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APPROACHES TO INSTITUTIONAL QUALITY AND CYCLICITY OF MACROECONOMIC POLICIES

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Abstract *Recent developments of economic theory analyzing institutions and the importance of alternative institutional structures on economic performance have created the possibility to consolidate a core of economic research on institutional issues. The integration of institutions into general economic research therefore creates the opportunity to reassess the disciplinary boundaries among social sciences. This study aims to provide a methodological and analytical framework on the relation between institutional quality and macroeconomic policies underlining the importance of institutions in designing, putting into practice and development of macroeconomic policies.*

Key words:
institutional quality, effectiveness of macroeconomic policies, fiscal policy, procyclicality
JEL Codes:
E02, E60, O43

1. Introduction

Institutional quality of an economy and its political system are essential for the welfare of a state. In the absence of proper institutions, individuals are not able to recognize what is socially beneficial.

Even if there is plenty of literature on macroeconomics and institutions, there is less literature assessing the influence of institutions on macroeconomic policies. There are few empirical studies in this area, the first researchers of this topic were Gavin and Perotti (1997). These studies appeared especially due to inefficient use of macroeconomic policies in developing countries and they showed that procyclical macroeconomic policies in developing countries may be explained by inadequate institutional environment. In other words, weak institutions do not impose macroeconomic policy constraints on decision makers and they implement expansionist policies on a discretionary basis ignoring the economic cycles in order to generate profit, to favor their interest groups and, why not, to be re-elected.

On this line, our research aims to provide a methodological and analytical framework on the relation between the institutional quality and the macroeconomic policies underlining the importance of institutions for the design, putting into practice and development of macroeconomic policies. Some ideas presented in this study have been presented in extenso in an earlier study (Popescu, 2012).

1. Benefits of efficient institutions

Good formal and informal institutions reduce uncertainty and transaction costs enabling people to interact easily and with trust. Low transaction costs, private property, free market generate a complex division of labor, an introduction of new technology, an increase of efficiency and continuous innovation that are essential for the economy of a developed society.

Good institutions also provide immaterial benefits by creating a feeling of security and by facilitating social contacts. After all, people are not isolated individuals. They strive and function most efficiently in the company of others (Kasper and Streit, 1998).

In case if different people, with different aspirations pursue their interests may create inevitable conflicts. Even in best institutions, conflicts cannot be fully eliminated. Institutions though provide us solutions for solving these problems. Whether we talk about legal procedures, compensations or spontaneous sanctions, they are needed to maintain peace and social harmony.

Social rules limit the use of power and protect the freedom of individuals. Good institutions exclude unjustified constraints and provide limits to exercising individual freedom without infringing the freedom of others. Freedom certainly derived from rules of law; thus, the theory of freedom (protection) shows systematically and depending on the needs what content law and legislation should have as to reflect the rules of positive law. Consequently, freedom means the rule of law, the law stemming from it, the domination of rules of property law (Marinescu *et al.*, 2011). Freedom is essential for the motivation and creativity of an entrepreneur.

2. From institutional quality to cyclicity of macroeconomic policies

In case of fiscal and monetary policies, various empirical studies show the importance of institutions in establishing the cyclicity of macroeconomic policies. Generally, macroeconomic policies are used to stabilize economic cycles. Precisely, expansionist fiscal and monetary policies are used during recession in order to influence main macroeconomic indicators and to restore balance. During periods of economic boom, budgetary deficits should decrease due to automatic stabilizers, constant expenses and tax growth. If in case of developed countries, it is obvious, in case of developing countries, the improper institutional environment leads to a procyclical use of fiscal and monetary policies. These policies are expansionist during favorable economic periods and restrictive during recession.

To explain the inclination of developing countries towards procyclicity, several authors justify it by insufficient access to funding on international markets, the closeness of deadlines for debt repayment, political turmoil and improper institutions that develop a rent-seeking behavior and deepen the problems of basic resources (Gavin and Perotti, 1997, Calderon, 2004, Talvi and Vegh, 2005, Alesina and Tabellini, 2005).

