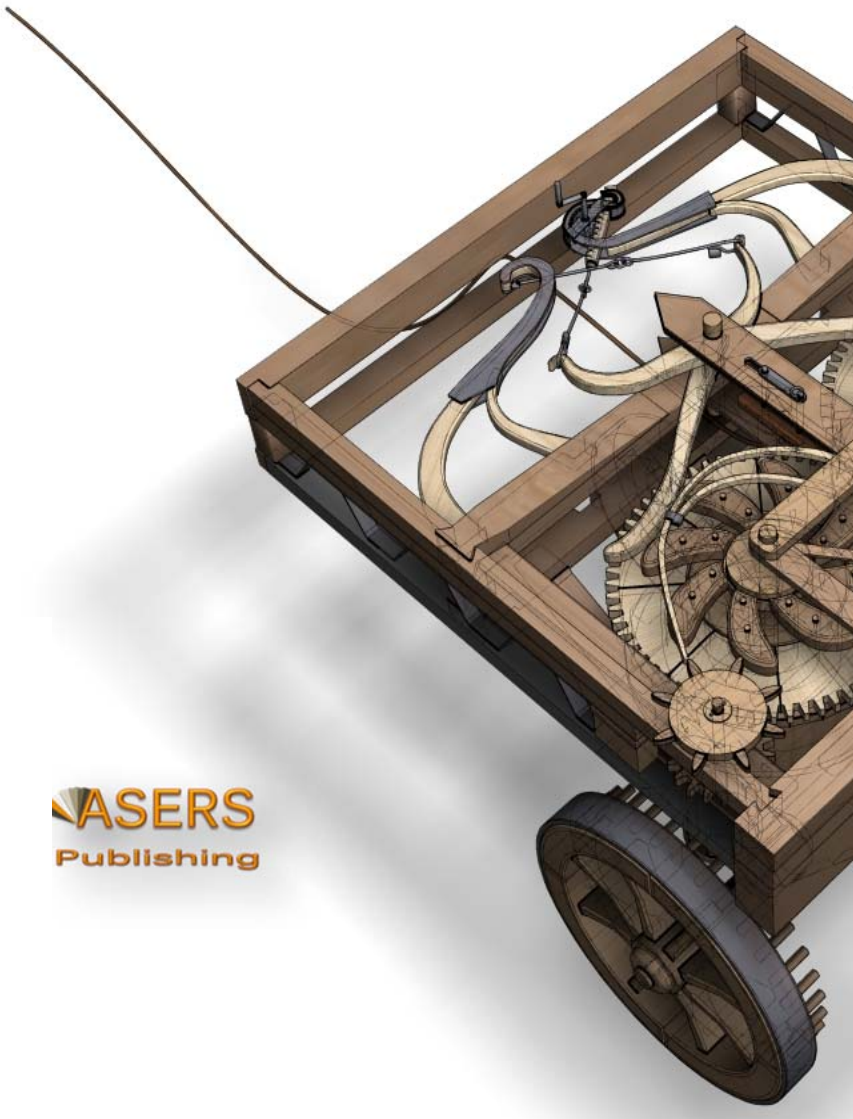
Theoretical and Practical Research in Economic Fields



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Theoretical and Practical Research in Economic Fields

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ECONOMIC DEVELOPMENT. A HISTORICAL - NEOINSTITUTIONAL APPROACH OVERVIEW

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Abstract: *This paper aims to investigate economic development through a historical-neoinstitutional approach, to improve the understanding of the process of economic change. It will try to demonstrate how the intervention of the institutions can trigger a virtuous circle able to reduce transaction costs, facilitate the dissemination of information, in order to make the functioning of the economy more efficient. In this sense, economic change is identified as an intentional process triggered by the combination of the beliefs and preferences of individuals. All this takes place through the intervention of rules, procedures and organizations. This scenario differs from that represented by the neoclassicists, both for the importance given to the market, to companies and other organizations linked to the institutional environment, and for the importance given to transaction costs. In this regard, the reasons for the existence of institutions such as companies and hierarchical organizations have been researched. The survey will therefore focus on the importance of the link between institutions and economic development, in order to achieve an improved understanding of the process of economic change.*

Keywords: beliefs; economic development; institutional change; uncertainty; institutionalism; game theory.

JEL Classification: B15; B25; B52.

1. Introduction

The study of development economics can be undertaken following different approaches, one of which is that of neo-institutionalism[1]. In this approach, within development economics, and as comparative economic history shows, contexts of underdevelopment are accompanied by high transaction costs and difficulties in transmitting information. Therefore, in order to create a development scenario, the intervention of all the institutions that are able to reduce high transaction costs and facilitate the transmission of information is necessary (Libecap 1998). This also enables us to improve our understanding of the process of economic change and explain the different behavior of economic systems in terms of growth.

Looking at a fairly developed economy, such as America for example, North (1984) highlighted the key role that the evolution of institutions has played in reducing transaction costs and, therefore, in increasing both production and income. On the contrary, if we consider the South of Italy, "institutions and norms" play a crucial role, as they orient and regulate the life of individuals, communities and nations; if it is insufficient, it hinders cooperative and efficient behavior. If we take a poorly developed country as a reference, the deficiencies of

[1] Oliver Williamson was the first to introduce the expression "new institutional economics", which, since the 1990s, has become the benchmark for different theoretical currents, united by the thought that institutions 'matter', and their analysis can be carried out through the tools of standard economic theory, making adjustments for the incompleteness it features (Williamson 1973). However, the origin of the 'new institutional economics' is to be found in Coase (1937).

institutions and rules imply a series of negative consequences, ranging from an increase in uncertainty to high transaction costs, resulting in a malfunction of the markets. In addition to these, there are other critical issues, such as the absence (or almost absence) of specialized labour and venture capital, which hinder the creation of new businesses, leading to processes that are both demultiplicative and decelerating (Marzano 2011, 60-63).

