New Institutional Economics and Economic Development of the Republic of Kosovo

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Abstract: The purpose of this study is the analysis of the new institutional economics according to parameters and criteria that affect the growth and economic development such as free movement of capital, contract enforcement, information costs, risk transfer costs, free competition and their application into practice. Institutional innovation, in terms of establishing more efficient and effective institutions, can only be done if there is support of the whole society, but given the limitations set forth in Kosovo, as possible change of the Constitution, some laws and other internal and external restrictions, the achievement of this goal is difficult. Because of the very specific and serious past, and also very long delay in the process of transformation and transition, the economic development and new institutional economics in Kosovo, according to almost all development indicators has significantly stagnated in comparison with the countries of the European Union and Western Balkans. Economic growth and development implies a very complex and multidimensional process, influencing many factors such as economic, technological, institutional, political, social and cultural. Economic growth depends on political institutions and their capacity to define in a more clear and acceptable way its common goals. Given the political dimension of the capacity of the state, certainly should be considered also the institutional approach of development i.e. political dimensions of the institutions that support economic development.

Keywords: new institutional economics; economic thought; economic development; transaction costs; property rights

JEL Classification: D23. E02, F43, O11

1. Introduction

Contemporary theory of economic development has broaden our knowledge by explaining of why some countries are rich and other countries are poor, by analyzing institutions, namely the norms of behavior that enable the acceleration of economic growth. Within the new institutional economics, the institutional aspect of economic growth increasingly is being treated, and particularly the origin of some institutions. What are those institutions that accelerate economic growth, and which are the ones that slow the economic growth? Why in some countries have

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been created certain institutions that bring higher efficiency, and in some other countries institutions have much lower efficiency?

These questions and dilemmas, respectively the research to find answers to these questions, in recent years are bringing more and more together the economics science with the justice science.

A well-regulated legal system in a country represents a value for both, economists and lawyers, but their motivation up somewhere is different. Lawyers, view the system as a value of its own, while for economists such a system has institutional value, since such regulation ensures maximizing economic efficiency and social Welfare. At first we must emphasize that the current institutional environment is not suitable to sufficiently affect the proper and adequate acceleration of growth and economic development. For states that are under transition period, representatives of this field present and provide adequate proposals that will affect the acceleration and strengthening of institutional innovation, which in the short term will provide an efficient legal system, an efficient competition law, consumer protection and an effective regulatory system that will affect the creation of a safe and sustainable financial system.

Key terms on which the new institutional economics relies, are: institutions, economic development, capital, contracts, etc.. Within this concept are presented different dilemmas: why some countries in a successfully and highly efficient way are organizing their economies, while other countries are failing to realize the growth and economic development, or achieving an insufficient economic development that does not provide demographic investments? Numerous authors are arguing that the answer to this question is primarily determined by the importance and the role of the institutions in the economies of these countries.

2. New Institutional Economics and Economic Development of Kosovo

Because of the very specific and serious past, and also very long delay in the process of transformation and transition, the economic development and new institutional economics in Kosovo, according to almost all development indicators has significantly stagnated in comparison with the countries of the European Union and Western Balkans (*Based on public institutions index, which is estimated by The Global Competitiveness Report. Kosovo is not on the list of countries analyzed, but the Western Balkan countries have a lower ranking).

After World War II onwards, within the theory of economic development are profiled mainly two economic concepts, the first, the traditional concept of economic development that emphasizes mainly the primary importance of the state as the initial instigator of the development processes and secondly, neoclassical concept that emphasizes the crucial role of the market, prices and different stimulants of economic development.

After the destruction of the socialist-centralist system, almost on all former socialist countries has dominated the neoclassical concept, where all states of the region, as well as Kosovo after 1999, were treated by centralist-planning virus through transitional standard package. This transitional package was based on the principles of the Washington Consensus, which is prepared on the basis of the neoliberal model of economic development and the same was strongly supported by the IMF and World Bank. This model in most transition countries was based on the full operation of the free market, to which is achieved through rapid and massive privatization. Recent years many experts and representatives of new institutional economics emphasize that the models that offers the neoclassical school of economic development, noting hypothetically that production, economic growth and the differences between industrial countries and developing countries can be explained by focusing on basic elements (resources), technology and preferences are not sufficient for good and efficient economic results.

Neoclassical theory in most cases was an inappropriate tool for analyses and for determining economic policies that will promote efficient economic development. Relying on efficient markets to foster efficient allocation of the vast majority of resources, the neoclassical economics does not reflects many institutional requirements of particular importance to enable the creation of such markets, calculating that rational decision makers in certain markets due to the action of the information, will improve their previous decision, if the same is proved to be wrong. This is further strengthened also by the conclusion of one of the most prominent scholars of the modern economy, Stiglitz, who points out that “Self-regulating market is not able to respond to these requests. This was confirmed by the contemporary economy, in which in the period of dominance of the free market - market fundamentalism, the state has supposedly saved many times the self-regulating apparatus of the financial system, eventually the financial collapse in 2008” (Beroš, 2013).