The studies we will be mentioning have a specific linearity, all reach the same conclusion: the Government and the Central Bank in developing countries use procyclical policies during periods of economic boom. We will be presenting them trying to express our own conclusions and recommendations.

Cyclicity and access to national and international financial markets

Some studies argue that the procyclicity of macroeconomic policies in emerging countries is linked to their ability to borrow money on foreign markets during recession when creditors are more reluctant to provide loans. If, however, lenders grant loans, these have high interest rates compared to periods of economic stability. This is the reason why emergent countries use procyclical policies during periods of economic growth in order to increase funds needed for repaying debits (Gavin and Perotti, 1997; Calvo and Reinhart, 2000; Catao and Sutton, 2002).

Caballero and Krishnamurthy (2004) analysed 31 countries, out of which, 18 developed and 13 developing, based on a panel-type regression and reached several conclusions. So, firstly, there may be noticed a significant negative effect between the degree of development of financial markets and the procyclicity of macroeconomic policies. In other words, the higher development of financial markets in developed markets determines the use of anticyclical policies to attenuate the economic crises. Secondly, the „crowding-out" effect existent both in developed and in emergent countries, being stronger in the case of the latter.

In case of developed countries, the crowding - out effect is the same during periods of economic growth and during crises, while in emergent and developing countries, it is more than one on short-term and two for long-term, namely, a massive withdrawal of capital in case of recession persistence. If, for instance, the fiscal multiplicator is 0, 8 (the average in developing countries) and the value of crowding-out effect is 1, then practically the effect of fiscal policy is cancelled.

Similarly, Riascos and Végh (2004), applying a neoclassical model based on incomplete markets, reach the same conclusion that procyclicity is determined by the access of developing countries to loans.

Institutional environment and procyclicity of macroeconomic policies

The second main factor influencing the procyclicity of macroeconomic policies is the improper institutional framework. Insufficient protection of property rights for investors, repudiation of contracts, large scale corruption and beaurocracy, lack of institutions limiting political power are factors that explain the volatility of economic growth in emergent countries.

Using a sample of 54 countries during 1970-1998, Braun (2001) found that the procyclical fiscal policy in developing countries is generated by the existence of presidential regimes (compared to parliament-based regimes) and by the inadequate enforcement of laws. Therefore, fiscal resources suffer as several interest groups make pressures for spending budgetary resources when these are available.

Also, some authors view inadequate economic policies as being a symptom of improper institutional framework and not as a cause explaining economic growth differences (Acemoglu *et al.*, 2002). Trying to prove empirically the above mentioned statements, Acemoglu, Johnson and Robinson (2002) used a panel-type regression for 61 countries, mainly former colonies and reached the conclusion that main causes for the volatility of economic growth among countries seem to be institutional. This approach though does not state that macroeconomic policies are important but suggests that there are institutional causes leading to economic instability and these institutional causes lead to poor macroeconomic results through various channels.

The procyclical macroeconomic policies („distortionary" in the opinion of mentioned authors) belong to these channels or, in other words, are some of the instruments that different groups in power use to get rich and stay in power. These policies are just one of possible instruments and the inadequate implementation of policies and poor macroeconomic performance from which these countries suffer are symptoms of poor institutions.

Lane (2003) assesses the cyclical nature of fiscal policy in the OECD countries for the period 1960-1998. He considers that the cyclicity of different types of expenses varies significantly among countries due to dispersion of power and the existence of multiple veto rights in the process of fiscal policy making.

Using a panel-type regression and 20 emergent countries to explain differences among developing countries in the application and implementation of fiscal and monetary macroeconomic policies, Calderon, Duncan and Hebbel (2004) underline that have higher quality of institutions compared to a specific average apply anticyclic policies. It is due to applying specific internal rules, statutory and legal, limiting the discretion of decision makers in the area of macroeconomic policy. For both fiscal and monetary policies, the borderline of institutional quality is similar (57,5 for monetary policy and 58,9 for fiscal policy). If developing countries have an institutional environment under these values, then their tendency will be to use procyclical monetary and fiscal policies.

