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Institutional economics approach in tourism: A review of economic philosophy

Syahrul Karim[1]*, Bambang Jati Kusuma[1], and Farida Farida[1]

Abstract

Purpose - This article reviews the application of Institutional Economics in the tourism sector, evaluating its ability to address the limitations of conventional economic theories and enhance understanding of tourism's social and economic impacts.

Methodology/Design/Approach - Using a theoretical approach, the article explores how Institutional Economics can overcome traditional economic theories' limitations and contribute to more inclusive and sustainable tourism policies.

Finding - Institutional Economics offers valuable insights into tourism, addressing gaps in conventional models. It promotes a more comprehensive understanding of tourism's impacts, particularly in sustainability and inclusivity, aiding the development of policies that prioritize long-term societal welfare and economic growth.

Originality/Value - This article introduces a novel perspective by applying Institutional Economics to tourism, emphasizing the need for sustainable and inclusive tourism policies that focus on societal and economic well-being.

Keywords Institutional economics, tourism, economic inequality, social impact, sustainable tourism.

Introduction

Economic thought applied in almost all countries (except for socialist and communist nations) today is based on a mixed approach. It no longer relies solely on Classical or Neo-Classical foundations. Whether or not there is government intervention, whether it enriches individuals or distributes benefits across society, and whether it is dominated by a single group are all considerations. Despite the fact that individual wealth has continued to rise over the past decade, Oxfam's 2014 data highlights a striking phenomenon where 1 percent of the wealthiest individuals control 48 percent of the world's economy. This has led to the notion that the role of government is merely to pave the way for the wealthy. Therefore, the implementation of a blend of Classical and Neo-Classical economic schools of thought, as pioneered by Adam Smith and Gossen, needs to be designed to create a new formula in economic theory.

The Classical school, led by Adam Smith, emphasizes that government intervention in economic affairs is not permitted, and also incorporates the use of mathematics in economic analysis (Santosa, 2010; Yustika, 2011). According to Mubyarto (2002), the economics taught and applied globally since World War II was pioneered by Paul Samuelson's book, Economics: An Introductory Analysis (MIT, 1946). The core of Samuelson's teachings is known as Neo-Classical economic theory. Neo-Classical economics is a synthesis between Classical free market competition theory (homo economicus and Adam Smith's invisible hand) and marginal utility-

*Correspondence:
Syahrul Karim
syahrul.karim@poltekba.ac.id
[1]Department of Tourism, Balikpapan State Polytechnic, Balikpapan, East Kalimantan 76126, Indonesia

and general equilibrium theories. Neo-Classical economics is a synthesis between Classical free market competition theory (homo economicus and Adam Smith's invisible hand) and marginal utility and general equilibrium theories. The emphasis of Neo-Classical economics is that, under certain assumptions, free market mechanisms always lead to equilibrium and optimal efficiency that benefits everyone. In other words, if markets are left free, undisturbed even by well-intentioned government regulations, society as a whole will achieve optimal collective welfare (Pareto Optimal).

A hallmark of Neo-Classical economics is the dominance of quantitative methods in economic analysis. The quantitative approach used in economics, much like in the exact sciences, is rooted in the positivist paradigm. The fundamental belief of positivism is based on ontological realism, which states that reality exists and operates according to natural laws. Research aims to uncover the truth about existing reality and how it operates in practice. Positivism, which later gave rise to post-positivism, posits that valid knowledge is built from empirical evidence.

In contemporary times, there is a push to develop more comprehensive paradigms, such as Institutional Economics, which focuses on the role of institutions, social, and cultural factors in shaping economic dynamics. Institutional Economics, whether in the form of Old Institutional Economics or New Institutional Economics, critiques the limitations of Neo-Classical theory and offers a more holistic and multidisciplinary perspective.

