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Institutions and Economic Growth: Insights from Theory and the Indian Experience

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Abstract

This paper reviews the theoretical and empirical literature on the relationship between institutions and long-run economic growth, with particular emphasis on sub-national variation in India. Drawing on Old and New Institutional Economics, institutions are conceptualized as path-dependent formal rules and informal norms that shape incentives, reduce transaction costs, and condition economic performance. Using a systematic narrative approach, the review synthesizes foundational theoretical contributions, cross-country empirical evidence, and state-level studies from India. While global evidence consistently associates institutional quality particularly property rights, political accountability, and state capacity with long-run growth, national-level analyses often obscure substantial internal heterogeneity. The Indian experience illustrates this limitation: despite a common constitutional framework, states exhibit wide variation in governance capacity and growth outcomes. The review highlights that institutional effectiveness depends not only on formal structures but also on enforcement capacity, administrative capability, and adaptability. It underscores the importance of historically informed, sub-national institutional analysis for understanding growth outcomes in federal and developing-country contexts.

Keywords: Institutions; Economic Growth; India; State Capacity.

INTRODUCTION

The pursuit of sustained economic growth has long been a central concern of economic theory and development policy. Traditional approaches, rooted in neoclassical growth models, emphasize proximate determinants such as capital accumulation, technological progress, labor productivity and trade openness, as the engines of economic growth. While these factors explain part of the growth story, they fall short in accounting for persistent and often stark differences in income levels and developmental trajectories across countries and regions. Increasingly, scholars have turned to institutions the underlying rules and norms that govern economic, political, and social life as the deep determinants of long-run growth.

North (1984) defined institutions as "rules of the game". They refer to both formal rules (such as constitutions, property rights, and legal systems) and informal norms (such as customs, ideologies, and unwritten codes of conduct) that shape incentives, reduce uncertainty, and enable or constrain collective action. By governing who holds power, how resources are allocated, and how economic interactions are structured, institutions directly influence the efficiency of markets, the responsiveness of the state, and the inclusiveness of development. They shape not just how economies function, but whether and how they grow. As transaction cost economics and contract theory suggest, institutional quality plays a critical role in reducing friction, enforcing agreements, and facilitating productive exchange.

The intellectual foundations of institutional economics can be traced to Old Institutional Economics (OIE), which emerged in the late nineteenth century as a critique of the static and individualistic assumptions of classical economics. Scholars such as Thorstein Veblen (1898) argued that economics failed to evolve as an institutional and evolutionary science, emphasizing that economic behavior is embedded in social structures, cultural norms, and historical processes. John R. Commons (1931) further highlighted the central role of legal institutions, collective action, and transaction governance in shaping economic outcomes. Despite their influence, early institutionalists lacked formal analytical tools and were gradually sidelined by the rise of neoclassical economics. This limitation was subsequently addressed by the New Institutional

Economics (NIE), which integrated institutional insights into mainstream economic analysis through more rigorous theoretical frameworks. Ronald Coase (1984) reintroduced institutions by foregrounding transaction costs and the legal foundations of market exchange, while Douglass North (1990, 1991, 1994) conceptualized institutions as the "rules of the game" that structure incentives and interactions over time, emphasizing path dependence, institutional evolution, and the role of adaptive and credible institutions in shaping long-run economic performance.

This framework was further advanced by Acemoglu, Johnson, and Robinson (2001, 2004), who provided compelling empirical evidence on how historical differences in institutional development particularly those shaped by colonial rule account for present-day disparities in income levels across countries. Their concept of inclusive vs. extractive institutions, and their emphasis on political accountability, rule of law, and credible enforcement, have redefined the discourse on economic development. Today, the mainstream consensus holds that strong, inclusive, and adaptable institutions are critical for long-run prosperity.

Despite these theoretical and empirical advances, most research on institutions and growth has remained at the cross-country level, relying on aggregated national indicators that obscure important sub-national variation. This is particularly important in the case of India, a federal democracy marked by substantial inter-state disparities in economic performance and governance. Although governed by a shared constitutional and legal framework, Indian states differ widely in terms of bureaucratic capacity, political accountability, fiscal management, and public service delivery. Some states have achieved sustained high growth and better institutional outcomes, while others continue to struggle with weak institutions, corruption, and governance inefficiencies. Understanding this variation is crucial for both academic inquiry and policy design.

Furthermore, most existing Indian studies rely on one-off state-level governance rankings or national-level time series, offering limited insight into how institutions evolve over time and how those changes interact with development outcomes at the state level. There is a pressing need for a more systematic, longitudinal, and subnational approach to institutional measurement and its impact on economic growth.

In addition, India's institutional evolution cannot be fully understood without a historical-institutional perspective**.** Colonial administrative structures, post-independence socialist planning, and the post-1991 liberalization reforms have each left distinct institutional imprints. These path-dependent institutional trajectories influence the functioning of state apparatuses today shaping the responsiveness of governments, the autonomy of bureaucracies, and the effectiveness of public service delivery.