In this regard Coase (1998) argues that if the productivity of economic systems depends on specialization, and that it is not reflected in the absence of exchange, the lower the exchange costs are, the higher the productivity of the economic system will be. He adds that market transactions generate costs, which are reflected in the search for appropriate prices and the negotiation of separate contracts. When transaction costs become excessively high, one can, alternatively, rely on the company, which presents itself as a centralized institution marked by hierarchical principles. For example, an individual, rather than selling his own products or services in the marketplace, may choose to work in a company, voluntarily subjecting himself to the authority of an entrepreneur. In this way, within a company these transactions are eliminated, and the complex structure of market transactions is replaced by the entrepreneur, who can coordinate production. It is clear that in this specific case the company replaces the market, thereby reducing the costs of the pricing process.

Coase (1992) thinks that the performance of an economy is linked to what happens inside the enterprises, and the entrepreneur must do everything possible to produce at a lower cost than the purchase cost on the market. He explains that reality is different from the zero negotiable costs represented by neoclassical theory (Coase 1960). Coase thinks of a different economy from the one imagined by the neoclassicists, both for the importance given to the market, to companies and other organizations linked to the institutional environment, and for the importance given to transaction costs.

Individuals are constantly searching for rules to build an environment as predictable as possible. Beliefs and institutions developed by individuals help to reduce the various levels of uncertainty to create a more predictable economic and social environment (Morselli 2018*b*).

According to Acemoglu *et al.* (2001), it is quite clear that with neo-institutionalism the role of institutions in economic development is crucial[2]. This paper will attempt to investigate the relationship between institutions and economic development in order to improve the understanding of the process of economic change.

2. Transformation and Uncertainty

The increase in information on the characteristics of a specific activity has led to an improvement in forecasting capacity. For example, in the 15th century, the introduction of marine insurance, which concerned the collection and comparison of information about ships, their cargoes, destinations, journey times, shipwrecks and related compensation, allowed uncertainty to become a risk, and was an important factor in the growth of European trade in the early modern age (North 2005).

The change in the institutional framework, a key factor in reducing environmental uncertainties over time, implies changes in the structure of incentives. This is the main tool used by individuals to transform their own environment. Historically, institutional change has changed the benefits obtained from cooperative activities (*e.g.* the introduction of mandatory contracts), developed incentives for innovation (patent laws) and reduced transaction costs in the markets (introduction of laws to reduce contract enforcement costs) (Morselli 2017).

According to Greif (2006), the response of individuals to new scenarios depends on how new they are and on the cultural heritage of the actors. If they are well equipped with this heritage to cope with the new contexts, they are able to implement responses that make the environment more predictable.

Although the uncertainty of the natural environment has diminished over time, the remaining part that defines non-rational beliefs still plays a major role nowadays, as well as throughout human history. Secularized beliefs and ideologies are the two most important factors in changing society, one example being the history of the rise and fall of the Soviet Union (Morselli 2015).

So, we have analyzed the different degrees of uncertainty highlighted in the introduction, trying to trace a path that can produce a more predictable environment. Changes in the environment will inevitably produce a new context, which we are unprepared to deal with in the light of our experience of the past. The way in which institutions and beliefs from the past influence current choices plays an extremely important role. Communities that, on the basis of past experiences, face innovative change with suspicion, contrast with those whose heritage gives them a favourable predisposition to change; in these cases there are different shared mental models of the participants,

[2] Furthermore, Rodrik *et al.* (2004) argue that quality institutions can influence income levels through three channels: reducing information asymmetries; enforcing property rights; and reducing politicians' actions:

and our ideas and beliefs formalize the decisions we make, which keep bringing about changes to the environment in which we live.

3. Beliefs, Institutions and Economic Change

Understanding the process of change starts from the awareness that the individual has an imperfect knowledge of reality. Therefore, the development of beliefs establishes the individual choices, which subsequently shape the changes in the contexts of the environment.

In order to better understand the human environment, it is particularly important to overcome the assumption of perfect rationality[3] regarding complex situations that involve the presence of uncertainty. Individuals are placed in contexts where all participating agents have imperfect information, and the reaction to the actions of other actors is also imperfect. Both the imperfect information and the imperfect reaction are at the basis of the nature of uncertainty, the presence of which cannot be avoided. It is also pointed out that the application of the principle of rationality is not adequate to explain the relationship between the external environment and the human mind. Most rational choices are only partly the result of individual reasoning, but they come from the process of forming thought in a social and institutional scenario. In fact, Satz and Ferejohn (1994) state that rational choice theory works in contexts where the choice is limited.

The effort underway is to try to achieve an improvement in knowledge of the complex interaction between cognitive processes, belief building and institutions. According to North (1994, 362-363):

Learning involves the development of a structure through which one can interpret the different signals received by the senses. The initial framework of such a structure is genetic, but the subsequent scaffolding is the result of the experiences made by the individual: experiences that come both from the natural environment and from the linguistic-socio-cultural one. The structure consists of categories, *i.e.* classifications that evolve gradually, from early childhood, to organize our perceptions and store traces of analytical results and experiences in our memory; by building these classifications, we develop mental models to explain and interpret the environment, usually in ways that change according to our objectives. Both categories and mental models evolve to reflect feedback from new experiences, which sometimes strengthens our initial models and categories, and at other times brings about changes; this is what we call, in short, learning. Therefore, mental models can be continuously redefined through new experiences, including contacts with the ideas of others.

The learning process is unique to everyone, but it is also true that a common cultural/institutional structure leads to shared beliefs and perceptions. For this reason, a common cultural heritage provides the means to diminish the diversity of mental models that in a society are specific to each person and constitutes the vehicle for intergenerational transfer for unifying perceptions (Denzau, North 1994).

According to von Hayek (1952, 143) beliefs are the result of mental constructions in the light of the interpretation provided by the senses, i.e. that we do not reproduce reality, but construct classification systems to interpret the external environment.

Hutchins (1995, 354), states that it is not possible to fully understand the cognition process, without clarifying the key role played by culture and history, and also points out that they cannot be integrated into a context where the abstract properties of minds belonging to isolated individuals are privileged. The main objective must be to place cognitive activity not in a predefined scenario of surrounding conditions, but in a more extensive dynamic process of which the cognition of the individual is only a part. Only by ensuring this objective is it possible to demonstrate that human cognition is not only conditioned by culture and society but is itself a social and cultural process.

In the light of this, when dealing with cognitive change, the socio-material environment where thought occurs must be considered in the analysis. For Hutchins (1995, 289), culture is an adaptive process, able to accumulate partial solutions to the problems that have been encountered most frequently in the past. This statement highlights the important cognitive role played by social institutions. An efficient interrelation of individual beliefs and social contexts can make it possible to implement a set of mechanisms through which culture and social institutions operate directly in explaining the process of economic change.