Alesina and Tabellini (2005) argue that the procyclical and myopic fiscal policy originates in the dilemma of the principal-agent type. „Voters face coorupt governments *using a share of* fiscal revenue for an unproductive public consumption, namely, the political rent-seeking. *The may be for their own benefit or indirectly by favoring specific interest groups.* Voters may replace a government abusing its power but they cannot reduce rent-seeking to zero. This issue of agency interacts with lack of information*:* voters notice the state of economy but they do *not* know the state of loans and governmental rent-seeking making pressures to increase the access to public goods, to decrease taxes, etc. It forces the government to incline towards a procyclical fiscal policy making more loans. So, the procyclical fiscal and miopic *policy* results from the demands of voters. Voters do not require irrational policies, they are just poorly informed about economic policies." (Alesina and Tabellini, 2005: 3)

Talvi and Végh (2005) use „ *a standard model of optimal fiscal policy comprising political pressures making it therefore difficult to maintain a budgetary surplus.* Bearing in mind this political denaturing, a government facing big (*and* perfectly foreseeable) fluctuations in the tax base, will choose to reduce taxes *to get rid of pressures regarding expenses"* (Talvi and Végh, 2005: 158). Applying this model to 56 countries (20 industrialized and 36 developing countries), the authors reach the following conclusions (Talvi and Végh, 2005: 158-181): the correlation between the procyclicity and GDP for G7 countries is zero; for the 9 remaining industrialized countries, there is a positive correlation between governmental expenditure and GDP; the correlation is positive for all developing countries.

The authors found that inflation tends to decrease during recession and increase during expansion in developed countries, the opposite being true for developin countries and the increase volatility of GDP (due to focus of developing countries on consumption taxes), it is a perfect environment for the appearance of pro-cyclical policies.

Another author (Ilzetzki, 2007) uses a regression correlating the governmental spending and GDP with corruption, democracy and political polarization. The conclusions underline that political polarization and corruption play an important role in explaining the cyclicity of macroeconomic policies.

Using the same models, Calderon and Hebbel (2008) investigates a larger sample of 91 countries during 1970-2005. Their conclusion states that the institutional factor explains mostly the differences in poor implementation of macroeconomic policies, economic factors being less important.

Using quarterly and annual data as in the previous study, Ilzetzki and Vegh (2008) analyze a group of 49 countries during 1960-2006. They believe that the procyclicity of macroeconomic policies in developing countries is obvious but they do not provide explanations of its causes. Compared to previous studies, the authors find evidence of procyclicity also in developing countries.

Duncan (2013) uses a model that includes the index of institutional quality, the correlation between the interest rate and the GDP, the volatility of the interest rate and the economic growth for a group of 56 countries. The results confirm the hypothesis stating that institutional quality influences monetary policy. The author mentions that measures conditioned or not by the monetary cyclicity are strongly linked to the index of institutional quality. Lack of financial independence or the Central Bank independence is not supported empirically and countries with strong institutions usually have high correlations between the size of GDP and the rate of interest. In emerging countries with weak institutions, this correlation is zero or negative. It is usually viewed as a sign of procyclicity of the monetary policy. Also, economies with weak institutions also have a high volatility of production and interest rates. In this study, Romania has a correlation of - 0.01, its monetary policy being viewed as procyclical (The Euro Zone has the value of 0,90, the Czech Republic of 0,22, Hungary 0,13).

All these studies tell us that institutions matter even when they refer to the rules in making economic policies. To conclude, based on the literature presented above, we believe that procyclicity is determined by such factors as access to higher foreign borrowing during economic growth, improper institutions (presidentialism), inadequate political institutions (dispersion of power, veto rights), but lack of budgetary rules non-compliance with the law, asymmetry of information and rent-seeking behavior, political polarization (polarized positioning of political parties) and corruption, lack of quality institutions in general.

