# EXPLORING THE FORMAL AND INFORMAL INSTITUTIONS AS A KEY TOOL FOR ENHANCING ECONOMIC RESILIENCE

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**Abstract:** *Despite the fact that there have been many institutional studies over the past two decades and the role of institutions in economic life is extremely high, we could state that modern economic theory of institutions is in its infancy. Institutions organize the relationship between people as well as determine and limit the set of alternatives in the economic behavior. This paper aims to investigate and to understand the impact that formal and informal institutions induce on the broader growth of economic resilience capacity and the development outcomes as well as to consider ways of prospect measuring of this institutional approach. Content analysis of fundamental research papers on the issue of resilience and institutional theories has been carried out. According to the result, we state that formal and informal institutions retain their backbone role, even under strong external influences. Also, the long-term differences in the functioning of economic systems are shaped by a very deep influence of institutions.*

**Keywords:** resilience; economic resilience; formal and informal institutions
**JEL Classification:** F6; O1

## Introduction

During the last two decades, many state economies have undertaken extensive institutional changes and economic reforms such as privatizations, trade liberalization, financial and macroeconomic stabilization intended to make domestic markets more open, competitive and efficient (Castellacci, 2015; Pascariu and Tiganasu, 2011). The new competitive environment opens up new challenges and opportunities for different regions. For this purpose it is essential to assess the degree of those institutional reforming influence on economic resilience capacity. It is also important to investigate how this process of institutional change affects the economic resilience capacity and how this varies across different economies.

Economic modernization is closely related to the implementation of a number of institutional reforms aimed at the transition to an innovative model of development and improving the quality of life of the entire population tending to reach appropriate resilience capacity (Handmer and Dovers, 1996). One element of the reform is the creation of institutions like the organizational and economic structures that facilitate the allocation of resources in favor of the project to create a new growth

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potential through the active involvement of investment in social and physical infrastructure, developing industry and human capital, as well as through the creation of new technologies and promoting competitiveness.

Researchers do not precisely define the respective roles of formal and informal institutions in resilience processes. Institutions are seen in very broad terms as relating to certain political or economic rules of behavior (Hutter and Kuhlicke, 2013). Their basic thesis is that inequitable economies develop exploitative and inefficient institutions. However, the pace of the transition has been uneven with some regions continuing to be dominated by the “old” institutions while others have almost fully transited to the new, market-oriented institutions.

This paper aims to provide a theoretical justification of the role of institutional approach as a key tool for enhancing economic resilience capacity.

## 1. Methodology

This study is based on qualitative research methods to address the research questions and objectives. Depending on these research questions the methods of literature review, content analysis and comparative analysis will be used. Different methods will allow the different research objectives and questions to be fully explored.

## 2. Formal and informal institutions

Institutions are a set of man-formal and informal rules of acting as a constraint for the economic agents, as well as appropriate mechanisms for monitoring their observance and protection. Modern economic theory of institutions is in its infancy, although there have been many studies over the past two decades. In 1993, Douglass North was awarded the Nobel Prize in Economics as one of the pioneers of new institutional economics.

### *2.1. Definition of institution*

The importance of any institute is to guide individual behavior in the right direction by fixing norms of behavior of economic agents, as well as restrictions on the use of resources and options for individuals to use them. Institution is quite debatable concept. Scientists did not give a clear statement what an institution is. Moreover, in economic terms, the institutions are defined in different ways.

**Table 1 – Definition of institution**

| Author | Definition |
|---|---|
| Thorstein Veblen | Habitual methods of carrying on the life process of the community in contact with the material environment in which it lives (Veblen and Howells, 1965) |
| Wesley Mitchell | Models and standards of behavior rooted in customary ways of acting and thinking (Mitchell, 1914) |
| Gustav von Schmoller | The specific order of living together, which serves a specific purpose and has potential self-evolution (Schmoller, 1967) |
| Douglass Cecil North | Formal rules (constitutions, laws, property rights) and informal restraints (sanctions, taboos, customs, traditions, codes of conduct), which usually contribute to the perpetuation of order and safety within a market or society (North, 1990) |
| Geoffrey Hodgson | Systems of established and prevalent social rules that structure social interactions (Hodgson, 2006) |

To summarize, we state that institution is a basic concept of the new institutional economics, and an integral part of the general economic theory. In general, institutions can be defined as a set of formal and informal rules, including mechanisms to ensure their observance. We note that the most common view on the institutions in the economy connected with limitation of certain macro and micro-economic development parameters. Limitation of behavior of economic agents by institutions is a direct consequence of the new institutional approach. At the present stage, the institutions should be defined not in terms of the neoclassical "efficiency", but in terms of time and value categories. Only coincidence of parameters of time and the availability of the necessary social-economic environment should determine the decision on establishment of institution.