There is a strong relationship between belief systems and institutional structure. Beliefs include the representation of the human environment, whereas institutions represent the structure that individuals impose on

[3] Perfect rationality has as its reference the *homo oeconomicus*, the foundation of neoclassical economy and *laissez-faire*. It presents the concept that each individual was able to order his or her preferences in a rational manner, to be perfectly informed about the current state of the world, and all possible future states, to act following objectives of maximisation of benefits and/or minimisation of costs (Blume, Easley 2008).

that environment. If there are opposing beliefs, institutions will manifest the beliefs of those who are able to implement their own choices (Bendor, Swistak 2001). According to Loasby (1999) the foundations of society are formed by the beliefs of its members. It is also important to highlight the work of Greif (1994) on the effects of beliefs on economic results. In the comparison between Genoese and Islamic merchants, during the Mediterranean trade in the 11th and 12th centuries, he realized the differences existing in their organizational structure. These differences came to light from the clash between beliefs of individualistic behavior and beliefs of collectivistic behavior. The Islamic merchants, in order to favor their collective action, had created a network of social communications within the group, but such a network was not able to favor the exchange, which came from the increasing size of the markets. Whereas, the Genoese, in order to ensure the compliance with the agreements, had introduced bilateral mechanisms of application which provided for the formation of organizations of a legal and political nature, allowing a more efficient trade. Therefore, the performance of an economic context comes from agents who are constrained in their choices by the combination of beliefs, institutions and structures from the past; and beliefs represent the initial path in order to understand the process of economic change.

4. Institutionalist Analysis and Game Theory

At the time of its development, game theory was placed within the paradigm of rational agents, and utilitarianists, reasoning in the context of methodological individualism and had an ahistorical and decontextualized nature. Among the contributions to this placement there are the game rules that are considered given*, i.e.* they are exogenous (Chavance 2010, 76).

Nevertheless, if we consider the important issue of coordination or cooperation and repeated games involving evolutionary processes, it is possible to link game theory to institutions (Walliser 1989)[4]. When repetitive games are involved, players are inclined to develop new implicit rules, norms, conventions and institutions based on a social agreement, which will be passed on to subsequent generations of players, thus constituting mechanisms aimed at providing information on the possible actions of other agents (Schotter 1981).

However, in such approaches there are some problems, namely the initial rules of the game are given and influence the new rules that emerge from the process of evolution or learning. The analysis of the institutions, therefore, implies a circular reasoning, linked to the absence of a concept of hierarchy or historicity of the rules. However, this does not detract from the fact that game theory has a considerable influence on certain trends of institutionalist economics. Moreover, game theory is sometimes also applied to historical experiences or institutions. In this respect, it is possible to highlight the comparative institutionalist analysis by Aoki (2000) and Greif (2006), which aims to compare institutions or national historical systems.

Aoki's theory is based on the concept that institutions represent forms of equilibrium within game theory. He states that there are three different approaches: institutions are identified in the players; institutions as rules of the game; institutions are the result of equilibriums or beliefs related to the games. According to Aoki, the concept of institutions as equilibriums has the merit of considering them endogenous (Aoki 2000, 141; 2007). As Field (1979) pointed out, it is not possible to create a game model that lacks institutions. Actually, every game model requires pre-existing human institutions, therefore Aoki (2001, 26) states that game theory, which is the basis of the institutionalist analysis, needs to be integrated by historical and comparative indications, and adds that the institution is a system of shared beliefs which reproduces itself autonomously and which concerns the modes in which the game is implemented.

An equilibrium identified as an institution can also be represented explicitly. But such representation will have the characteristic of an institution only if individuals consider it to be so. Thus, law and regulations are not institutions if they are not recognized and respected. If, for example, the State prohibits the import of certain goods, but one is convinced that it is sufficient to pay bribes to customs officers to circumvent the law, and suppose that this practice materializes, then it is the practice of bribes that is considered as an institution, instead of legislation being considered ineffective (Aoki 2000, 13).

In his comparative institutionalist analysis, Aoki (2001, 87) takes into account the example of the Sillicon Valley model, the Japanese model of the central bank, and thinks that the effectiveness of an exchange governance

[4] We also remember the study by Axelrod (1984), where players face each other in a series of direct matches, as in the prisoner's dilemma, and the choice not to cooperate gives a better result than the choice to cooperate, whatever the choice of the other player; but if both players decide not to cooperate, the result is worse than if both decide to cooperate. In the case of non-repeated play, the equilibrium solution is the choice not to cooperate. In the case of repeated games, on the contrary, if each player remembers how the other behaved in previous match situations, there may be willingness to cooperate.

mechanism can be strengthened by the institutionalization of a particular mechanism in the same economic system. Moreover, he adds that the institutional diversity of the different countries will not be erased by the process of globalization; on the contrary, this diversity is beneficial because the different institutions interact in a competitive way and the national contexts will continue to adapt to the changes in the global and technological environment[5]. In his update work, Aoki (2011) further explores the important role of institutions in the process of strategic interaction of individuals and their individual beliefs in societal games. Thus Aoki, in this paper, demonstrates the continuity of his basic position on the importance of institutions, trying to clarify the function of institutions as social constructions that cognitively mediate the interactions of agents and their individual beliefs in societal games (Takizawa 2017).

Turning to Greif (2006, 153), he is a supporter of comparative historical institutionalist analysis, as he thinks that it is a tool for reducing the existing gap between the evolutionary perspective of the old institutionalist economy and that of the new institutionalist economy, which basically considers the deliberately established institutions[6].

Greif (1998) shows interest in institutions that constitute spontaneous results, since they are based on an external sanction; the proposed approach considers the historical process and combines studies of game theory with empirical, historical and comparative analyses. As we have seen, Greif compares Genoese merchants (individualists) with Muslim merchants (collectivists), who traded in the Mediterranean area in the 11th and 12th centuries. The Muslim merchants created communal communication networks in order to act collectively, which, however, proved to be not very effective for relations with merchants of different ethnic origins. Whereas the Genoese merchants developed bilateral mechanisms of control with a limited level of communication, which produced formal organizations and policies designed to follow and sanction the established agreements, favoring the enlargement of the exchanges. In the end, the Genoese merchants replaced the Muslim ones; therefore, it is noted that the cultural values influence the institutions and, consequently, the performances. For this reason, Greif (1994) thinks of institutions as a system that includes rules, beliefs and organizations. Moreover, Nelson (1995) considers institutions as a set of socially learned and shared values, norms, beliefs, meanings, symbols, customs and standards, such as to outline a series of behavioral expectations accepted contexts of action.