Long dominance of neoliberal concept, in most cases regarded as a withdrawal of the state from the economy, as well as reducing the political and institutional capacities in order to implement the control of economic processes. Typical neoliberal formulas in most transition countries are implemented through the full liberalization of financial markets, liberalization of the labor market, complete removal of restrictions on flows of goods and capital, increasing the participation of foreign capital, privatization of the public sector, and a restrictive financial and monetary policy.

But, on the other hand, is emphasized that efficient markets are a function of institutions that enables measuring and enforcing contracts with as less costs, ie. as how the transaction costs are lower, so and markets will become more efficient (Shavell, 2009, p. 291-330).

Understanding the institutions can be defined that institutions are the system of established rules and the social dominant rules that structure the social interactions. In most cases, institutions as a term is used in the sense of defining the organization as Ministry, state agencies, administrative bodies, universities etc., but in this treatment will be used in a slightly different meaning. The impact of institutions on economic development can be determined after determining the two meanings, (1) that institutions are important for economic development and (2) that the analysis are possible through the economic theory instruments.

3. The Impact of Institutions on Economic Development

Institutions are essential for economic development, which help explain market failures and provide explanations for the role of the state in the economy. Institutions consists of formal constraints, such as constitutions, laws, rules, property rights etc. and informal constraints, such as the code of conduct, agreements, self-imposed rules of conduct etc. (North, 1994, pp. 359-368).

Measurement of institutions includes: measuring the quality of institutions, social capital, social and political features and political instability. Numerous researches made in this field have verified that the quality of institutions and social capital have positive correlation with economic development, while social features and political instability have negative correlation, while for the political features of institutions is not defined the significant interdependence in relation to economic growth (Aron, 2000, pp. 99-135).

If institutions are defined in such a way that will stimulate the economic activity and increase productivity, then this institutional arrangement, indirectly by allocating the resources, will stabilize the economic growth. Productivity as a ratio between inputs and outputs of production will increase if achieved to reduce overall costs, transactional costs and transformative costs. The first, relates to the measurement and enforcement of contracts and the second is related to the physical costs of production. Transactional costs are reduced through institutional changes, while transformative costs are reduced through innovative technological change. Institutional and innovative changes affecting reduction of transactional costs (and with it also the increase of productivity, and in the last instance in the economic growth) are those institutions that enhance the movement of capital, reduce information costs, reduce the costs of risk transfer, and increase the efficiency of contract enforcement.

Building genuine institutions that enable and stimulate the free movement of capital, gains even more importance due to the law of the tendency of the rate of yields to fall and simple account that in a country where there is more capital in proportion to the number of inhabitants, capital yields will be decreased. Since the lack of capital in developing countries affects and is reflected in increased yields of capital, then increased of its movement is crucial (Stiglitz & Driffill, 2000, p. 741). The development of the capital market and the ability of the market to more efficient allocation is a key precondition for meeting the previous criteria. Although the free movement of capital and investments (including individuals, goods and services) is guaranteed by the Constitution of the Republic of Kosovo (article 119.2 dhe119.6), this is not happening during these years, primarily due small market that Kosovo has, no confidence of the population, the lack of public information, the non-existence of adequate legislation etc. (capital market in the Republic of Kosovo was opened for the first time in 2012 with Regulation of Ministry of Finance-CBK no. 01/2014 for the primary and secondary market securities of the Government of the Republic of Kosovo and over the years many auctions were held with the participation of primary stakeholders, but turnover is symbolic and with very short maturity).

4. Institutional Environment, Risk Transfer and Contract Enforcement

The institutional environment appears also as a constraint to successful management. Informal institutions, in most cases in different analyzes are taken as input and provides the institutional space in which they operate, such as customs, habits, traditions, norms, cultures etc. But, in this case also the religion is of particular importance. This level of informal institutions is often outside of the economic and political scope.

The institutional environment that occurs through formal institutions is the first level of economization that should be changed as soon as possible, while the management, dealing with the last unit of economic action and it is the transaction. At this level of reality, in the practical way is reflected functioning of the social and economic system. Often times, since also the actions of formal institutions are not perfect and free of charge, participants in the transaction are oriented in a private and alternative solution aiming to resolve the dispute and that in the form realize mutual benefit (notary services, private bailiffs, arbitration, bankruptcy administrators, etc.).

In most cases, changes in institutional environment are developed more slowly than changes at the management level. An institution to change in general, it is not enough to change only the formal rules, which is in the state authorities responsibility, but should also influenced in informal rules, which are created according to the specific logic and dynamics, but on the other hand, should not left aside the application of these rules.

Demands for the efficient economic institutions cannot be created timely, which largely confirms the continuous demand for this type of institutions in the Western Balkans countries and their very fragile success in creating these institutions. Many of these countries for years are waiting to put the adequate policies and transform existing institutions from which will benefit their citizens.

