

Institutions and Economic Growth: The Case of BiH*

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Summary

This paper is aimed to explore the relationship between institutions quality (as institutional economics conceives it) and economic growth (measured in GDP_{pc}) in Bosnia and Herzegovina. Regarding the lack of consolidation of thoughts upon the definition and concept of economic institutions it has been chosen *regulative* type of institutions in the paper. By institutions here it is assumed written 'rules of the game' in which government appears as a creator, a referee, and an enforcer of the rules. The aim of this paper is to compare the trends of aforementioned parameters. Through the paper it is tried to confirm the following claim: improvements in institutions quality positively affect the economic growth. Contribution of the paper lies in suggestion of the direction of economic policies in Bosnia and Herzegovina.

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Acronyms

BiH – Bosnia and Herzegovina, GDP_{pc} – Gross Domestic Product per capita, USA – United States of America, NIE – New Institutional Economics

1. Introduction

Economic transition from the previous socialist to the market economic system in BiH is an extraordinarily important and complex process. As a phenomenon ‘this is one of the most important experiments in economics ever to have occurred’¹ since it represents extremely wide and relatively unexpected change in institutions. It was necessary to build and establish socio-economic rules which would structure and coordinate the main processes in an economy. Being established these rules will settle down incentives for various economic activities. These rules, formal and informal, broadly conceived, are institutions. ‘It is the polity’ – says North – ‘that defines and enforces the formal economic rules of the game and therefore is the primary source of economic performance’².

Building institutions of market economy solves the problem of coordination in an economy, particularly in BiH where the institutions building represents the process of change from the previous state and central coordination into an efficient market mechanism which is among the main tasks of the whole transition process. In that manner market will be allowed to offer an answer to the three questions lying in front of every human society: *what, how* and *for whom*³ to produce. The most prominent countries of the transition process are the most successful in the institution building process and as it will be indicated bellow, they have also experienced the highest rates of the real GDP per capita. Indeed, how much the differences in institutions quality, namely those mentioned by Redek and Susjan (2005), compare to other factors, are important as an explanation for the economic performance of the transition process?

2. Concept of institutions

The word of *institution* is often used in its non-technical sense to mean a certain organization⁴ such as ministry, university, agency, etc; however, in this paper a distinction is made between that and technical meaning which is used in institutional studies. Literature on economic development abounds with endless efforts of researchers trying to get deep understanding of theoretical and empirical relationships between institutions and economic growth.

In the literature there are numerous definitions of institutions, so one can conclude this is a branch open to research and of wide scope for innovative endeavors. Institutions are ‘the rules of a society or of organizations that facilitate coordination among people by helping them to form expectations which each person can reasonably hold in dealing with others’⁵. In his seminal work North offers probably one of the most quoted definitions of institutions considering them as ‘the rules of the game in society or, more formally, (they) are the humanly devised constraints that shape human interaction’⁶. On the other place, by the definition of institutions, he precisely states that the interaction is taking place in political, economic and social sphere⁷. Furthermore, according to Kratke⁸ institutions are defined as ‘the set of conventions and rules of action that prevail in the economy, are em-

¹ Stiglitz (1997, p. 127).

² North (2005, p. 57).

³ Samuelson & Nordhaus (2001, p. 7).

⁴ Matthews (1986, p. 905).

⁵ Ruttan and Hayami (1984, p. 204).

⁶ North (1990, p. 3).

⁷ North (1991, p. 97).

⁸ See in: Parto (2005, p. 24).

bedded in the local social structure, and show a marked regional differentiation'. Similar to above is the definition suggested by Hodgson who defines institutions as 'systems of established and prevalent social rules that structure social interactions'⁹. In a serious, scientific based analysis of the impact of institutions on economic growth setting boundaries of concepts that are being observed can not be neglected simply because carrying out any theoretical or empirical analysis without adequate conception of their essence is questionable. Therefore, in Table 1 it is suggested a classification of the institutions types with indications of their manifestations on various levels and scales.

Institution type	Examples
Associative: Institutions as mechanisms facilitating prescribed or privileged interaction among different private and public interests.	Business networks, kinship groups, social classes, associations, interest groups.
Behavioral: Institutions as standardized (recognizable) social habits – manifested in activities of individuals and groups as reflections of social norms.	Habits, routines, artifacts, ways of doing things, shared beliefs, theories in use, "how the game is played."
Cognitive: Institutions as mental models and constructs of definitions – manifested primarily in what society expects of individuals.	Cultural and social values, superstitions, "wisdom", "how the game ought to be played."
Regulative: Institutions as prescriptions and proscriptions.	Written and unwritten "rules of the game"; state as rule maker, referee, and enforcer.
Constitutive: Institutions setting the bounds of social relations	Collective actions initiated by the state agencies, firms, unions, or citizens groups; language; property rights structures; agreements; arrangements; marriage; family.

Source: Parto 2005.

