect on incomes, while geography has at best weak direct effects”, e.g. oil exporting countries tend to have higher income, whereas countries with a prevalence of malaria tend to have lower income.

Regarding natural resources, one must take into account the various experiences of countries rich in natural resources. Often a high share of primary exports has led to a decrease in GDP and an increase in inequality, corruption and civil conflict (more likely regarding capital-intensive resources such as oil, but not labour-intensive resources as coffee, rice or bananas). Especially countries with low institutional quality have become victims of the “resource curse” (Van der Ploeg 2011).

The results in Rodrik *et al.* (2004) show that some of the trade and geography indicators even enter the income regression with a negative sign, while such institutional quality indicators as property rights and the rule of law always enter with a positive sign and are statistically significant. Moreover, when analysing the links among determinants, they found that institutional quality and integration have a significant positive mutual impact. Also, geography has a significant effect on the quality of institutions. Interestingly, French legal origins have a positive effect on income, while the impact of having been colonised by the United Kingdom is negative.

Acemoglu *et al.* (2002) argue that institutions, not geography, explain the causes of the reversal of fortune in colonised areas that were relatively rich (in terms of density in population) before the colonisation, but now are relatively poor. They oppose the view that geography has a direct effect on economic performance, and suggest that the cause for the reversal of fortune is institutional reversal. An analysis of quantitative data on urbanisation and population density, measures of current institutional quality, economic performance and geography substantiates their hypothesis.

However, they do not rule out the role of geography but argue that it was working through institutions. Europeans were more likely to introduce extractive institutions in areas which were densely populated. There they could use the cheap labour force to directly extract natural resources or to develop plantations and mining. Moreover, they could take control of already existing extractive institutions, e.g., tax systems.

As institutions tend to persist, a high concentration of political power has significantly altered societies in previously prosperous areas. For example, “slave trade fundamentally altered the organisation of society in Africa, leading to state centralisation and warfare as African polities competed to control the supply of slaves to Europeans”. Consequently, as extractive institutions are more likely to impede new technologies, these areas failed to industrialise and remain underdeveloped.

On the contrary, in sparsely inhabited areas with a favourable disease environment (low mortality rates), colonisers developed institutions that provided secure property rights and thus fostered commerce and industry. In addition, in areas where large number of Europeans settled they demanded similar or even better rights than in their home country.

Šeputienė (2009) has evaluated the impact of institutions (measured by such indicators as civil and political freedom, business freedom, the rule of law, corruption and the protection of property rights) on income level (GDP per capita); the worldwide analysis covers 128 countries. Her research supports the primacy of institutions over international trade and geography, but only in the 41 countries with relatively high quality of institutions. She concludes that high institutional quality positively influences investment and creation of new technology thus increasing the GDP per capita.

The authors of this article have also evaluated quantitatively the impact of institutions on socioeconomic development in their previous research. We used a multiple linear regression analysis that covers 54 to 108 countries on the world scale. To measure the level of socioeconomic performance in a comprehensive way we used such indicators as the GDP per capita and the life expectancy at birth, whereas to measure the quality of institutions we used the World Bank Worldwide Governance Indicators: for economic institutions – regulatory quality, rule of law and control of corruption; for political institutions – voice and accountability, government effectiveness and political stability and absence of violence. Last but not least, to measure values we used results from the World Value Survey – the trust, self-initiative, post-materialism and individualism indicators.

The regression analysis confirmed that institutions play an important role in socioeconomic performance; institutions significantly influence such socioeconomic development indicators as GDP per capita and satisfaction with life.

At the same time, the importance of specific institutions depends on the socioeconomic development level of the economy. In factor-driven economies an important role is played by institutions that shape the formal conditions for the economy, such as private sector regulation and government effectiveness. These results support the thesis that well-established property rights and efficient markets

are fundamental preconditions for socioeconomic development because they encourage investing in capital and human resources.

In efficiency-driven economies an important role is played by corruption control, voice and accountability. Corruption control increases the efficiency of markets, as well as decreases costs for economic agents, whereas voice and accountability increase the participation of economic agents in decision-making, thus shaping legislation that supports and encourages socioeconomic development. Also, government effectiveness, post-materialism, collectivism and initiative have a significant impact on socioeconomic performance at this stage of development.

Last but not least, in innovation-driven economies the critical role is played by such informal institutions as trust, initiative, voice and accountability. These results suggest that once formal institutions are in place informal institutions play an even more important role.

## Conclusions

Institutions are constraints that shape the interactions in society and provide incentives for regularities of behaviour. They consist of not only formal, state-order rules, but also informal, private-order beliefs, norms and conventions. A large body of literature in institutional economics focuses on the formal institutions, most often the property rights and rule of law, but this is only the most visible part. Culture, religion, legal origins, and even historical events long after they have passed also play an important role in economics.

Institutions affect investment in physical and human capital as well as the organisation of production. Quantitative research proves that institutional quality accounts for the greatest part of the differences in worker output and income around the world. Institutions should support productive activities, encourage capital accumulation, skill acquisition, invention and technology transfer. However, institutions are strongly influenced by path dependence. Thus countries might remain underdeveloped due to an inappropriate institutional environment.

The literature shows that institutions played an important role in facilitating technological progress and thus overcoming Malthusian stagnation. The interaction of economic power and economic and political institutions created the circumstances in which the industrial revolution could happen, thus leading the world into the modern economic regime. The decrease in transaction costs led to an expansion of markets, urbanisation and international trade. This created further incentives to improve institutions and to exchange knowledge and innovation, leading to the modern economic regime.

Some of the institutional innovations were introduced gradually, in line with changes in society, for example the

enforcement of property rights and the establishment of representative assembly and a professional bureaucracy in the Netherlands and Britain. In contrast, some innovations were introduced more rapidly as a result of historical shocks, for example Napoleon's codification of civil law, the "constitutionalisation" of Europe and fiscal centralisation after the Napoleonic Wars, as well as modernisation in Russia and Austro-Hungary due to fear of external threats.

Institutions influence the behaviour of every individual and organisation. The public, private and non-governmental sectors should pay more attention to the evaluation of institutions, by measuring institutional indicators and taking into account the institutional environment in public and private decision-making. The public sector should also focus on shaping policies that improve the quality of institutions.

The analysis of institutions should be mainstreamed in social science research. Not only formal institutions, but also informal ones, which characterize values and norms in society (e.g. trust, motivation), should be included in the evaluations of institutional environment. Vast data from worldwide value surveys allow us to integrate these indicators in economic research. Detailed evaluations of formal and informal institutions are especially important for relatively new democracies such as the Eastern and Central European countries which are adopting not only Western European legislation, but also values and norms that are crucial for the smooth operation of market economy.

To conclude, institutions have played and still play a prominent role in the economic development process. The interaction between formal and informal institutions, history and modern values, and the individual and society makes institutional economics a very promising discipline.

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