### *2.2. Formal and informal institutions*

Organization theory and economic sociology, in turn, have provided a deep examination of the role of institutions such as social norms, trust, routines, and political processes (Zenger *et al.*, 2000). According to economic theory institutions can be divided into formal and informal ones, the dividing criterion being the degree of formalization of existing bonds within them, interactions and relationships.

1. Formal institutions are institutions that receive legislative framework, supported by specially authorized persons (judicial authorities). They are officially described in documents and are applied to all individuals (citizens). It is applied to the property, labor, management authority. Formal

institutions are often created in order to serve the interests of those who control the institutional changes in the economy. The pursuit for self-interest for one could have a negative effect for others.

2. Informal institutions are the ethical conventions and ethical codes of conduct (traditions, customs and habits). Their functioning depends on the availability of social sanctions and formed by culture. These rules apply to limited socio - homogeneous groups. Informal rules regulate power, property and labor. Informal institutions form a sort of underwater part of an iceberg. They are spontaneously formed, without anyone's conscious intention, as a by-product of the interaction of many people, pursuing their own interests.

Formal institutions can quickly change, whereas informal change slowly and gradually. And the fact is that formation of institution is a long and complex, and continuous process caused by the development of society.

## 3. Role of institutions in economic resilience

Most of the scientific literature refers to resilience as the ability of any system to recover from an external shock or to absorb against downturns (Briguglio *et al.*, 2009; Rose and Krausmann, 2013; Brock et al., 2002; Gunderson and Holling, 2002).

Thereby, resilience capacity includes the ability to deal with external factors as well as to reduce vulnerability, and one of its main tasks is to minimize losses and, as a result, to ensure economic recovery as soon as possible.

Economic resilience means not only preserving the positive level of its economic performance, but also includes a development which manifests in the economic growth displayed by aggregate indicators of economic and financial development of the system. In order to characterize the economic growth using both general and particular indicators and definitions is preferable.

We state that the economic resilience can be defined as a state of the system in which its characterizing parameters (financial, operational, organizational or any others) tend to make the system “economically resilient” and, at the same time, capable of harmonic development and improvement at any changes of the external environment

One of the key factors in maintaining economic resilience is the quality of the institutions involved in a particular economic system. To better understand the phenomenon it is necessary to clearly understand the roles and functions performed by institutions. Melikhov (2011) identifies the following functions:

- *practical function* is manifested in the concretization of the theoretical conclusions and checking their authenticity through economic activity, the search for effective forms and methods of economic management, the establishment of an adequate mechanism for management at all levels of the economy;

- *reduction of transaction costs* is an important element in the analysis of economic institutions. Its components are: the costs of information search and partners, the cost of negotiation and preparation of contracts, the costs of monitoring and enforcement of contracts. There are a number of rather complex definitions of transaction costs, which are based on the fact that every transaction is an exchange of property rights;

- *informational function* of economic institutions refers to the accumulation, selection and transfer of information in space and time. Fulfilling information function, economic institutions ensure the continuity of social reproduction. If one of the actors knows how it should behave in certain circumstances, and the other does not, coordination may be compromised as a result of interaction of the participants;

- *regulatory function* refers to the fact that economic institutions direct the activities of economic entities in the direction most useful for the economy as a whole, and try to suspend the activities of entities that brings negative consequences. Media institutions as the rules and regulations govern the legal relations in the society and thus create an atmosphere of security and confidence in the assurance of human rights and freedoms.

Thus, formal and informal institutions are a relatively stable set of complex economic, legal, social and ethical relations, for a long time realized at the surface of social phenomena in the activities of institutional organizations and private individuals. Institutions incorporate a complex web of specific relationships, resulting in socio-economic system in the form of the objective and subjective aspects seeking to ensure economic resilience capacity.

## 4. Indexing resilience

Earlier studies of economic resilience centered on characterizing the idea of the phenomenon and applying of case studies. In recent years, the trend has changed towards the identification of indicators and establishment of full holistic index.

It should be noticed that the mechanism of indexing and monitoring the economic resilience of the socio-economic system acts as a tool to determine how to enhance economic resilience capacity and to achieve the desired state in the long term. The indices are released each year and allow us to analyze the current situation, based on the specifics of each of the indices, which include a certain number of indicators. Resilience indices used in the scientific community allow us to conclude that the institutional component is fundamental, being included in all of them. Among the institutional indicators presented in main resilience indices we highlighted the following, such as institutional environment, competitiveness, doing business, corruption perception, and governance (See Table 2).