5. Institutions and New Institutional Economics

The reintroduction of institutions into the *New Institutional Economics* originates from the analysis of the *organization*. Coase (1937) highlighted how conventional economics was lacking in explanations of the existence of enterprise. He believed that one cannot disregard the reflections on enterprise and organizational forms. This is because market transactions have a cost and a hierarchical organization is needed to counteract it. Thus, we arrive at the essential concept of "transaction cost", which will be developed by Williamson (1981).

He starts from Coase's analysis of the existence of the enterprise and the criticism of some hypotheses of neoclassical thought. Williamson supposes that in the beginning there was the market, later companies appeared, differentiating themselves by the importance of transaction costs. The latter are ignored by neoclassical theory, which only considers production costs. Moreover, another element of contrast with neoclassical thinking can be found in Simon's (1982) concept of bounded rationality. Williamson maintains that agents encounter limits in accessing information and its treatment. In actuality, individuals, companies and all other agents, possess limited information, and this represents a constraint on the ability of interactions in exchanges, so that decisions are the result of poor mental calculation skills. In such a scenario, it is evident that the choices that will be made will result in increased transaction costs (Chavance 2010, 65-66). The above mentioned poor mental calculation skills, together with incomplete information, appear to be the basis for an increase in transaction costs, as the information is expensive and asymmetrically distributed between the parties to the exchange[7].

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[5] The work of Rosenberg and Birdzell (1986) and that of Hall and Soskice (2001) highlight the differences between different areas of the world to explain the faster development of Western economies. Recent research includes research on the variety of capitalism, which analyses the different institutional structures of developed countries, using historical-sociological-empirical analyses.

[6] For an in-depth analysis of Old institutional economics and New institutional economics, see Morselli (2018*a*, 658-660).

[7] The assumption of perfect information presupposes that all agents know their reference variables as producers and consumers, as well as all prices and the characteristics of techniques and goods. The concept of perfect information is necessary and sufficient to achieve an overall competitive balance. It will also be important not to confuse it with the concept of complete information, which indicates that all agents know not only their reference variables but also the behavioural characteristics of all other agents. Under the assumption of perfect information, agents use a kind of statistical summary of the complete information. For more on this subject, see Rossitto (2008, 18).

Williamson (1998) also goes into the subject of bounded rationality, i.e. in the light of the economics of transaction costs, rationality, in the field of knowledge, is bounded. Furthermore, he maintains that, even within a market economy[8], the enterprise becomes a subject of regulation. Transaction costs are not limited to traditional production costs but are linked to human factors (bounded rationality and opportunistic behavior) or environmental factors (uncertainty, lack of information). These factors affect the exchange; therefore, the efficiency objective is not only the optimal allocation of resources, but also the minimization of transaction costs. In this context, the institutional approach identifies institutions, understood as principles and methods of exchange, as an important element of the regulation system, which is an alternative to the market (Morselli 2018*a*). Williamson (1964) sees clear advantages of the hierarchy and hierarchisation with respect to the market, since hierarchy limits uncertainty, reduces the lack of information and the incentives to opportunistic behaviour. Again, he argues that, considering the efficiency approach, the economics of transaction costs supports the hypothesis that the total variety of organizational forms develops to rationalize transaction costs.

North strengthened Williamson's theories. He began his work as an historian of economics with a neoclassical radicalism and the problem of efficiency based on the maximizing rationality of the individual, and then changed course and continued with the discovery of the importance of institutions; thus, gradually moving away from the neoclassical tradition, he developed an original institutional theory in the nineties (Chavance 2010, 67).

North (1994) criticizes neoclassical thinking because it disregards institutions and time, neglects transaction costs and relies on unlimited rationality. He argues that the institutions represent constraints decided by men, which structure human interactions, which concern formal constraints (rules, laws, constitutions) and informal constraints (rules of conduct, conventions, codes of conduct). In this regard, North refers to the work of Karl Polanyi, *The great transformation* (1944), which shows how the entire paradigm of *homo oeconomicus* is built in an ideological context developed with the Industrial Revolution and later became the postulate of the neoclassical economics. These reflections on Polanyi lead North to think about the importance of the historical dynamics that explain the problems of the market economy, so as to develop a new conception of institutions, precisely, as the rules of the game that found human interactions. In his important work *Structure and change in economic history* (1981, 202), Polanyi argues that institutions are sets of rules, procedures and moral and ethical rules of behavior created to constrain the behavior of individuals in order to maximize the wealth or usefulness of managers.

If institutions represent the rules of the game, organizations and their entrepreneurs are the players. The rules define how the game is played, while teams try to win within the scope of these rules using strategy, coordination, skills and more or less honest means. Organizations are formed by groups of individuals connected by a common project, to achieve objectives. The interaction between organizations and institutions is fundamental, as the institutional context conditions the kind of organizations that are created, as well as their evolution, but, in turn, organizations are at the origin of institutional change (Chavance 2010, 71).

As Hodgson (1995) points out, economic theory must be able to explain the economic choices made by individuals, the community and organizations. Behaviors are influenced by institutions, therefore individuals, the community, organizations, represent strategic elements of choices. When one of these elements is not explained, we are in the presence of a partially complete economic theory of choice.

6. The Role of Institutions in Economic Growth Models

We have analyzed the relationship between institutions and economic development from an empirical point of view. Let us see, now, what happens if we approach this issue at a theoretical level through extended growth models, in order to include institutional variables.