Institutions can be *associative* in the context of the socio-political structures characterized by exclusion, socialization, or express of the certain values or interests. Institutions also encompass *behavioral* aspects in themselves for they represent a regularity of the conduct of people which is self-sustaining or is held by external authority. Further, institutions may be *cognitive* because they are grounded on values and are embedded in culture. Institutions include a *regulative* component in themselves (and this one is of particular attention in the paper) with respect they are, at least formal ones, molded in laws and prescriptions. Finally, institutions may subsume *constitutive* dimensions in themselves remarked as a set of basic political, economic and legal norms which arrange authorities in a society, thus forming institutional environment¹⁰.

3. Recent research

A detailed review of impact of institutions on economic performance in 24 transition countries in the period of 1995-2002 is represented in Redek and Susjan (2005) where they come by empirical analysis to the conclusion that economic development is an interplay of standard economic variables such as capital formation, labor productivity, etc, and more subtle but not less important, institutional variables. Considering the impact of several determinants on economic development in the world measured as GDP_{pc}, Rodrik et al. found that institutional quality 'trumps' geography and trade, as determinants, in

⁹ Hodgson (2006, p. 2).

¹⁰ Williamson (1995, p. 174).

explaining economic growth¹¹. In practice, every successful market economy is overseen by panoply of regulatory institutions, regulating conduct in goods, services, labor, asset, and financial markets. It is not a coincidence that USA has the world's freest markets as well as toughest anti-trust enforcement (the later is example of *regulative* institutions). In fact, the freer are the markets, the greater is the burden on the regulatory institutions¹².

The question of the measurement and quantification of the institutions in institutional analysis is particularly sensitive. New institutional economics is an endeavor to incorporate the theory of institutions into economics as a science. Here, we will underline one of the differences between 'old' and 'new' institutional economics. Both of them are unanimous in the view that institutions matter in economic analysis, while only NIE is categorical that institutions are measurable and susceptible to analysis by the standard economic theory tools¹³. NIE suggests that the appropriate institutional variables to include in growth analysis are those that capture the quality of institutions rather than merely describe their characteristics or attributes. The most important contribution of NIE lies in efforts, opposite to the ignorance of them in neoclassical economics, to observe institutions as independent variables. So, the question is no longer 'do institutions matter?' but '*which* institutions matter and how to attain them'¹⁴.

High correlation between economic growth and institutions quality is confirmed by econometric findings¹⁵. BiH is included in this review, but concerning the fact that data about institutions quality in BiH exist only from 1998 onward and that the review encompasses period only to 2002 it is considered there is a need for more detailed insight in the issue in case of BiH. Thence, what is relationship between institutions quality and economic growth in BiH? In the remainder of the paper we try to find an answer to this question.

4. Index of Freedom and GDP_{pc}

Here, approach to examination of the impact of the institutions on economic growth in BiH is comparative and trends of the institutions quality measured by the Index of Freedom¹⁶ and of the economic performance measured by GDP_{pc}¹⁷ will be plotted. The Index of Freedom, taken as a proxy for institutions, is closest to the *regulative* type of institutions from classification in Table 1. Index of Freedom is composed of general assessment of the situation in ten areas of an economy. They are: trade policy, fiscal burden of government, government intervention in economy, monetary policy, foreign investment, banking and finance, wages and prices, property rights, regulation, and informal market activities (informal economy). The value of the Index of Freedom or numerical estimates of the institutions quality for Bosnia and Herzegovina is given in Table 2.

¹¹ Rodrik et al. (2002, p. 4).

¹² Rodrik (2000, p. 7).

¹³ Williamson (2000, p. 595).

¹⁴ Rodrik (2000, p. 2).

¹⁵ (Redek and Sušjan 2005, p. 1017).

¹⁶ Data about Index of Freedom for BiH is available at

[<http://www.heritage.org/research/features/index/country.cfm>, accessed 17.04.2006.]

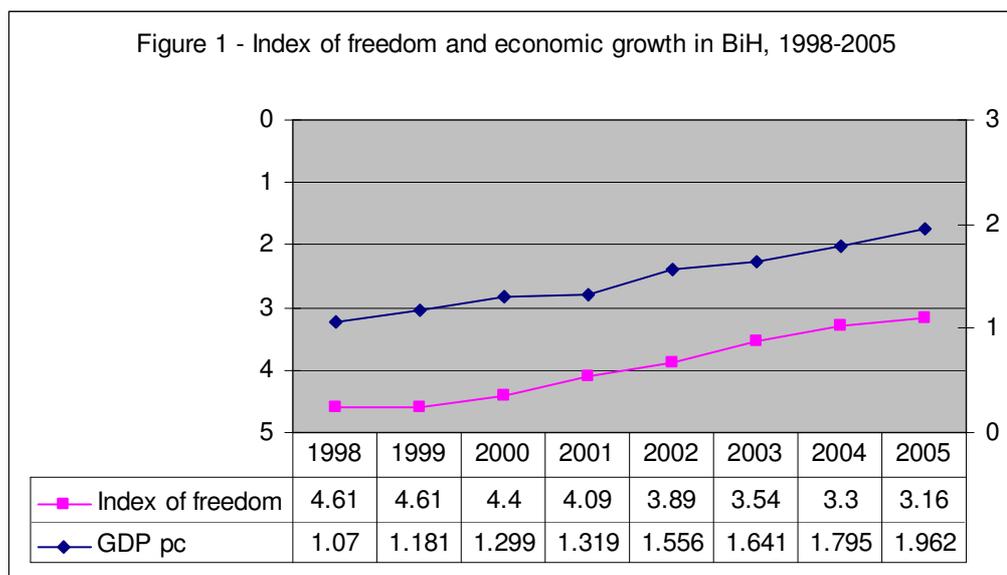
¹⁷ Data about GDP_{pc}: Statistics Agency of Bosnia and Herzegovina, "National accounts", Sarajevo, 2005:29, except the year 2005 for which is used the data of the Central Bank of Bosnia and Herzegovina, available at [<http://cbbh.ba/bh/statistika.html>, accessed 04.05.2006.]