The main sources of institutional change according to Douglas C. North, are relative price changes and change of preferences (North, 1997).

In the period so far in Kosovo, the international community on numerous occasions, by wanting to change the parallel inherited institutions or those created in the last decade of the 20th century, they often have used the mechanism of relative price change (through the blocking or permitting of economic aid or donations, or through setting conditions for membership in regional or global organizations), or some decisions that were in full competence of local institutions, but that cannot be implemented by them. In the event that local decision makers would not agree fully with the international community requirements, according to this logic, this approach would have a limited success. Changing the formal rules (laws) is the ultimate goal of approach of changing the institutions. But on the other hand, to make this policy effective, special attention should be paid to informal constraints and enforcement mechanisms. Since 1999, Kosovo was administered by UNMIK, while the Self-Government bodies and the Parliament had limited competences, while The Fourth Pillar of UNMIK was the main decision-maker and responsible for increased economic development. In 2002, it founded the Kosovo Privatization Agency (KPA), where its primary duty was the privatization of socially owned enterprises, in which process and decision-making on the KPA Board, the dominant role have had the international representatives.

From the perspective of economic policy, it can be said that the process of institutional change is greatly under the influence of force structure between different groups of interest, then the cultural and religious tradition. These factors depending on the proper orientation of actions can influence that certain institutional rules more easily be accepted. As stable institutions can be considered only those institutions that have the support of the whole society, which often can hardly be achieved, especially in the Western Balkan countries, in particular in the Republic of Kosovo, in which the ethnic divisions still remain very pronounced.

Risk transfer costs in different transactions can be very high, if it is carried out only by one subject or contracting party. For this reason, the importance of developing the capital market consist on the intention of diversifying the risk in smaller portions and extending to as many entities or participants in a certain market. Risk of fire and costs of insurance from possible fire, e.g. to a person (landlord) will be very high, if he as a person will cover the whole eventual costs. But, with the purchase of an insurance policy against a possible fire, he will share the possible risks and costs with another market participant, which in this case is the insurance company. Presentation and distribution of risk in the capital market usually takes place through the Joint Stock Companies.

Developmental projects, the construction of manufacturing facilities and projects of new lines within the existing production capacities are expensive and quite risky, and on the other side it has no sufficient guarantees that through market participation will be achieved safe return from the invested funds. This is the main reason, and also most individuals do not have sufficient funds but also the courage to face with such a project. But when a big investment, is distributed in larger numbers of individuals (Shareholders), then the overall risk will be shared between the shareholders, but also the incurred costs will be easily covered.

Cases dealing with risks, the economic theory puts them in direct relation to the development of the capital market, in which case the rapid development of capital markets would enable the highest level of risk management, and the opposite. Faster and efficient implementation of contracts, resolving business disputes, etc. does significantly influence the investment decision-making. Judicial system of the Republic of Kosovo is not currently providing a quick and efficient resolution of business disputes, for various reasons, such as inefficient processing of cases, primarily due to the accumulation of many cases from the past decade that have not yet been resolved, inadequate management of courts and prosecutors' offices at different levels, lack of professional staff with adequate experience in economic and financial fields etc.

Freedom is not only the basis of assessment of success and failure, but is also a key determinant of individual initiative and social effectiveness. The alternative of strong enforcement of the law is the existence of mutual trust and mutual separation of responsibility and commitment (Sen, 1999, p.39).

Preservation and enforcement of contracts often have been exacerbated or prevented in situations where the morality of the market and the business confidence are dysfunctional and nonexistent. Viewed in the long run, the state should engage in more extensive promotion of these two “business values” that are part the informal institutions. So far in Kosovo is still not provided any measure of social values that will be supported by the existing political system.

5. Concluding Remarks

Institutional innovation, in terms of establishing more efficient and effective institutions, can only be done if there is support of the whole society, but given the limitations set forth in Kosovo, as possible change of the Constitution, some laws and other internal and external restrictions, the achievement of this goal in Kosovo is very difficult. In what form the support should be created for the establishment of these efficient, consistent and stable institutions?

New institutional economics elaborates that the way to achieve this goal has to do with action in informal institutions, affecting in various measures to increase the trust in institutions, and this goal can be achieved in two ways: first, the continuous explanation of the mutual interdependence of personal and common benefits, and their indivisibility to all citizens of Kosovo, and secondly, on increasing the costs for the negative impacts of certain individuals or groups of interest in the stability of institutions.

In relation to the formal institutions, the responsibility of every Government should be building institutional infrastructure, i.e. providing of efficient legal system, effective laws in all segments of society, efficient regulatory system that would ensure a safe and sustainable financial system.

Some key indicators of the state of the Republic of Kosovo institutions have a tendency of a slow improvement, but at a lower level compared with other Western Balkan countries, such as protection of property rights, legal certainty and guarantee of signed contracts, protection of intellectual property rights, guaranteeing free competition, consumer protection, burden of state regulatory, etc.

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