In order to define, from a theoretical point of view, the role played by the institutions within a model, Solow (1956) has been taken into consideration. An example is that provided by Tebaldi and Mohan (2008), who develop the Solow model including the institutions. This model examines the effect of the quality of the institutions on the level of the product and on the growth rates of the production. Specifically, Tebaldi and Moham have changed the function of aggregate production and the equation of capital accumulation of the Solow model, to allow the study of the effects of the institutions on economic performance. In the model in question, goods are produced through technology with constant returns to scale and offered in a market marked by perfect competition. Institutions play

[8] North (1999, 23) argues that even in the presence of a market economy, institutions are fundamental to create an environment capable of developing cooperative processes that can encourage exchanges. However, Acemoglu and Robinson (2013, 85-88) assert that the only positive institutions are the inclusive ones, which ensure that every citizen can follow his or her inclinations and enjoy the fruits of his or her work safely; while, the extractive institutions are negative, as they take the wealth produced by the working masses to give it to a small ruling aristocracy.

a major role in determining factor productivity and technology adoption, which is why output (Y) is produced using the following production function:

$$Y = f\,[A(T, t)\, K(t,T) L(T,t)] \qquad 6.1$$

where L represents labour, $A \geq 1$ is an index that indicates the level of technology, K is capital, T is an index that specifies the quality of institutions and t is time.

Let us assume that the economy taken as a reference has a stock of exogenously produced technology that grows at a constant rate g; and assuming that the growth rate of the workforce and the labour participation rate are constant over time, then $\dot{L}/L = n$ where n is the population growth rate. T is considered constant and is normalized between 0 and 1. Therefore T is equal to 1 for those countries with the best institutions, T is equal to 0 for those countries with the worst institutions.

Institutions can influence the use of available technology and the productivity of physical capital. As Tebaldi and Elmslie (2008) state, institutions in poorer countries can hinder the use of available technologies and limit efficiency. Thus, good institutions increase technological efficiency, and increase both labour and capital productivity.

Tebaldi and Mohan (2008) say that the elasticity of production in relation to capital is influenced by institutions. In particular, efficient institutions increase the productivity of capital, thus affecting production and investment indirectly. Therefore, we have:

$$Y = K^{\alpha T} (AL)^{1-\alpha T} \qquad 6.2$$

where $0 < \alpha < 1$. By defining $y = \frac{Y}{AL}$ and $k = \frac{K}{AL}$ we are able to rewrite the production function in the following way:

$$y = k^{\alpha T} \qquad 6.3$$

By combining the equation 6.3 to the capital accumulation function we obtain:

$$\dot{k} = sk^{\alpha T} - (\delta + n + g)k \qquad 6.4$$

δ is capital depreciation rate; n is population growth rate; g is technological progress rate.

Equation (4) indicates that the economy will converge to an equilibrium growth path where:

$$\frac{\dot{y}}{y} = \frac{\dot{k}}{k} = 0$$

This allows to solve equation 6.4 for the stock of capital in the steady state:

$$k^* = \left[\frac{s}{\delta + n + g}\right]^{\frac{1}{1-\alpha T}} \qquad 6.5$$

where k^* indicates the steady state of variable k. Equation 6.5 specifies that institutions have a positive effect on the stock of capital in the steady state and consequently on the level of output per worker. In particular, better institutions (T) increase capital accumulation and this implies higher steady state capital (k^*) and output per worker (y^*). However, in the long run, the growth rate of output per worker is still determined by the speed of technological progress. By defining $\bar{y} = \frac{y}{L}$ and considering that $\frac{k*}{k*} = 0$ and by log-differentiating equation 6.3 we have:

$$g_{\bar{y}} = \frac{\dot{\bar{y}}}{\bar{y}} = g \qquad 6.6$$

that model indicates that countries are richer or poorer because of their technology. Equation 6.5 means that rich countries should have better institutions than poorer countries. Equation 6.6 means that there should be no effect of the quality of institutions on the long-term growth rate. Therefore, institutions have effects on output levels, but not on its growth rate.

Another version of the model identifies the effects of institutions on technology and the productivity of capital. Tebaldi and Moham rewrite the production function:

$$Y = A^{T-1} K^{\alpha T} (AL)^{1-\alpha T} \quad 6.7$$

Equation (7) incorporates the effects of institutions into a Solow production function. The model is resolved by defining $y = \frac{Y}{A^T L}$ and $k = \frac{K}{A^T L}$ allowing the production function to be written in terms of actual work:

$$y = k^{\alpha T} \quad 6.8$$

the equation of capital accumulation is given by:

$$\frac{\dot{k}}{k} = sk^{\alpha T-1} - (\delta + n + Tg) \quad 6.9$$

this model presents a steady-state solution in which $\frac{\dot{y}}{y} = \frac{\dot{k}}{k} = 0$. Therefore, we have:

$$k^* = \left[\frac{s}{\delta+n+Tg}\right]^{\frac{1}{1-\alpha T}} \quad 6.10$$

This extended model means that institutions have an effect on the level of long-term production and the growth rate of output per worker. By defining $\bar{y} = \frac{y}{L}$ and knowing that, log-differentiated equati$\frac{\dot{k}}{k}=0$) generates:

$$g_{\bar{y}} = \frac{\dot{\bar{y}}}{\bar{y}} = Tg \quad 6.11$$

The model therefore implies that the growth rate of output per worker is determined not only by technological change, but also by the quality of the institutions. A given economy can have the technology, but its institutions (if they are not efficient) can hinder the adoption of technologies and decrease the productivity of production factors. The effect of institutions on output per worker comes not only from its impact on the state of technological efficiency, but also from its effect on capital accumulation. Institutions influence the marginal product of capital and consequently investments and capital accumulation. Specifically, since the ratio $\frac{y}{k}$ is constant in the steady state, Tebaldi and Moham derive equation 6.8 in relation to *K*, we thus have:

$$\text{MPk}\frac{\partial y*}{\partial k*} = \alpha T k^{\alpha T-1} = \alpha T \frac{y*}{k*} > 0$$

This means that the improvement of the quality of the institutions has a proportional impact on the marginal production of capital in the steady state. In particular, efficient institutions increase investment returns which, as a result, increase capital accumulation. The result obtained is consistent with empirical studies that state that capital accumulation is indirectly influenced by 'bad' institutions (Mauro 1995).