This study seeks to address these gaps by synthesizing historical-institutional scholarship and empirical evidence from existing econometric studies on India. By integrating qualitative historical analysis with findings from time-series and panel-based research, the paper provides a comprehensive review of how institutions evolve and shape economic performance within a single country. The findings are expected to offer valuable insights not only for academic scholarship but also for policy debates on federal governance, institutional reform, and regionally balanced development in India.

THE REVIEW OF LITERATURE

The relationship between institutions and economic growth has been extensively studied, yet critical gaps remain particularly in the context of sub-national dynamics of developing economies such as India. This section reviews the evolution of institutional thought, beginning with foundational contributions from Old and New Institutional Economics (Veblen, 1898; North, 1990), and moves toward contemporary empirical studies that examine the impact of institutional quality on development outcomes (Acemoglu *et al*., 2001). While global analysis consistently demonstrates strong linkages between institutions and growth, studies at the state or regional level are relatively limited. By surveying theoretical frameworks, cross-country evidence, and sub-national empirical approaches, this review identifies key methodological and contextual gaps that motivate the present study.

Theoretical foundations of institutional economics

Veblen (1898), "Why Is Economics Not an Evolutionary Science?" marks a foundational critique of neoclassical economics and a call for a new paradigm grounded in evolutionary thinking. This paper is considered a cornerstone of Old Institutional Economics (OIE), as it introduces key concepts such as institutional evolution, cultural embeddedness, and the rejection of methodological individualism. In this paper, Veblen challenges the prevailing "taxonomic" nature of classical and marginalist economics, arguing that it treats economic behavior as static, individualistic, and detached from its historical and institutional context. He critiques the rational actor model the "hedonistic calculus" as overly mechanistic and insufficient for capturing the complexity of human motivations shaped by habit, culture, and social institutions. Drawing inspiration from Darwinian evolution and pragmatist philosophy (especially William James and John Dewey), Veblen advocates for a dynamic, historical, and process-oriented approach to economic inquiry. He proposes that economics should focus on cumulative causation and the co-evolution of institutions and behavior, rather than assuming equilibrium and utility maximization. Veblen's argument laid the groundwork for subsequent institutional critiques and helped shift the focus of economic analysis toward historical processes, social norms, and power structures, distinguishing institutionalism as a heterodox alternative to mainstream economic thought.

Commons (1931),*"Institutional Economics,"* presents a systematic exposition of institutional economics as a distinct and necessary approach within the discipline. Commons critiques both classical and neoclassical economics for abstracting from the social and legal foundations that underpin economic activity. He emphasizes that the unit of analysis in institutional economics is not the individual or the commodity, but the transaction a socially embedded, legally structured interaction between individuals mediated by institutions. Commons argues that institutions understood as collective actions controlling individual actions shape economic behavior through laws, customs, and organizational rules. He stresses the importance of working rules, collective bargaining, and the role of the state in regulating and organizing economic life. By integrating legal reasoning and economic analysis, Commons develops a pragmatic, problem-solving framework that focuses on how institutions evolve to resolve conflicts and allocate rights. His approach is evolutionary and historical, rejecting static models of perfect competition or idealized markets. The paper also introduces Commons' view of economics as a science of artificial selection, where institutions evolve through purposeful human design rather than natural law. This work is foundational for Old Institutional Economics, particularly in its emphasis on legal realism, collective action, and the institutional structuring of markets. It marked a pivotal moment in the institutionalist tradition by offering a coherent methodological alternative to orthodox theory, and laid the groundwork for later developments in labor economics, law and economics, and governance studies.

Coase (1984) marks a pivotal turn toward realism in economics by reintegrating institutions into analysis. He criticizes classical and neoclassical models for isolating firms and markets from the legal, social, and organizational contexts that actually govern behavior. The hallmark of his approach is an empirical grounding drawing on court cases, firm histories, and transactional anecdotes to show how property rights and contract enforcement shape economic outcomes. Unlike earlier institutionalists, who were rich in descriptive insight but light on formal modeling, Coase fuses rigorous theory with hands-on study of how institutions operate in practice. He frames the New Institutional Economics as a necessary corrective: "economics as it ought to be," where human behavior and institutional constraints replace the simplifying "rational actor" abstractions of old.

North (1986) lays the groundwork for New Institutional Economics (NIE) by defining institutions as the "rules of the game" that shape individual incentives and market outcomes. Here, the primary variables are transaction costs, property rights, and political structures: institutions reduce uncertainty and lower costs of exchange, which influence individual choices and market efficiency. Methodologically, he weaves neoclassical models of efficiency together with historical case studies, showing how government enforcement of property rights is essential to market functioning. Importantly, he already flags the endogeneity of institutions how they emerge from the interplay of individual strategies and political power and gestures toward ideology's subtle role in shaping both formal rules and perceptions of fairness. Ideology is acknowledged as a factor affecting institutional evolution and perceptions of fairness. North advocates for NIE as a framework to move beyond traditional efficiency models, offering deeper insights into economic development and the design of effective public policies.

