THE ROLE OF INSTITUTIONS, BUSINESS, AND SOCIETY IN SHAPING MODERN ECONOMY

Julia G. Dobreva

VUZF University, Department of Finance, 1 Gusla str., Sofia, Bulgaria

Abstract

Institutions are a part of the social order of society and they govern behaviour and expectations of individuals, while at the same time they regulate business operations and ethics. In fact, the morality of institutions is guaranteed by the process of social evolution. On the other hand, the role of business in society is an important aspect of leadership and not in conflict with profitability and economic growth. The role of business in society is in fact the challenge of what is called "corporate social responsibility". The aim of this paper is to critically discuss the interrelations between institutions, business, and society by closely looking at the way institutions operate in terms of guaranteeing economic development, their role in building social structures and improving social development, and their contribution to the overall process of establishing a tight link between the economy and social welfare.

Key words: institutions, economic development, social development

1. Introduction

Institutions are a part of the social order of society and they govern behaviour and expectations of individuals, while at the same time they regulate business operations and ethics. In fact, the morality of institutions is guaranteed by the process of social evolution. On the other hand, the role of business in society is an important aspect of leadership and therefore its social responsibility should not be in conflict with profitability and economic growth. The role of business in modern day society is in fact the challenge of what is known and widely discussed today as "corporate social responsibility".

Hence, when discussing economic development one should take into account that it is not a single process, governed only by mechanisms of attaining economic growth through the accumulation of capital. Rather it is a complex phenomenon that binds closely together specific processes related to the establishment of deeply embedded relations between institutions, business units and society. Furthermore, the failure to achieve and sustain development is as much a political and social concern, as it is a problem with purely economic foundation. In other words, politics and social structures also shape development and likewise a failure to get growth started is first and foremost a political and social problem. Proper government policies are a key factor in boosting modern economic growth and they should be set forth through the establishment and operations of sound institutions.

The aim of this paper is to critically discuss the interrelations between institutions, business, and society by closely looking at the way institutions operate in terms of guaranteeing economic development, their role in building social structures and improving social development. Also, the analysis distinguishes their contribution to the overall process of establishing a tight link between the economy and social welfare.

2. A model of interrelation between institutions, economy and society

Economic development requires both a government capable of directing or supporting a major growth effort and people who can work effectively and manage the enterprises and other organizations that arise in the course of development [1]. The terms economic growth and economic development are still sometimes used interchangeably although there is a fundamental distinction between them.

Economic growth refers to a registered rise in national or per-capita income and product and is measured by GDP (GNP). *Economic development* implies more in addition to the purely monetary registering of a rise in per-capita income. It implies fundamental changes in the structure of the economy.

For example, what has happened historically in Libya as a result of the discovery of petroleum as opposed to economic processes in South Korea is a good explanation of the differences between the two concept, even though both countries have experiences a huge rise in per capita income. In Libya, however, the rise was achieved by foreign corporations, which produced a single product consumed mainly in the USA and Europe. Hence, the effect of petroleum development has been rather a process of granting aid from developed nations to Libya. In contrast, if we look at South Korea since 1960 we can clearly observe a process of economic development due to structural changes. Why? Two of the most important structural changes are the rising share of industry (paired with a falling share of agriculture) in the national product and an increasing share of people who live in cities rather than the countryside. In addition to that, countries that enter into economic development usually pass through periods of accelerating and the decelerating population growth during which the nation's age structure changes dramatically. Also, consumption patterns change as people no longer have to spend all of their income on necessities, but instead move on to consumer durables and eventually to leisure time products and services.

Therefore, a key element in economic development is the active participation of the people of the country in the process which brings about all changes attributable to the economic structure. It is also important to note that participation in the process of development implies participation in the enjoyments of the benefits of development as well as the production of those benefits.

The process, therefore, requires a representation of the interaction of three key elements, as illustrated in figure 1.