**Table 2 – Resilience Indices**

| Year | Index | Author(s) | Indicators |
|---|---|---|---|
| 2009 | Economic Resilience Index | Briguglio, L., Cordina, G., Farrugia, N. and Vella, S. | Macroeconomic stability, Microeconomic market efficiency, Social development, Good governance |
| 2009 | Index of Economic Resilience | EDAW and AECOM | Sectoral Mix; The Workforce; Enterprise; Labour Market; Assets and Infrastructure; Scale and Proximity. |
| 2010 | Disaster Resilience Index | Cutter, Burton and Emrich | Social Resilience, Economic Resilience, Institutional Resilience, Infrastructure Resilience, Community Capital, |
| 2011 | Community Resilience Index | Norris, F.H. | Diversity of Economic Resources, Equity of Resource, Distribution |
| 2012 | Community Resilience Index | Ainuddin, S. and Routray, J. | Economic resilience, Social resilience and Institutional resilience |
| 2014 | City Resilience Index | Rockefeller Foundation | Four categories: the health and wellbeing of individuals (people); infrastructure & environment (place); economy and society (organization); and, finally, leadership and strategy (knowledge). |
| 2015 | Resilience Index | FM Global | Economic, Risk Quality, Supply Chain |

Considering the fact that the institutional part is the basic component in all indices, it is possible the implementation and further development of certain institutional index of economic resilience capacity. This will widen understanding of the variability of the phenomenon and will be both guide point and benchmark for countries that are active in the process of institutional reforming. This institutional index should consider and include the specificity of different countries and regions for a more detailed institutional indexing.  Since the intentions to enhance economic resilience capacity are the result of findings reached by comparing the level of the planned strategic development, this index will try to present possibility of providing more objective conclusions and recommendations for further development in the long term.

## 5. Methodological aspect for assessing institutional component

Concept of searching the institutional causes of economic resilience requires separate consideration of such phenomena as "institutional factors" and "the parameters of the institutional environment." In this approach, the system of institutional factors of economic resilience of the particular country or region is influenced by a set of formal and informal rules of acting in different situations, as well as the economic interests of powerful groups. The system includes factors such as bureaucracy, business coalitions, civil society, democracy, the judiciary, corruption and informational openness in society.

Tereshchenko (2012) argues, that within the framework of study the problems of measuring the relationship of institutional quality and the level of economic development we can use the following methods:

- inclusion of institutional parameters in the analysis of economic resilience;
- econometric analysis;
- method of quasi-natural experiment.

In order to analyze each method, we must consider the advantages and disadvantages of each, in order to maximize the benefits of their use in further studies (See Table 3).

**Table 3 – Methods of assessment of institutional component of the economic resilience**

| **Method of assessment** | **Advantages** | **Disadvantages** |
|---|---|---|
| inclusion of institutional parameters in the analysis of economic resilience | - offers to consider the impact of innovation and institutional components, including human capital and administrative resources, ratio of public goods and the total value of private equity, etc. | - considers the factors of economic resilience (labor, capital and technical progress) and institutional factors on one methodological level |
| econometric analysis | - involves complex statistical methods (simple correlation regression analysis, method of instrumental variables)<br>- detects direct close statistical relationship between the indicator parameters of institutional environment and process indicators | - problems of any empirical research related to the problems of sampling and measurement of institutions;<br>- limited econometric studies, which is linked to the fact that such studies only reflect statistical dependence between phenomena and processes |

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|---|---|---|
| | of economic resilience in the presence of valid theoretical model<br>- allow to make comprehensive conclusions that could make a significant contribution the development of the institutional hypothesis | - problem of choice of instrumental variables, since it is usually carried out subjective, intuitive. |
| method of quasi-natural experiment | - clarify what factors have greater impact on the economic resilience | - depends on subjective considerations and complexity of finding suitable illustrative examples |

As we can see in Table 3, each of the methods is different and includes certain risks. Despite this, the relationship of these methods of assessment and measuring enables us to consider comprehensively the whole process and thus present the most realistic picture of the institutional component of economic resilience capacity.

**Conclusions**

To summarize, we state that institutions play an essential role in the development of the economic system. They form the "institutional framework" of the economic system. Institution is a basic concept of the new institutional economics, and an integral part of the general economic theory and economic resilience capacity in particular.

Despite existing methodology for assessing the quality of institutions, the issue of quantifying this phenomena in the framework of economic resilience capacity remains open. The importance of the institution is to guide individual behavior in the right direction by fixing norms of behavior of economic agents, as well as restrictions on the use of resources and options for individuals to use them.

Indexing of economic resilience capacity is one of the main trends in modern economic theory. The possibility to develop an economic resilience index based on institutional parameters as key indicators seems a very good choice taking into account the importance of formal and informal institutions in social-economic environment. Not only that formal and informal institutions retain their backbone role, even under strong external influences, but also they are deeply shaping long-term differences in the functioning of economic systems.

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