North (1991) argues that institutions are the humanly devised constraints. He sharpens his focus on the dual nature of constraints formal rules (laws, constitutions) versus informal norms (customs, traditions) and adopts game-theoretic language to analyze their strategic interplay. While transaction costs and property rights remain central, he introduces path dependence as a structural mechanism: historical "critical junctures" lock economies onto divergent trajectories. His comparative lens contrasting colonial outcomes in the Americas illustrates how similar institutions can yield very different growth patterns depending on the sequence of past events. Unlike in 1986, North underscores the interplay between formal and informal constraints, stressing that both are essential for sustained growth. Institutions that fail to adapt risk stagnation or decline. He calls for deeper exploration of institutional evolution, particularly in reversing unfavorable paths and integrating formal rules with informal norms to drive economic progress.

Coase (1998) calls for economists to abandon abstract equilibrium models and instead map the actual flow of goods and services within institutional frameworks. Institutions here are again the "rules of the game," but the emphasis shifts squarely onto transaction costs information gathering, bargaining, and enforcement expenses as the key variables determining economic performance. Coase laments the mainstream's detachment from real-world phenomena and champions an interdisciplinary stance, weaving insights from law, sociology, and technology to unpack economic complexity. He boldly predicts that NIE, with its focus on transaction-cost economics, will supplant traditional paradigms and yield a richer, more accurate picture of how economies evolve.

North (1994) underscores the pivotal role of institutions in shaping long-term economic performance by establishing incentive structures for societies. In this later treatment, North extends his analysis to the interaction between institutions and organizations firms, bureaucracies, political bodies as co-drivers of institutional change. He retains his emphasis on transaction costs and property rights, but elevates the concept of adaptive efficiency: the capacity of institutions to evolve in step with technological and economic shifts. Drawing on comparative and cognitive frameworks, he examines how "mental models" (belief systems and cultural attitudes) underlie both formal and informal rules. Here, the notion of path dependence is synthesized with a dynamic view: uneven economic progress reflects not only past legacies but also each society's ability to retool its institutional architecture for impersonal exchange.

Historical evolution of institutions and growth

Acemoglu, Robinson, and Johnson (2000) analyze how European colonialism shaped the long-term economic development of former colonies, focusing on the role of colonial institutions. They argue that the feasibility of European settlement, influenced by settler mortality rates, determined whether colonies adopted inclusive institutions protecting property rights or extractive institutions prioritizing resource exploitation. Using GDP per capita in 1995 as a measure of long-term economic performance, they find that better institutions correlate with significantly higher income levels. Employing an instrumental variables (IV) approach with settler mortality as an instrument, they establish that institutions, not settler mortality itself, drive economic outcomes. The authors highlight the persistence of colonial institutions, shaped by historical path dependence and post-colonial incentives, as a key determinant of modern economic disparities. Their findings emphasize the importance of historical factors and institutional quality in explaining global economic inequality.

Williamson (2000) reviews the advancements in New Institutional Economics (NIE) and emphasizes its focus on the role of institutions, defined as the formal and informal rules shaping economic activity. Key variables include transaction costs, governance structures and property rights, which influence economic performance by minimizing contractual hazards such as opportunism and bounded rationality. Using frameworks like Transaction Cost Economics (TCE) and comparative institutional analysis, Williamson highlights how governance structures align with transactions to reduce costs, enhancing efficiency. The NIE's empirical successes in explaining firm boundaries, vertical integration, and contractual arrangements affirm its relevance to public policy and institutional design. Williamson advocates for further exploration in areas like technological innovation and political economy, stressing the need for a unified theory of institutions. He positions NIE as a promising paradigm for understanding complex economic systems while calling for pluralism in methodologies and continued empirical validation.

Acemoglu, Johnson, and Robinson (2001) explore how geography and institutions shape global income disparities, emphasizing an "institutional reversal" caused by European colonialism. They show that regions prosperous in 1500, marked by high urbanization and population density, experienced long-term economic decline due to the imposition of extractive institutions by colonizers. Using urbanization rates, population density, and measures of institutional quality (e.g., property rights protection), they find that historical prosperity correlates negatively with modern income levels in former colonies. Robust econometric methods, including instrumental variables and interaction effects with industrialization opportunities, reveal that institutions more than geography drive economic outcomes. Their analysis underscores the persistence of colonial-era institutions and their critical role in economic performance, particularly during industrialization. The study concludes that historical events profoundly influence contemporary inequality, challenging the geography hypothesis and affirming the decisive role of institutions in shaping long-run economic development.

Acemoglu and Johnson (2003) explore the roles of property rights institutions and contracting institutions in economic development, concluding that property rights are more crucial for economic outcomes. They argue that stronger property rights institutions lead to higher GDP per capita, greater investment, and better financial intermediation, as they protect citizens from expropriation by the state or elites. In contrast, contracting institutions, measured by legal formalism, have a weaker impact, with a negative effect on stock market capitalization and little effect on private credit. The authors use a two-stage least squares regression with settler mortality rates and legal origin as instruments to establish these relationships. Their findings suggest that while contracting institutions shape transaction mechanisms, property rights institutions are more foundational in fostering economic growth by ensuring asset protection and limiting arbitrary government actions.