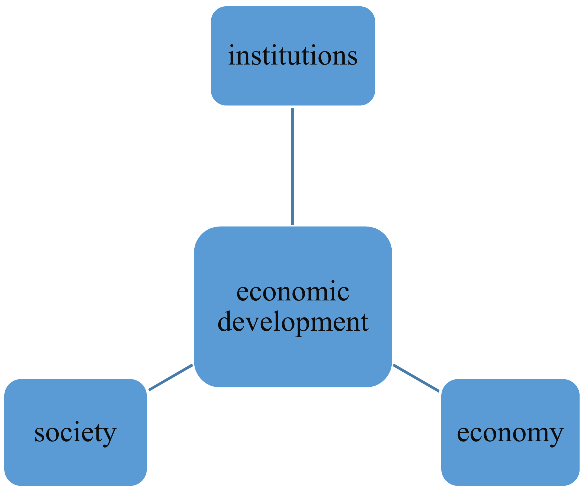

Fig. 1 The three key elements for economic development (own model)

Institutions are structures that matter most in the society. According to Hodgson [4] institutions enable ordered thought, expectation, and action by imposing form and consistency on human activities. Thus they depend upon the thoughts and activities of individuals but are not reducible to them. *Another important trait of institutions is that they constrain and enable behavior at one and the same time by imposing rules.* The original institutional economists understood institutions as a special type of social structure with the potential to change all people participating or being affected by the rules of institutions. Hence, development is concerned with how one creates institutions that facilitate it in the first place. Therefore, some questions could be particularly relevant to establishing the institutional context of economic development and the role played by society and the economy. For example:

- ✓ *How does a nation acquire a government interested and capable of promoting economic growth?*
- ✓ *Can efficiently functioning markets be created in countries which currently lack them or should the state take over the functions normally left to the market?*
- ✓ *Is it necessary to have a well-developed and regulated financial system and is land reform necessary for development?*

These institutional issues are at the core of the process of economic development and they require the active participation of both business and society.

Economic development is first and foremost a process involving people, who are the prime movers of development and its beneficiaries. It is very important then to observe how the human resources are transformed in the process of economic development and how that transformation process contributes to the development process itself. Society and social values can contribute to the shaping of the economy and changing the economic profile of a country, but they can also significantly impede and even in some cases damage institutions and hence prevent economic development. *So, while we look at institutions as modelling and shaping society, it is also society modelling and shaping institutions and thus influencing economic development.* In this respect, both political and social obstacles arise that prevent the boosting of economies and institutional design should follow strict patterns in order to avoid, or at least to reduce, such negative influence.

The other major physical input in the economic growth and development process is capital, how it is mobilized and allocated for development purposes. This issue treats problems related to savings and their transformation into investments by businesses. Also, a major role in this process is played by the financial system and its contribution to capital accumulation. In addition, technological change, innovation and the related institutional reform significantly add to the development of investments and the improvement of the business environment.

3. Institutions and economic development

According to Margareta Drzeniek-Hanoutz if one wants to predict the prosperity of a country, one needs to just look at its institutions. This is so, because the legal and administrative organizations that underpin every society form together what economists call an “enabling environment” for the creation of wealth. When institutions fail, trust is eroded and economies can become damaged. Collaboration between public and private sectors is therefore particularly important when it comes to boosting economic productivity and growth. However, in the absence of strong institutions the collaboration between the public and private sector can become dysfunctional. Thus, both sectors will collude in the pursuit of profit and at the expense of the consumer [2].

It is generally assumed that institutions change the processes within a given economic system. However, Chang observes that economic development, on its turn, also changes institutions through a number of channels. First, increased wealth due to growth may create higher demands for higher-quality institutions (e.g., demands for political institutions with greater transparency and accountability). Second, greater wealth also makes better institutions more affordable. Institutions are costly to establish and run, and the higher their quality the more ‘expensive’ they become. Third, economic development creates new agents of change, demanding new institutions. In the 18th century, the rising industrial capitalists supported the development of banking against the opposition to it by landlords, while in the late 19th and the early 20th centuries, the growing power of the working class led to the rise of the welfare state and protective labour laws, against the capitalists who thought those institutions would bring about the end of civilization as they knew it [3].