Unfortunately, the growth model taken into consideration, even including the institutional variable, overlooks some basic problems. This model provides for constant returns to scale and a perfectly competitive market. We are certain that these two conditions are not met in the real world. Moreover, the saving rate has no effect on long-term income trends, affecting only the system's ability to grow in the short term. The growth rate of technological progress is considered exogenous and its determinants are not adequately addressed. Finally, the process of economic growth is summarized in a simple competition between capital accumulation, fed by savings, and population growth. The neoclassical model does not pose the problem of investigating the forces that determine the trend of development, since it assumes that any increase in savings is automatically converted into investment. However, as the Keynesians say, saving reduces global demand and generates unemployment. In this context, the role of aggregate demand, as a factor capable of contributing to economic growth, is ignored; as well as the balanced growth equilibrium, proposed by Solow, is not adaptable for an analysis of actual growth processes.

An attempt to overcome some of the aforementioned strictures has been advanced by Mankiw, Romer and Weil (1992), which focused on the endogenization of the determinants of growth, considering, for example, the saving rate as a function of household choices, and the accumulation of human capital and technology as a function of business choices. According to the three economists, institutions can influence growth indirectly through an effect on investment, just as institutions can influence growth through total productivity. In this case, we can make explicit the notion that institutions influence productivity by specifying technology (*A*) as a function of institutions (*F*). This means that technology evolves in an exogenous way, but at the same time differences between institutions

have a fixed effect on the level of production between countries. Therefore, if growth affects productivity directly, both investment and institutional measures will be significant.

However, the consideration of the poor performance of most developing countries in terms of economic growth in the 1950s and 1960s, mainly as a result of non-quality or non-existent institutional structures, has again made it necessary to deepen the analysis of the determinants of development. Only those countries which applied growth models oriented towards foreign trade and which had institutions more attentive to the valorization of internal resources, such as the countries of South-East Asia (Singapore, Hong Kong, Taiwan, South Korea), showed, in that period, positive growth rates of their economies (Montalbano, Triulzi 2012, 311-329).

The Nobel Prize for Economics Myrdal (1974) proposes the structuralist - Keynesian approach to analyze economic development. A supporter of Keynesian theses, he understands economics not so much as an empirical science, rather as a moral science; it is the non-economic factors that represent the main source of strengthening effects, therefore a dynamic process can only be studied taking into account the interdependence of all its aspects, economic and non-economic. For Myrdal, the neoclassical economics, based on equilibrium, can only fail when considering poor countries, since the system does not move towards a form of equilibrium, rather tends to move away from that position. Therefore, the economist states that we are in the presence of a circular constellation of forces that tend to act and react on each other in order to keep a poor country in a state of poverty. This theory is called 'circular cumulative causation' (Myrdal 1957), in which backwash effects and spread effects can be recognized. The former is represented by those circumstances that explain the growing disparities between countries, regions and social groups; whereas the latter are those elements, which, as development progresses, can cause a decrease in territorial competitiveness.

Myrdal (1957), in the model of cumulative causation explains how the concentration of enterprises can strengthen itself, causing the increasing development of the locality and the impoverishment of the periphery. He uses the Keynesian tool based on an income multiplier mechanism, in order to highlight the need for external intervention by the state to hinder the natural tendency to inequality. Myrdal did not put faith in market mechanisms; in fact, he thought that if the market is left free to follow its own course, economic development is a process of circular cumulative causation that tends to produce its positive effects on those who are already well endowed and not on backward regions.

Myrdal's concept of circular cumulative causation has contributed to the development of the modern economy of non-equilibrium (in fact the model shows the possibility of persistent and cumulative imbalances). For Myrdal this concept is at the basis of institutionalist thinking, contrasting with neoclassical schemes. He is convinced that economic development cannot be analyzed through categories typical of neoclassical economics, whereas economic reflection must be combined with sociological and historical reflection.

7. The Virtuous Circle of Institutions and Economic Development

It is particularly important to create an institutional environment that encourages economic agents to invest in productive activities. Institutions reduce uncertainty, contribute to trade stability and make the information circulating in the economic system accessible; they create specialized labour, reduce transaction costs and encourage the formation of venture capital. All this sets in motion a virtuous circle, where the efficiency of institutions plays a major role in economic growth.

The institution factor orients the lives of agents, the community and nations in such a way that if it is present it favors cooperative behavior and coordination processes. Conversely, the absence of this factor leads to a high degree of uncertainty in the economic and social context, high transaction and coordination costs, poorly functioning markets and low business competitiveness.

In this regard, it is possible to draw up a scheme, called the *virtuous circle of institutions* (Figure 1), which summarizes how economic development is encouraged by efficient institutions.