Acemoglu, Johnson, and Robinson (2004) argue that economic institutions, rather than geography or culture, are the key drivers of differences in economic development across countries. They focus on property rights security and access to economic resources as central components of economic institutions, alongside political institutions that constrain power-holders and allocate political authority. Through historical analysis, case studies, and econometrics, they demonstrate how institutional differences shape economic outcomes. They highlight examples like the economic divergence between North and South Korea and the colonial reversal of fortune to show how institutions established during

European colonization shaped prosperity. Their instrumental variables analysis, using settler mortality rates, suggests that institutions have a causal effect on income per capita. The authors conclude that understanding the relationship between political power and institutions is crucial for promoting long-term economic growth and designing policies for sustainable development.

Johnson and Subramanian (2005) argue that good governance and institutions are crucial for economic growth and development, particularly in low-income countries. They distinguish between broad economic institutions, which ensure property rights and enforceable contracts, and narrow economic institutions focused on specific sectors. Despite the importance of institutions, the authors emphasize the lack of clarity on how to implement effective policies or institutional arrangements that guarantee sustainable growth. They note that institutional persistence makes change difficult, but not impossible, and highlight the challenges of external interventions in fostering development. They conclude that while external aid and conditionality can play a role, low-income countries must take primary responsibility for driving institutional reform, with a focus on transparency and identifying appropriate institutional preconditions.

Devesh Kapur (2005) argues that India's remarkable post-independence stability and growth cannot be understood without examining the design, autonomy, and accountability of its core public institutions. Drawing on comparative historical analysis and administrative data, Kapur shows how institutions such as the Election Commission, the judiciary, and the civil service evolved to manage electoral uncertainty, enforce checks and balances, and mitigate transaction costs thereby underpinning both democratic resilience and investment climate improvements. He identifies three institutional traits as key: (1) rule-bound autonomy the capacity to act independently within a clear legal mandate; (2) multi-layered accountability formal oversight by elected bodies alongside informal pressures from civil society and media; and (3) adaptive capacity the ability to innovate processes in response to changing social demands. Kapur illustrates, for example, how the Election Commission's procedural rigor secured electoral legitimacy during times of coalition volatility and how incremental judicial activism expanded property-rights protection, thereby encouraging private investment. He concludes that India's institutions "lubricate" democracy and markets not through grand design but via an incremental layering of rules and norms that reduce uncertainty, suggesting that policy reforms should focus on strengthening institutional autonomy and accountability rather than merely overhauling formal structures.

Subramanian (2007), "The evolution of institutions in India and its relationship with economic growth" provides one of the few comprehensive examinations of how key public institutions in India have changed over time and whether these changes have fostered economic performance. Drawing on three strands of evidence administrative measures of institutional outcomes (e.g., power-generation losses, court-case backlogs), long-run perception-based governance indicators dating to the 1960s, and customs administration efficiency the paper finds that, contrary to conventional wisdom, institutional quality has stagnated or even deteriorated across these dimensions over several decades. Subramanian then tackles the bidirectional growth–institutions nexus, uncovering two paradoxes: despite modest or negative institutional evolution, India achieved periods of rapid growth, and growth itself did little to spur institutional improvements. Methodologically, the paper combines descriptive trend analysis with econometric tests of causality, highlighting both the data challenges in measuring sub-national institutions and the limits of a purely growth-driven improvement narrative. Its core contribution is to underscore the enduring institutional constraints on India's development and to call for policy focus not just on economic reforms but on deepening institutional capacity from judicial backlogs to customs enforcement to sustain long-term growth.

Singh (2020), examines the convergence of political accountability and state capacity across 16 Indian states from 1985–2016, embedding his Governance Index into the broader convergence literature. Drawing on Acemoglu & Robinson (2012), Kaufmann & Kraay (2002), and Savoia & Sen (2015), he argues that, under diminishing-returns logic, poorer states should "catch up" with richer ones in institutional quality. After assembling 23 indicators into aggregate accountability and capacity indices, he finds robust evidence of unconditional and conditional convergence in both dimensions despite diverging income trends. Descriptive statistics reveal rising accountability but declining capacity on average most pronounced in the poorest states highlighting a paradox wherein institutional improvements outpace fiscal-institutional strength. Singh concludes that institutional catch-up has occurred even as public institutions strain under growing citizen demands, raising critical questions about the sustainability of India's growth trajectory.

Global empirical evidence on institutions & growth

Dawson (1998), *"Institutions, Investment, and Growth: New Cross- Country and Panel Data Evidence",* explores the role of institutions in economic growth. Using a neoclassical growth model, Dawson investigates two channels through which institutions impact growth: directly, by influencing total factor productivity, and indirectly, by affecting investment efficiency. The analysis incorporates data on economic freedom, political freedom, and civil liberties, alongside variables like initial income, investment share, labor force growth, and human capital. The study finds that economic freedom has a significant positive impact on growth, while political and civil liberties do not. Countries with higher economic freedom ratings experience faster economic growth, largely due to its indirect effects on investment, particularly in human capital. Dawson also highlights the importance of the initial level of economic freedom over changes in freedom over time in explaining cross-country growth differences. These findings align with Milton Friedman's idea of a link between economic and political freedoms but emphasize the dominant role of economic freedom in fostering growth. Dawson underscores the value of institutions that promote economic freedom, which creates an environment conducive to sustainable investment and productivity-led growth. The paper calls for further exploration of the complex interplay between various freedoms and their economic impacts.