The therapy may include remedies to constant problems linked to:

- stricter budgetary rules (limitation introduced by law or Constitution, as a percentage or as a number of years to achieve a budgetary equillibrium, minimizing the number of budget adjustments, etc);
- political rules (bicameralism, governmental coalitions, 2/3 or 3/5 majority to change budget rules);
- increasing the independence of the court system and the implementation of broader measures to fight corruption;
- a deeper state involvement in the provision and quarantine of property rights, contracts, these two being the main economic institutions;
- providing sanctions for failing to reach or breaking the mid-term or long-term goals (in New Zeland, the Governer of the Central Bank may be dismissed if he fails to achieve the goals);
- increasing the transparency and responsibility of decision makers in the process of designing and implementing macroeconomic policies as to enable voters to „judge" the activity of politicians by voting;
- replacing at specified intervals provided by law of officials involved in the design and implementation of macroeconomic policies as not to be influenced by interest groups;
- decentralizing and increasing the independence of governmental agencies, it may lead to increase of political „competition" and ensuring better public goods at lower costs;
- appointing decision makers based on their reputation and high moral standards.

Nobody denies the role of institutions in economic development; these determine the socioeconomic progress of any nation. If we take into account Kasper's statement (1998: 8) that „*the institutions … are the link keeping communities together and enabling individuals to self-govern themselves as members of a society*", then the role of political decision makers is to find out what are the rules and incentives ensuring this link without infringing the individual freedom and initiative enabling individuals to self-govern themselves", to follow their own good in accordance with the goals of society thus contributing to common good. A consequence of good institutions is that they facilitate the creation and innovation of other new institutions thus ensuring an order in the actions of individuals and businesses. Nothing occurs randomly and outside spontaneous or imposed rules. Literature does not mention an optimal degree of institutionalization, we believe also duet o the influence of informal institutions. How much the state should intervene to provide good institutions, without undermining or suffocating the entrepreneurial initiative of individuals is a question that has not been answered by literature yet.

Politicians and decision makers suppose that economy in its entirety is some kind of firm where orders may be given to achieve the desired goals. But, even in firms, management is participatory, a kind of spontaneous cooperation in accordance with the rules. The implementation of economic policy by discretion leads to unwanted outcomes at the microeconomic and macroeconomic levels.

Governments should focus on providing institutions that promote social order and cooperation, such as: ensuring property rights, enforcing contracts and ensuring monetary stability. But even the enforcement and formalization of these institutions involve the compliance with specific rules related to universality, stability, clarity and predictability. Legislative change and thickness typical for developing countries complicate the situation increasing uncertainty and transaction costs.

CONCLUSIONS

This socio-economic study on institutions tried to answer a fundamental question for any economist: *why some nations are richer than other nations?* There are many benefits of good institutions: they ensure market foundation by protecting the property right, secure contracts, promote cooperation and generally advantageous action, motivate specialization and change, reduce uncertainty and transaction costs making people interact easily and trustfully, etc. These aspects make us believe that institutional differences among countries influence the economic results as these impact decisions related to labor, saving, investment, innovation, production, division of labor and exchange.

Good Institutions increase the efficiency of macroeconomic policies by diminishing the impact of the Ricardian equivalence and rational anticipations, provide easier access to borrowing on domestic and foreign markets in case of severe recessions, the elimination of procyclicity and limiting political opportunism, rent-seeking activities and corruption, ensuring a bigger fiscal and monetary space in case of recessions, increasing the credibility of decision makers and the possibbility to practice broader expansionist policies, eliminating inflation caused by „loans" to Government granted by the Central Bank and increasing transparency and responsibility of decision makers involved in the process of design and implementation of macroeconomic policies.

Macroeconomic policies are generally used to stabilize economic cycles. Precisely, expansionist fiscal and monetary policy is used during periods of recession to influence main macroeconomic indicators and to restore equilibrium. During economic booms, budget deficits should be diminished duet o automatic stabilizers, constant expenditure and increase of taxes. If it is obvious in case of developed countries, for most developing countries, the improper institutional environment leads to the procyclical use of fiscal and monetary policies. These are expansionist during favorable economic periods and restrictive during recession. Institutional and financial factors generate procyclicity. Failure to protect property rights in specific areas, ignoring law, non-compliance with contracts, large scale corruption, lack or insufficient political constraints are just few examples of weak institutions that may generate an opportunist behavior or pressure of some interest groups for decision makers in charge with the application and implementation of macroeconomic policies.

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