Furthermore, Chang [3] argues that the dominant discourse on institutions and development fails to recognize that the relationship is not linear, it differs across societies and also changes over time even in the same society. If an institution promotes growth, in certain cases it may actually hamper economic growth in a larger dose. Thus, while some protection of property rights is absolutely necessary for there to be investment and growth at all, an overly strong protection of property rights may reduce growth. For example, a stronger protection of property rights increases the costs from monopoly, which may more than offset the benefits from greater innovation that it may bring. Moreover, if excessive, protection of property rights may hinder innovation itself by making technological diffusion overly costly. Second, even the same institution in the same dose may be good for one country but bad for another and thus a level of protection of property rights that may bring net benefit to a developed country may be harmful for a developing country. A developing country is likely to have few economic agents capable of responding to the incentives provided by the protection through technological innovation. Many countries from Eastern Europe experienced difficulties with their property rights transformations in the early 1990s due to lack of transparency, institutional inadequacy, and the necessity for adaptations in the relevant legislation.

Furthermore, even in the same dose and in the same country, the same institution may promote growth at one point in time but not in another. For example, concentrated land ownership promoted agricultural development in Japan until the First World War, when landlords were personally involved in cultivation and thus invested in irrigation and technological improvement, but then turned into an obstacle to development after the First World War, as most landlords became absentees who were not interested in investing in raising agricultural productivity. The over-riding of landlord property rights in the post-Second World War land reform, however, helped subsequent economic development of Japan. Yet, the same exercise in the late 19th century would have had negative economic consequences [3].

The same case is observed with Bulgaria. There was significant increase in productivity and economic growth with the nationalization of privately owned land in mid-20th century (after the Second World War) up to the point where in the 1990s the society saw the need for reforms in the political system and the return to private property. The expectations were to get the same benefits from privately owned land as the ones people had between the First World War and the Second World War. However, a number of problems appeared, related to the fact that one and the same parcel of land was owned collectively by a number of landowners, many of whom were not interested in cultivating it and investing in machinery and equipment. Hence, small parcels were brought into larger blocks, managed by a small number of companies who gradually monopolized the agricultural market and distorted market competition, preventing smaller companies from the chance to have their fair share. Furthermore, the land reform in Bulgaria in the early 1990s significantly distorted the structure of the economy by making agriculture the prevailing sector and thus industry started to lag behind in its development. This, on its turn, had a huge impact on low economic growth and a staggering development that continued even in the beginning of the 21 century and was paired with income inequality, unemployment and social isolation in rural regions.

4. Institutions and political obstacles to development

Gillis et al. [1] argue that political stability is important for development because governments must be able to create and maintain a stable environment for modern enterprises. This implies that civil war, or invasion by hostile forces must be avoided. China, for example, failed to enter into modern economic growth prior to 1949 due to prolonged instability connected with civil war and foreign invasion. A long list of nations, including Bolivia, Pakistan, Ghana and many others have experienced prolonged domestic instability which has significantly inhibited growth. In general, foreign investments require political stability. Investors will not put their money into projects that in the short run will lead to the projects' rendered unprofitable by the introduction of new laws and other restrictions. The failure of Bolivia's economic development is largely due to the fact that since it was declared as independent in 1825 until 1987 it has had 150 governments.

Along with political stability, independence also plays a key role in economic development. In historical perspective, colonial governments were usually quite stable and for long periods of time. There were rebellions against British rule in India, French rule in North Africa, and Japanese rule in Korea. Yet, these rebellions were short-lived or on the periphery of the colony. Most colonial governments had a very specific interest in creating a stable environment for private business.

However, few European or Japanese colonies experienced anything that could be described as sustained economic development. It could be explained by the fact that the stable environment created was only to the benefit of a small number of traders and investors from the colonizing nation whereas the citizens of the colonies received little support. In addition, most colonial governments made limited investments in training local people, in developing the energy supply system or promoting industrial production. Therefore, for these countries political independence was necessary before economic growth could occur.