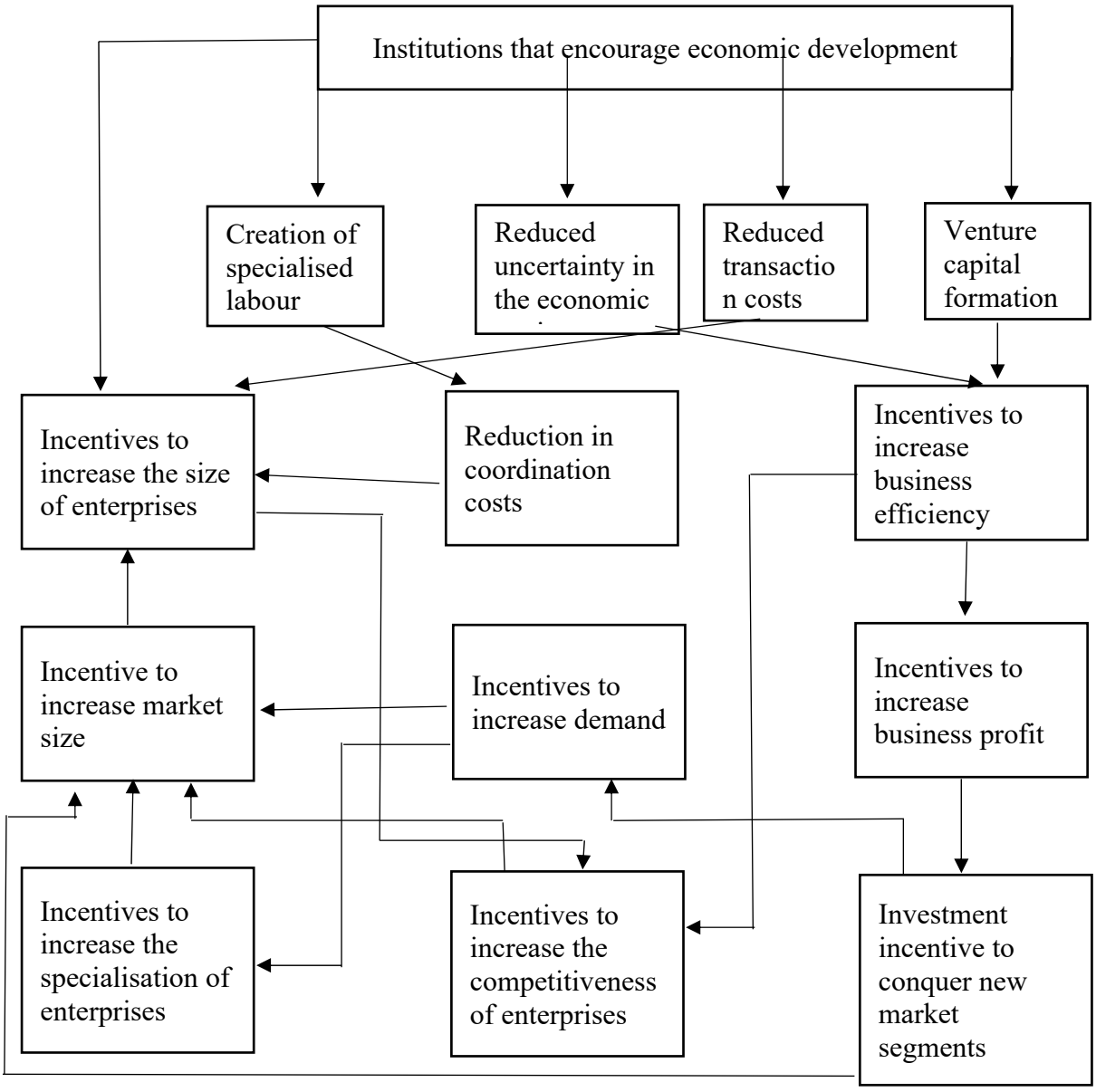

Figure 1. Virtuous circle of institutions

8. Institutional Transformations and Industrial Revolution

The Industrial Revolution had positive effects on the entire English economic system. There were clear improvements in transport, metallurgy and steam engines, but the most significant innovation was the mechanization of weaving and the development of industrial fabric factories. These developments began with the institutional changes resulting from the Glorious Revolution between 1688 and 1689, a period marked by institutional innovations. The change was also accelerated by the reorganization of economic institutions that helped innovators and entrepreneurs, based on a more efficient system of property rights (North, Weingast 1989; Weingast 1995). Investments in canals and roads increased after 1688, and as transport costs decreased, these investments laid the foundations for the subsequent Industrial Revolution (North, Thomas 1971, 777-803).

At the basis of the transport revolution and the reorganization of the land in the 18th century, there were a series of parliamentary acts that transformed the nature of land ownership, allowing groups of individuals to petition to reform property rights (Acemoglu, Robinson 2013, 211-213).

In an institutional environment scenario, we are in a state of equilibrium when the cost of the exchange exceeds the possible benefits, thus creating imbalances that lead to institutional innovation. In the passage from

the feudal system, marked by an economy of self-sufficiency, to an economic system based on the division of labour and the accumulation of capital, during the Industrial Revolution, three different forms of imbalances can be traced. First, long-term changes in the price of productive factors and products; second, an increase in the size of markets; and finally, structural changes in the criteria governing the state. The first change is due to the increase in population, which, due to the reduction of available land, caused a decrease in the value of labour, resulting in the production of an independent workforce. The second change concerns the expansion of markets which stimulates the process of institutional innovation, since transaction costs are influenced by economies of scale (North, Thomas 1970). The third change concerns the advent of socio-economic pluralism which resulted in new political institutions capable of strengthening the Parliament to the detriment of the Sovereign. The process of centralization of the governmental fabric that the Tudors had followed was essential to prevent the political change from taking place without the collapse of the system. Huntington (1968, 162) argues that the centralization of power was necessary to dismantle the old order, destroy feudal privileges and bonds, in order to create new social groups and develop new economic activities. A relevant factor is that the opposition to monarchic power came not from a monolithic elite, but from a coalition of social forces. This allowed the British institutions to assume a lasting plural attitude. The composition of the social forces of a system has an impact on the nature of the political regime, and if the dominant economic elite is homogeneous, then the political institutions, reflecting the power structure of the regime, will not need to be pluralistic; presumably, there will be institutions able to favor the closure of the system and the perpetuation of the economic ruling class, which, in return, will bring support to the political elite. Thus, in England, business and innovation were encouraged, property rights were protected, the law became more and more impersonal and the discretion of royal action decreased. Here too the foundations were laid for the Industrial Revolution (Vercesi 2015), which began in England thanks to the formation of an open political system attentive to the economic needs of society.

Conclusions

The evolution of market economies is based on the presence of institutions that play a major role. The absence of institutions, or their malfunctioning, represents an obstacle to investment and innovation and, therefore, to economic growth, and, as we have seen, the literature on the subject is now very extensive.

Despite everything, in the first part of the 20th century, neoclassical thought represented the benchmark of the international economy, dulling and overshadowing the institutional economy. The neoclassical current is based on the market, the analysis is set in terms of balance and develops from rational individual actions, focusing on efficiency; therefore, the themes related to institutionalism and the historical dimension of the economic process are not considered. The dominant economy, in its analysis of big business and the economy of development, has preferred to ignore institutions.

Coase decided to reintroduce institutions into the economic analysis through the *New Institutional Economic*s, starting in 1937. He pointed out that it is not possible to disregard reflections on business and its organizational forms, since market transactions have a cost and in order to reduce it, or not increase it, the need for a hierarchical organization arises. Coase's reflections, taken up by Williamson, represent the origin of the theory of transaction costs, which make it possible to understand and explain the existence of organizational models.

Certainly Coase's analysis, starting from his main work *The nature of the firm*, is a pioneering one, in which theoretical constructions are highlighted that need to be inspired by, in order to integrate the role of information in the structure of (transaction) costs, which, in turn, influence the dynamics of market prices.