This article aims to review the Institutional Economics approach in the context of tourism, assessing how this perspective can address the limitations of conventional economic theories and provide deeper insights into the social and economic impacts of tourism activities. By focusing on how Institutional Economics can assist in designing more inclusive and sustainable tourism policies, this article seeks to present a more comprehensive understanding of tourism's contributions to societal welfare and economic development.

Philosophical Foundations of Classical and Neo-Classical Economics

Economic thought began with pre-classical ideas from scholasticism, mercantilism, and physiocracy (Ancient Greece) (Yustika, 2011). However, broadly speaking, the development of economic thought started with Classical economics. This era was pioneered by Adam Smith, who emphasized the existence of an invisible hand in regulating the allocation of resources. The role of the government (state) was limited as it could interfere with economic processes. This concept of the invisible hand was later interpreted as market mechanisms. The market determines prices. The Classical school faced its downfall after the Great Depression of the 1930s, which showed that the market could not respond to stock market upheavals. Another notable figure was Thomas Robert Malthus. Malthus's foundational ideas and analytical framework concerned land rent theory and population theory.

During the Classical era, economists placed economic phenomena within a comprehensive economic system of society. This period was marked by several foundational principles that were relatively simple, aimed at understanding the economic developments occurring in advanced countries with established industries. These economies had evolved into production forms with increasing incomes.

The perspective or discussion of economics during this time focused on paradigms aimed at achieving optimality in activities. Individuals, as homo economicus, were assumed to seek optimality both as consumers and producers. Economic theory was developed on the understanding that the market is an institution connecting these two individuals. If each individual acts freely, facilitated by the market through invisible hands, optimality will be achieved.

Equilibrium is a theoretical concept used to demonstrate the alignment between consumer and producer desires at a specific price level in the market, although in reality, this equilibrium is difficult to prove. To achieve equilibrium, as proposed by the Classical economists, consumer and producer theories were developed.

Fundamentally, Classical concepts focus on individual discussions, markets, and prices as forms of consumer (buyer) and producer (seller) activities. Consumers aim to maximize satisfaction, while producers aim to maximize profits. The market functions as a signaling mechanism for both through price mechanisms. The government is seen merely as an institution or agency given authority in the economic realm to manage goods related to public interests.

The Neo-Classical school altered views on economics both in theory and methodology. The theory of value was no longer based on labor value or production costs but shifted to marginal utility. One of the founders of the Neo-Classical school, Gossen, contributed to economic thought with what is known as Gossen's First and Second Laws. In addition to Gossen, Jevons and Menger also developed the theory of value from marginal satisfaction. Jevons argued that individual behavior plays a role in determining the value of goods and that differences in preferences lead to differences in prices. Menger, on the other hand, explained the theory of value in terms of the order of various goods, positing that the value of a good is determined by the lowest level of satisfaction it can fulfill. This theory of the order of goods also encompasses distribution theory.

Walras's impressive contribution was his general equilibrium theory, developed through a system of simultaneous equations. This system interconnected various economic activities such as production, consumption, and distribution theories. Walras's assumptions included perfect competition, limited capital, labor, and land, while production technology and consumer preferences remained constant. Changes in any of these assumptions lead to changes across all economic activities.

Marshall's most renowned contribution is the interaction of demand and supply forces. Thus, production cost analysis supports the supply side, and marginal utility theory forms the core of demand discussion. To facilitate the analysis of partial equilibrium, the ceteris paribus assumption was used, and to incorporate time factors into the analysis, markets were classified into very short-term, short-term, and long-term. In discussing marginal satisfaction, another assumption was included, namely that the marginal satisfaction of money remains constant. Marshall also discovered consumer surplus, which is linked to welfare economics. When consumers spend less than their purchasing ability, a consumer surplus occurs. If taxes imposed on consumers are less than this surplus, their welfare does not decline. However, taxes can also be used for subsidies, especially for industries with increased cost structures. Marshall further explained why average total cost curves decline and rise depending on internal and external factors affecting firms or industries.