It is also important to observe if there are governments which for domestic reasons are unwilling to do what is necessary to achieve growth. The decision to pursue economic development involves the hard choices called trade-offs. While there a many people whose position is significantly improved by economic development, there are also people whose position becomes worse off. In such cases, if those who become worse off in the short run are in a position to topple the government, that government will be unwilling or unable to make the necessary steps and promote growth. This problem could be illustrated with the experience of a number of developing countries which have attempted to devalue their currencies, eliminate excessive administration or staff in public enterprises or remove subsidies for basic consumer goods. For example, in Shri Lanka and Bangladesh, political supporters of the government have been forced on the managing board of public enterprises and the result was a large number of overstaffed and inefficient enterprises that were unable to channel national savings mobilization efforts or to effectively deliver goods and services. In Egypt in the 80s the problems were both with overvalued currency and large subsidies on food and other necessities. Subsidies are a major drain on a government's budget and make it difficult to find funds for development. Yet when in 1977 the Egyptian government tried to remove those subsidies, the result was a widespread urban rioting that led to the government's decision to reverse its policy and keep the subsidies.

There are some nations, which feel that certain international goals should take precedence over domestic development goals. For example, a number of Arab states have devoted a share of their surplus resources to a confrontation and war with Israel. As their resources were limited they had to choose between having either confrontation or economic development, they could not have both. Other nations have concentrated their energies on achieving what could be termed social goals rather than economic development. As economic development includes both growth and the wide distribution of the benefits of growth, some nations have pursued growth but not development while other nations have sacrificed growth in order to achieve wider distribution and other social goals. For example, Cuba in the 60s experienced little economic growth because energies were concentrated on achieving a major redistribution of income, education and other benefits in favor of the poorest groups of society. Another example is China's cultural revolution for the period 1966-1976, where the ultimate goal was to eliminate all class distinctions and to minimize the role of material incentives. Chinese leaders were willing to sacrifice growth at least temporarily to achieve those objectives. While growth and distributive goals need not be in conflict and income redistribution can make an important contribution to a more rapid growth, China's and Cuba's experience from the 60s show that when they are in conflict leaders do not always choose growth.

Hence, one of the reasons some nations are still underdeveloped is due to the fact that their governments have been either unable or unwilling to implement development policies. Governments and their institutions represent various interests in society and in some cases it has been impossible to pursue development goals and maintain support to stay in office.

5. Society and social values as obstacles to development

Social values have a direct bearing on whether or not development occurs and one of the most outstanding examples in support of this argument is how societies create a sufficient number of entrepreneurs to lead the development effort. Those societies that lacked a sufficient number of entrepreneurs failed to initiate a sustained period of growth and the reason for this insufficiency was in the way different societies were structured [1].

The concept of entrepreneurship was developed by Joseph Schumpeter who put the entrepreneur in the center of his book *Theory of Economic Development* in 1911 [5]. The entrepreneur was someone who could take a new technical discovery or a new method of management and make use of it in his business. It was one thing to develop a new technique into a business but unless someone put that to practical use to turn it into an innovation it would have little or no impact on economic development. The entrepreneur who played this crucial role was someone with imagination to see the potential for profit from the innovation. He had the initiative to carry out the task of introducing the innovation and also a willingness for taking risks in case his undertaking fails and leads to a loss rather than profit. Also, it was not necessary for the entrepreneur to be a manager or an investor. He was an inventor who could hire managers. But Shumpeter raised one very important question – was entrepreneurship necessary when industrial development had already reached an advanced level? In advanced economies innovation is an activity which is successfully managed by corporations and innovations could be though to managers in universities. Hence, if innovation can be routinized in advanced economies, it should be easily implemented in developing economies as well and the value of such inventions is clear. The task for the developing nation is to find the capital and managerial talent to run such new enterprise.

It is then important to identify what has blocked the development of entrepreneurship in certain societies. Most entrepreneurs have come from what is called *blocked minority groups*. As certain individuals in a traditional society are prevented from rising to more conventional sources of prestige, power and wealth such as high government office. The reason for this is that they are members of religious or ethnic minorities, subject to discrimination, or because they are immigrants from abroad and not natives of the country and the only rout open for them is to become wealthy through entrepreneurship. It is interesting to observe that in Latin America most industrialists have been of Lebanese, Arab, Jewish German, Basque, or Italian origin, rather than from the dominant Spanish or Portuguese origin.