We start from the fact that prices are marked, on all markets, by a more or less strong dispersion and change with a variable frequency. Discarding the hypothesis of the presence of a completely centralized market, no individual is able to know, at a given moment, the range of prices applied by the different bidders, since all potential buyers, in search of the most advantageous price, should contact all the different sellers; a hypothesis that Stigler (1961) defines as 'search'. The optimal search rule suggested by the economist concerns a search such that its marginal cost is equal to the expected growth in revenue. A valid rule for buyers and sellers. On second thoughts, this is the traditional neoclassical research of equality between marginal costs and revenues, since the search for information about the optimal price will be pursued to the point where the cost of the additional research will equal the gain derived from this additional research unit. Despite this search for the cheapest price, a certain price dispersion will continue to persist, also due to the precariousness of knowledge, as supply and demand conditions change rapidly over time. Thus, dispersion will be all the more relevant the more unstable the market conditions are, to the detriment of information provision.

As we have seen, Williamson maintains that agents encounter limits in accessing information and its treatment. In actuality, individuals are in possession of limited information, and this is a constraint on the ability to

interact in the exchanges, so that decisions are the result of poor mental calculation skills, increasing transaction costs.

At this point, the institutional approach comes into play, which identifies institutions, understood as principles and methods of exchange, as a relevant element of the regulation system, which is an alternative to the market. In this framework, the advantages of the hierarchy are identified, since it limits uncertainty, reduces the lack of information and the incentives to adopt opportunistic behavior.

North strengthened the institutional approach. Starting from Polanyi's considerations on *homo oeconomicus* matured during the Industrial Revolution, he reflected on the importance of the historical dynamics, in order to develop a new conception of institutions as rules of the game which found human interactions. Thus, it is possible to demonstrate that the origins of institutional doctrine are to be found in economic history. In fact, one of the main criticisms that North addresses to the neoclassical economics concerns its lack of consideration of the temporal dimension, and this has led him to favor the study of institutional change and the evolution of institutions, and not the origin of the latter.

As argued by Hodgson, behaviors are influenced by institutions, thus individuals, the community and organizations are configured as strategic elements of choices. When one of these elements is not explained, the economic theory of choice is incomplete.

At the conclusion of the study performed, the importance of institutions is evident, since they reduce uncertainty, encourage trade stability and make the information circulating in the economic system accessible; they create specialized labour, reduce transaction costs and encourage the formation of venture capital. In other words, long-term economic development can receive a great deal of help from institutional theory and the latter is able to intervene more directly in explaining the process of economic change.

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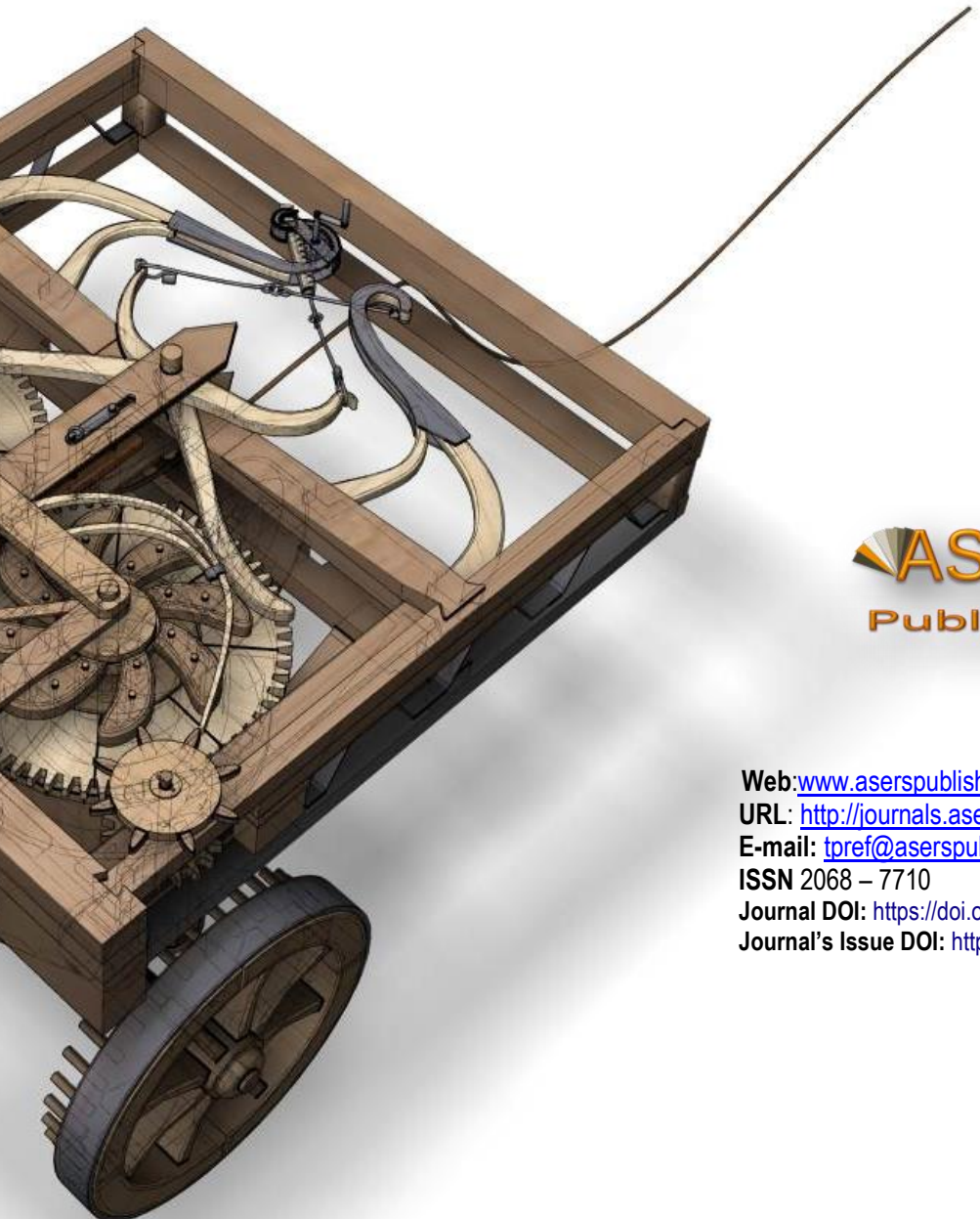

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