M. Ahsan and Jaideep Oberoi (2003), *"Inequality, Well-Being and Institutions in Latin America and the Caribbean,"* examines the role of institutions in reducing poverty and inequality in the LAC region. The authors adopt a broader view of poverty, focusing on non-income poverty (NIP), which includes health, literacy, and nutrition, and institutional capital (IC), which includes both formal institutions (e.g., property rights, rule of law) and informal social norms. Using descriptive and regression analyses, the paper finds that political stability and institutional quality are crucial in reducing NIP, while income growth and inequality have a weaker effect. Interestingly, globalization (measured by trade-to-GDP ratio) shows a negative impact on NIP, suggesting that trade openness might not always improve non-income well-being. The paper recommends prioritizing institutional reforms, fostering social capital, and promoting inclusive economic growth as key strategies for sustainable poverty reduction in the region.

Compton and Giedeman (2007) examine the relationship between financial development, institutional quality, and economic growth, focusing on whether these factors act as substitutes or complements. Using data from 90 countries between 1970 and 2004, they analyze financial development through private credit, stock market turnover, and market capitalization, and institutional quality via contract-intensive money, corruption, and rule of law measures. The study employs cross-sectional OLS and instrumental variables (IV) methods, along with panel analysis using System-GMM. The findings suggest that banking development and institutions are substitutes for growth, with strong banking systems compensating for weaker institutions in fostering economic growth. The interaction between private credit and institutional measures is negative and significant, indicating they work against each other. However, the relationship between stock market development and institutions is more ambiguous, with turnover showing no significant interaction, and capitalization yielding mixed results. The authors conclude that both financial development and institutional quality independently contribute to growth, with banking systems providing a substitute for institutional strength.

Sihag (2007) reviews empirical studies examining the relationship between institutions, governance, and economic growth, emphasizing the complexity of their interplay. The author discusses variables like political instability, human capital, and income, noting that some studies use settler mortality or population density as instruments for institutions. Sihag critiques the methodological flaws in these studies, particularly regarding endogeneity and inappropriate model specifications. While some studies suggest a positive relationship between institutions and economic growth, others find human capital as a more significant predictor. Sihag concludes that both institutions and governance are crucial for growth, advocating for a more nuanced understanding of their interdependence. He calls for future research to move beyond data mining and focus on improving the quality of institutions and understanding the growth process in a more comprehensive manner.

Carlin (2010) examines the role of institutions in economic reforms, focusing on property rights and contracting institutions. The paper compares the success of the 1948 Currency Reform in West Germany with the struggles of post-communist reforms in Eastern Europe, emphasizing the importance of institutional continuity. In West Germany, the success was attributed to the continuity of property rights institutions, while Eastern Europe faced the challenge of building new institutions in an institutional vacuum. Carlin highlights foreign ownership as a potential driver of productivity in transition economies, filling gaps where domestic institutions were weak. The paper also suggests that contracting institutions should be tailored to the specific economic context, as different types of institutions are better suited to supporting various economic activities. Overall, Carlin stresses that institutions matter in shaping reform outcomes, urging that reforms be sensitive to the existing institutional landscape.

Oatley (2010) investigates how political institutions, particularly the degree of political inclusivity, influence foreign debt accumulation in developing countries. Using data from 78 developing countries between 1976 and 1998, the study focuses on government debt to foreign creditors as a percentage of GDP, with regime type as the key independent variable. Regime type is measured using the Polity IV democracy-autocracy index, the Freedom House political rights index, and the Winning Coalition Size relative to Selectorate (W/S). Control variables include terms of trade, world interest rate, per capita income, GDP, trade openness, and participation in World Bank/IMF programs. The Error Correction Model (ECM) is used to separate short- and long-term effects. Results show that more democratic countries have smaller increases (or larger decreases) in foreign debt over time, while autocratic regimes tend to accumulate more debt. The paper concludes that political institutions are more crucial than external shocks in explaining debt accumulation, highlighting the role of inclusive political systems in ensuring debt sustainability.

Tun, Azman-Saini, and Law (2012) analyze the role of institutional quality in attracting foreign direct investment (FDI) using data from 77 countries (1981–2005). The study employs a system GMM panel estimator to address unobserved country-specific effects and endogeneity. The dependent variable is FDI inflows as a percentage of GDP, with the key independent variable being an Institutional Quality Index comprising five indicators: bureaucratic quality, rule of law, corruption, expropriation risk, and government contract repudiation. Control variables include lagged FDI, trade openness, life expectancy, infrastructure quality, and population. Results indicate that institutional quality significantly increases FDI inflows, with a robust positive effect even after removing outliers. Additional significant determinants are past FDI, trade openness, and human capital (life expectancy), while market size and infrastructure quality are insignificant. The study concludes that institutional reforms to enhance transparency, reduce uncertainty, and improve governance are crucial for fostering FDI and long-term economic growth.