Another factor that contributes to people ending up as entrepreneurs is that of *need achievement*. This concept was developed by the American psychologist David McClelland. According to McClelland an individual's specific needs are acquired over time and are shaped by his life experiences [6]. He proposes achievement as a psychological need and observes that certain societies produce a large number of people with a high level of desire to improve themselves in order to become financially better off, achieve something or become recognized and reach a higher social status. It is then expected that such societies will produce large numbers of entrepreneurs and hence will develop. Appropriate motivation arises more or less automatically as economic development creates opportunities for people to exploit.

Hence, it is clear that the problem for appropriate motivation for economic development exists in some developing societies and for various reasons certain societies and cultures seem more resistant to change than others. Also, economic development requires the availability of effective managers and hard-working and disciplined workforce, so motivation has something to do with this as well. Therefore, an environment full of economic opportunity eventually brings forth success in economic development.

The role of institutions has been widely discussed in terms of social and individual well-being. Their governing force is distinctive in the process of identifying and solving issues of national and global importance, mainly related to political stability and economic development. It is the primary function of institutions to eradicate problems of a broad scope and variety like poverty, unemployment, income distribution, gender equality, political stability, human rights, etc. The most outstanding function of modern day institutions, however, is to build equitable societies [7].

6. Conclusion

The aim of this paper was to critically discuss the interrelations between institutions, business, and society by closely looking at the way institutions operate in terms guaranteeing economic development. The analysis looked at their role in building social structures and improving social development, and their contribution to the overall process of establishing a tight link between the economy and social welfare.

The paper argued that when discussing economic development one should take into account that it is not a single process. Rather, development is a complicated process, governed only by mechanisms of attaining economic growth through the accumulation of capital. Also, as a complex phenomenon it binds closely together specific processes related to the establishment of deeply embedded relations between institutions, businesses and the society at large.

The failure to achieve and sustain economic development is a political and social concern. It is a problem with purely economic foundation but has social and political impacts. In this paper we claimed that politics and social structures also shape development and a failure to get growth started is first and foremost a political and social problem. Proper government policies should be considered as a key factor in boosting modern economic growth and they should be set forth through the establishment and operations of sound institutions.

Also, we argued that economic development is first and foremost a process involving people. The population of a country are the prime movers of development and its beneficiaries. The other major physical input in the economic growth and development process is capital. It is important how citizens mobilize and allocate it for development purposes. These are problems related to savings and their transformation into investments by businesses. Therefore, a major role in this process is played by the financial system and its contribution to capital accumulation. Among the other important factors are technological change, innovation and the related institutional reform. The paper claimed that these significantly add to the development of investments and the improvement of the business environment, thus furthering growth and economic development.

References

[1] Gillis, M., Perkins, D. H., Roemer, M. & Snodgrass, D. R. (1987). *Economics of Development*. W. W. Norton & Company.

[2] Drzeniek-Hanoutz, M. (2015). Why institutions matter for economic growth. Retrieved from: https://www.weforum.org/agenda/2015/01/why-institutions-matter-for-economic-growth/

[3] Chang, H. J. (2011). Institutions and economic development: theory, policy, and history. *Journal of institutional Economics*, 7: 4, pp. 473-498.

[4] Hodgson, G. (2006). What are institutions? *Journal of Economic Issues*, Vol. XL, No 1, pp. 1-25.

[5] Schumpeter, J. A. (1980). *Theory of Economic Development.* Routledge.

[6] McClelland, D. C. (1983). *Human Motivation.* Cambridge University Press.

[7] Dobreva, J. (2017). Institutional change: a theoretical framework. In: Institutions, National Identity, Power, and Governance in the 21st Century. Eds: Dogan, E. & Koc, S. *IJOPEC Publication*, pp. 151-173.