

Institutions, Capital Formation And Economic Growth: Theory and Evidence

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Abstract

This paper examines the role of institutions in capital formation and economic growth by following a two-stage approach. In the first stage, the study develops a growth model that reveals how institutions affect capital accumulation and production when capital markets operate imperfectly due to transaction/information costs. Relying on the assumption that capital market efficiency is primarily dependent on institutional quality, the model shows that institutional structures have notable impacts on capital formation and economic performance. The results derived from this model indicate that high-quality institutions that lower transaction costs and uncertainty in the capital market will foster capital accumulation and output production in the long run. Moreover, the model shows that the transitional period growth rate is a function of institutional quality, thus suggesting that institutional differences not only matter for long-run development but also affect short-term economic performance and convergence dynamics. In the second stage, the study runs a series of regressions to test these implications empirically. The results from both cross-section and panel data models reveal that the data is compatible with the predictions of the theoretical model. As hypothesized, the evidence shows that institutional quality is correlated positively with income levels, growth rates, and capital formation. More importantly, empirical results demonstrate that the effect of institutions on economic outcomes is sizeable and remains valid even after controlling for country-specific factors and the endogeneity problem. In the light of these results, the study concludes that to prosper and develop, countries, especially those lagging in economic development, should primarily focus on establishing an inclusive institutional framework that secures property rights, maintains the rule of law, and supports political freedom.

Keywords: Economic Growth, Institutions, Convergence, Economic Development

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