Kebede and Takyi (2017) examine the causal link between institutional quality and economic growth in 27 Sub-Saharan African countries over 1996–2014. Using panel cointegration, causality tests, and system GMM estimation, they identify a long-run relationship between institutional quality and growth with unidirectional causality from economic growth to institutional quality. Economic growth significantly enhances institutional quality, while institutional quality also drives growth. Factors like trade openness, financial development, and political freedom positively influence both, whereas natural resource dependence and debt servicing negatively impact them. The findings highlight economic growth as the primary catalyst for institutional improvement, underlining the importance of growth-focused policies for institutional development. The authors advocate for strategies that promote trade openness, financial development, and political freedoms while addressing resource dependence and debt burdens, aiming to achieve sustainable growth and strengthened institutional frameworks in the region.

Arbolino and Boffardi (2017) examine the impact of institutional quality and the efficient use of EU Cohesion Funds on regional economic growth in Italy from 2007 to 2015. Using a fixed-effects panel regression model, they find that the financial realization index (funds spent vs. allocated) has a positive and significant effect on per capita GDP growth, emphasizing the importance of spending allocated funds. Regions with higher institutional quality also experience stronger economic growth, highlighting the importance of effective governance. The efficiency of payments is less consistently significant but interacts positively with both financial realization and institutional quality in some models. The study concludes that improving institutional quality, financial realization, and payment efficiency, alongside investments in education and infrastructure, is vital for growth, particularly in underdeveloped Southern and Insular regions of Italy. Strengthening institutional capacity is essential for maximizing the benefits of EU Cohesion Funds.

Khan and Hanif (2018) analyze the interplay between inflation and economic growth, emphasizing the modifying role of institutional quality using data from 113 countries between 1981 and 2015. Employing system GMM and interaction terms, they reveal a nonlinear relationship: inflation has no significant impact on growth in countries with weak institutions but negatively affects growth as institutional quality improves. The adverse effects of inflation intensify as institutional quality crosses specific thresholds. These findings are robust, persisting after excluding high-inflation countries and across OECD and non-OECD subsamples. The study concludes that institutional quality is crucial in determining inflation's impact on growth. For countries with weak institutions, inflation might not hinder growth significantly, but institutional reforms are essential to enhance economic stability and mitigate inflation's negative effects, fostering sustainable economic development.

Zhao *et al*. (2021) explore the effects of institutional reforms on economic growth and investment in 122 developing countries from 1996 to 2019, focusing on whether economic or political reforms are more effective. Using difference-in-differences regression, they find that economic reforms significantly enhance growth and investment, with smaller reforms spurring faster growth and larger reforms attracting more investment. Sustained reforms lasting over three years yield enduring benefits. Political reforms, however, have a negative short-term impact, becoming beneficial only after three years, with gains increasing after four years. The sequence of reforms matters: implementing economic reforms before political reforms results in higher investment and growth, while prioritizing political reforms leads to slower outcomes. The study concludes that economic reforms, particularly those strengthening property rights and improving the business environment, should be prioritized in developing countries, as they provide stronger and more immediate macroeconomic benefits compared to political reforms.

Parsa and Datta (2022) analyze the impact of institutional quality on economic growth using data from 87 countries (middle-income and high-income) from 2000 to 2020. They find that institutional development significantly boosts GDP per capita growth in both groups, with regulatory quality having a stronger effect in high-income countries and legal systems and property rights being more crucial in middle-income countries. Institutions primarily influence growth by promoting investment, with human capital, trade, and investment also contributing positively. The study reveals a causal relationship running from institutional quality to economic growth, particularly in middle-income countries, where growth has a weaker effect on improving institutions. The authors conclude that strong institutions including well-defined property rights, effective legal systems, and quality regulations are essential for long-term growth and recommend prioritizing institutional reforms, especially in countries with weaker frameworks.

Gibogwe, Nigo, and Kufuor (2022) analyze the impact of institutional quality on economic growth in Tanzania from 1990 to 2021 using an ARDL model. The study finds that institutional quality has a significant positive long-run effect on economic growth, with a coefficient of 0.047, supporting the hypothesis that better institutions foster higher growth. Additionally, economic growth and gross fixed capital formation contribute positively to improving institutional quality, creating a feedback loop. The study also highlights the crowding-out effect of domestic investment on foreign direct investment (FDI) and the positive impact of FDI on human capital. The authors emphasize the need to strengthen institutional capacity to foster economic growth and acknowledge challenges in measuring both institutional quality and economic growth, advocating for new tools and methods in future research. The study suggests that improving institutional quality is crucial for sustainable growth and development in Tanzania.