	1998	1999	2000	2001	2002	2003	2004	2005
trade policy	5	5	5	3,5	3	2,5	3	3
fiscal burden of gov't	4,1	4,1	3	3,4	3,9	2,9	2,5	2,6
gov't intervention in the economy	5	5	5	5	5	3	2,5	2,5
monetary policy	4	4	4	2	1	2	1	1
capital flows and foreign investment	4	4	4	4	4	4	4	4
banking and finance	5	5	4	4	4	3	2	2
wages and prices	4	4	4	4	3	3	3	3
property rights	5	5	5	5	5	5	5	5
regulation	5	5	5	5	5	5	5	5
informal market activity	5	5	5	5	5	5	5	3,5
overall Index of Freedom	4,61	4,61	4,4	4,09	3,89	3,54	3,3	3,16

The Index of Freedom is arranged on a scale from 1 to 5, 1 being the best institutions quality, 5 the worst. Without going deeply into the methodology of estimation of the Index of Freedom, at first glance Table 2 reveals rather poor achievement in improvement of property rights, regulatory role of government in economy, capital flow, foreign investment, and informal economy, while remarkable improvement is made in areas of the monetary and trade policies in BiH.

Measurement of institutions is most usually performed, as in this paper too, by quantification of their proxies which comprise characteristics of institutions in themselves. These methods, on one side, considerably facilitate analysis of the institutions but, on the other side, they risk to elide valuable pieces of institutions and hence, incompleteness of analysis. This paper does not resolve that issue. The Heritage Foundation in its publications of the Index of Freedom (Marc et al. 2006, p. 10) mentions BiH as the most improved¹⁸ among countries compared by Index. Trend of overall score of the Index of Freedom is shown in Figure 1. Negative slope of the curve of the Index of Freedom is due to the way of grading, being that more qualitative institutions have minor Index grade.

¹⁸ BiH has made the best overall improvement of 1.6 points since it was first graded in the 1998 Index.



By comparison it is obvious that trend of change in institutions quality follows the trend of change in GDP_{pc}, the fact which confirms the importance of institutions in increasing economic growth in BiH. More qualitative institutions, *ceteris paribus*, will induce higher economic growth. Also there is an evident, general improvement in institutions quality in BiH as a result of reform processes in certain areas.

5. Conclusion

W. A. Lewis, Nobel laureate, recommended the studying of institutions in economic development analysis, especially at PhD levels¹⁹. In spite of that, it is not being paid enough attention to institutions in academic programs for economists. Institutional economics contributes to a more comprise of the real world into theoretical economic analysis. Models used for the estimation of economic growth have to encompass more variables from the real world in order to be able not only to predict events in the future with more confidence, but also to describe the current events and to account for those in the past. In that sense, economic development is ‘a response to the evolution of institutions that support social and commercial relationships’²⁰.

The quality measures for institutions include various indicators²¹. The current open debates on institutions definitions have caused different indicators to be picked up from the bundle of socio-economic complexity and accounted for institutional quality. General theory of institutions is still ahead of us. Measurement of institutional quality is a necessary, but not sufficient, condition for making serious steps to that end. In that sense authorities in BiH are faced with the urgent task. The sooner the measurement of institutions quality in BiH comes into practice the earlier the situation of where we are will be realized.

¹⁹ Lewis (1984, p. 8).

²⁰ Klein (1999, p. 461).

²¹ For more discussion see: (Aron, 2000).

To sum up, authorities should pay full attention to the improvement of institutions, their better examination and measurement; because institutions through incentive structure will induce faster economic growth and development. Intention of this paper was to draw attention to the importance of the studying formal, regulative-type of institutions and also to introduce their impact on economic growth in BiH, and by this step the field of research is just opened. At the end several questions that impose themselves in the field of NIE in BiH can be indicated: how to measure the overall institutional quality in BiH and how to build a model for their change.

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