Indian evidence on institutions & growth

Nirola and Sahu (2019) examine the impact of government size on economic growth across 23 Indian states, considering the role of institutional quality. They find that larger government sizes generally negatively impact growth, but this effect is less severe in states with higher institutional quality. Their analysis shows that improving institutional quality can mitigate the negative effects of increased government size on economic growth. The study suggests that reducing non-development expenditure especially in states with stronger institutions can foster growth more effectively than cutting development expenditure. The authors recommend that Indian states focus on enhancing institutional quality, minimizing government intervention, and prioritizing efficient resource allocation to promote economic growth. These measures include improving sectors like education, healthcare, and infrastructure, and streamlining regulations to create a more business-friendly environment.

Pattanaik and Nayak (2014) explore the relationship between economic freedom and economic growth in India, using data from 20 states across three periods (2004-2010). They find that economic freedom particularly in government size, legal structure, and market regulations positively impacts both per capita income and GSDP growth. Among the dimensions, the size of government and labor/business market regulations are most significant for GSDP growth, while property rights show limited impact. Key control variables like inflation rate, literacy rate, and share of tertiary sector employment also show positive relationships with growth. The study concludes that economic freedom is crucial for growth in India, recommending reductions in government size, flexible regulations, stronger legal structures, and policies to improve human capital and sectoral composition. The authors highlight the income divergence between states and recommend that lagging states focus on enhancing economic freedom and human capital to close the development gap.

Parul Jain (2021) in "Institutions and Economic Development: Understanding the Evidence from Indian States" aims to bridge a gap in the literature by examining the influence of institutional quality on economic growth at a sub-national level in India, specifically across 21 states between 2011 and 2017. The primary objectives were to construct a novel Index of Institutional Quality (IIQ) using factor analysis with principal component factoring, comprising three sub-indices: Economic Efficiency (IEE), Governance Capacity (IGC), and Law and Order (ILO). The study then sought to analyse the impact of these institutions on per capita income and its growth using pooled OLS and fixed-effects based panel data estimation. Data sources for the 20 variables used were carefully selected. The econometric framework included log of per capita income and year-on-year per capita income growth as dependent variables, with the IIQ and its sub-indices (often lagged) as independent variables, alongside control variables such as investment to SDP ratio, level of urbanization, and human capital. The empirical findings indicate that favourable institutions have a positive and significant impact on both the level of per capita income and its growth rate, albeit with a lag. More specifically, the Index of Governance Capacity (IGC) consistently showed a positive and statistically significant impact on per capita income (level effect), while both the IGC and the Index of Economic Efficiency (IEE) had a positive and significant impact on per capita income growth. Control variables generally aligned with economic theory, showing expected positive signs for investment, urbanization, and human capital. The discussion highlights that institutional quality is crucial even in the short run, suggesting that prioritising economic institutions and governance capacity could be "low-hanging fruits" for smart institutional reforms in India, supporting the notion that institutional and economic development can occur simultaneously. However, the study acknowledges limitations, including the coverage of only a few institutions, a relatively short 7-year time horizon, and the inability to address reverse causality due to data constraints.

Singh (2020 b), develops a novel annual Governance Index for 16 major Indian states over 1985–2016 by integrating North's "rules of the game" framework with World Bank governance concepts and Williamson's "play of the game" notion, filling a key gap in sub-national, time-varying institutional measures. Drawing on objective administrative data 30 indicators across accountability (e.g., electoral inclusivity, media reach), state capacity (e.g., police and judicial clearance rates, bureaucratic human-capital proxies), and fiscal performance (e.g., revenue effort, deficit control) he employs Box-Cox transformations, z-score normalization, and hierarchical aggregation to construct the index and tests robustness through alternative aggregations. His descriptive analysis reveals divergent trends: rising accountability, declining state capacity, and a post-2008 fiscal recovery, with low inter-pillar correlations justifying separate aggregation and evidence of both sigma-convergence (voter inclusivity) and divergence (media reach). By relying on hard data rather than perceptions and offering methodological rigor in handling state bifurcations and data interpolation, Singh not only benchmarks state-level governance trajectories but also establishes a replicable template for panel-structured institutional analysis in federations.

Singh (2020 c), situates itself within the extensive literature on institutions and growth drawing on Knack & Keefer (1995) on property rights, Evans & Rauch (1999) on public-goods efficiency, Acemoglu & Robinson (2012) on elite accountability, and Alesina *et al.* (1997) on bureaucratic efficiency while acknowledging persistent challenges of measurement error, endogeneity, and cross-country comparability. By exploiting the natural experiment of India's federal structure where 16 states share formal rules but differ in informal norms he employs the annual Governance Index developed in Essay 1 to test channels from governance to investment and per-capita NSDP growth. Using fixed-effects regressions and Arellano–Bond GMM to address reverse causality, Singh finds that higher elite accountability robustly raises both investment rates and growth, state capacity unexpectedly dampens investment and growth perhaps reflecting corruption "lubrication" and fiscal performance's impact shifts post-FRBM reforms; importantly, he uncovers no evidence of growth driving improvements in governance. He thus advances the field by combining sub-national panel data with rigorous dynamic methods to unpack the nuanced, dimension-specific effects of governance on economic outcomes in India.

METHODOLOGY

This study adopts a systematic review approach to synthesize theoretical and empirical contributions on the role of institutions in shaping long-run economic growth. Unlike meta-analyses that rely on statistical aggregation of effect sizes, this review employs a narrative synthesis to integrate findings from diverse theoretical traditions, historical analyses, and empirical investigations spanning both global and Indian contexts.

The review process followed three steps of selection of sources, categorization and analytical strategy. Selection of Sources was done on the basis of foundational works from Old Institutional Economics (OIE) and New Institutional Economics (NIE). It included key contributions by Veblen (1898), Commons (1931), Coase (1984), and North (1990, 1991, 1994), to establish the theoretical grounding. The seminal empirical studies such as Acemoglu, Johnson, and Robinson (2001, 2004), Williamson (2000), and Dawson (1998) were incorporated to capture the evolution of cross-country evidence. Whereas sub-national studies on India (Kapur, 2005; Subramanian, 2007; Singh, 2020; Jain, 2021) were prioritized to highlight institutional diversity within a single federal context.

Studies were classified into four groups namely: Theoretical foundations (OIE and NIE), Historical-institutional accounts, Cross-country empirical evidence and Sub-national evidence with a focus on India, for thematic categorization of literature available.

For analysis within each category, works were examined for their conceptual framework, methodology, findings, and limitations. Special attention was paid to (i) measurement of institutions, (ii) channels linking institutions to growth (property rights, accountability, state capacity, etc.), and (iii) evidence of causality versus correlation. The synthesis aimed to identify both consistencies (e.g., robust effects of property rights) and contradictions (e.g., whether growth improves institutions or vice versa).

This mixed historical–analytical approach enables the review to connect abstract theoretical debates with empirical trends and to highlight the relevance of institutional frameworks for India's regional disparities.

RESULTS

The literature review yields following broad sets of findings:

Theoretical Insights

The Old Institutional Economics (Veblen, Commons) emphasized evolutionary processes, social norms, and legal structures but lacked formal models. Whereas the New Institutional Economics (Coase, North, Williamson) formalized the role of transaction costs, property rights, and path dependence, making institutions central to mainstream development economics. The distinction between inclusive vs. extractive institutions (Acemoglu, Johnson, Robinson) has become a dominant framework, highlighting political accountability and rule of law as decisive for growth.

Cross-Country Evidence

Empirical studies consistently find that institutions, rather than geography or culture, are the deep determinants of growth (Acemoglu *et al*., 2001, 2004). Property rights institutions tend to have a stronger impact than contracting institutions (Acemoglu & Johnson, 2003). Several studies demonstrate persistence and path dependence: colonial legacies, settler mortality, and historical shocks continue to shape economic trajectories. The Institutional quality also influences outcomes such as foreign investment (Tun *et al*., 2012), fiscal sustainability (Oatley, 2010), and inflation-growth dynamics (Khan & Hanif, 2018).

Evidence from India

Indian institutions present a paradox: despite relatively strong formal democratic institutions, growth has been uneven across states. Some studies (Kapur, 2005) emphasize institutional resilience, while others (Subramanian, 2007) highlight stagnation and deterioration in governance. Singh (2020) and Jain (2021) provide sub-national governance indices, revealing heterogeneity across states: accountability has improved, but bureaucratic/state capacity often lags. The institutional quality (particularly governance capacity and efficiency) positively correlates with state-level per capita income and growth, though causality remains contested. Thus overall, Indian evidence supports the global finding that institutions matter, but it also illustrates that formal rules alone are insufficient without capacity and adaptability.

CONCLUSION

This review reaffirms that institutions are the deep determinants of long-run economic performance. From Veblen's evolutionary critique to North's transaction-cost framework and Acemoglu & Robinson's inclusive/extractive dichotomy, the theoretical consensus highlights the primacy of institutional arrangements in shaping incentives, reducing uncertainty, and enabling productive exchange.

The cross-country empirical literature provides robust evidence that institutional quality explains much of the global divergence in incomes and that property rights, accountability, and adaptability are particularly critical. However, the debate on causality whether institutions cause growth or growth enables institutional reform remains unsettled.

The Indian case demonstrates the importance of moving beyond national averages to examine sub-national institutional diversity. States with stronger governance capacity and efficient public institutions (e.g., Tamil Nadu, Maharashtra) achieve higher and more sustained growth, while weaker states struggle despite operating under the same constitutional framework. This highlights the significance of historical legacies, bureaucratic capacity, and political accountability in shaping state-level outcomes.

The review suggests that the literature increasingly emphasizes governance capacity, accountability, and adaptability as central components of effective institutional reform, rather than the mere expansion of formal legal structures.

Further research could be undertaken in developing longitudinal state-level indices of institutional quality in India and other federal systems. Exploring the channels (investment, innovation, human capital) through which institutions shape growth at the sub-national level and applying causal inference techniques (natural experiments, IV approaches) could be done to better identify the direction of the institutions–growth relationship.

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