Institutional Economics: Synthesis of Classical and Neo-Classical Economics

In 1976, a book titled "Economics in the Future" was published, expressing dissatisfaction with Neo-Classical economic teachings. Jan Tinbergen and Gunnar Myrdal, two prominent contributors to the book, proposed that future developments in economics should focus on inductive-empirical approaches and consider institutional issues. Chapra (2001) states that while conventional economics has gained significant intellectual prestige, it is not the sophistication of the discipline that attracts attention, but rather what it offers to humanity in achieving human goals, ultimately prioritizing justice and general welfare.

Conventional economics has failed in this regard due to its aversion to normative evaluations and its excessive concentration on wealth maximization, desire satisfaction, and individual needs fulfillment. To encompass social interests, conventional economists have generally assumed that competition will limit personal interests and thereby promote the fulfillment of social interests. If the orientation of economic science is on human welfare, its scope should not be limited to economic variables alone but should also address moral, psychological, social, political, demographic, and historical issues.

From the discussion of ideal economic thought, it can be concluded that the ideal alternative to Neo-Classical economic theory is one based on a holistic, human welfare-oriented, multidisciplinary paradigm. Institutional economics is considered a highly suitable and ideal alternative to replace the role of Neo-Classical economics.

Institutional economics is a new paradigm in economic science that views institutions (rules of the game) as central to shaping an efficient economy. It has two main types: Old Institutional Economics and New Institutional Economics (NIE). Old Institutional Economics emerged from Thorstein Veblen's critique of the basic assumptions of Classical/Neo-Classical economics, which he considered weak. Veblen's views include: (1) Humans are not only rational beings but also emotional beings with feelings, tastes, values, and instincts tied to their culture; (2) Tastes, feelings, values, and instincts also influence economic transactions; (3) Economic choices are also affected by physical and technological environments; (4) The economic world cannot be detached from or unaffected by historical, social, and institutional factors that are always changing and dynamic.

This perspective addresses the limitations of mainstream (Neo-Classical) economics in understanding economic development at the micro level. The choice to use institutional economics is supported by studies conducted by Hoskins (1993), Vel (1994; 2010), Gunawan (2000), Fowler (2005), Twikromo (2008), and Palekahelu (2011), which show that the Sumbanese people are still bound by the culture and social norms inherited from their ancestors. These cultural values are reflected in their daily behavior, which is often perceived as "irrational" by others. In social sciences, the cultural values and social norms within a community are referred to as informal institutions. However, besides informal institutions, Sumba's integration into the Indonesian state, the introduction of Christianity, and other external influences have led the Sumbanese to live by various formal rules and laws (Vel, 2008). The institutional economics perspective, which considers the importance of both formal and informal institutions in shaping human behavior and motivation, is suitable for a deeper understanding of changes occurring in Sumbanese society. Various studies on Sumbanese society indicate that while mainstream economic analysis can be applied, it is insufficient to reveal deeper aspects. Understanding economic behavior in such societies requires an alternative perspective not provided by mainstream economics.

Institutional Economics in the Field of Tourism

Tourism is a strategic activity when viewed from the perspective of economic and socio-cultural development, as it fosters economic growth, job creation, increased income for communities, taxation (foreign exchange), improved quality of life, and can enhance national pride through cultural values while serving as a tool for environmental preservation (Suradnya (1999, 2008), Lim Christine, McAleer (2001), Liping A. Cai, Bo Hu, and Feng (2001), Henderson (2002), Hanggidae (2006), Kartawan (2008), Fandeli (2008)). Since global travel became more accessible to the public in the 1960s, the number of international tourists has increased by an average of 7.1% per year. This positive trend is expected to continue.

In the year 2000, the World Tourism Organization (WTO) (as cited in Yasin et al., 2003) projected that by 2020, the global tourism industry would grow at an average rate of more than 6% per year. This growth presents both opportunities and challenges for various stakeholders, including destination managers. Designing effective marketing strategies for tourist destinations will help seize these opportunities and address the challenges. Similarly, the current global tourism market growth has prompted many countries to engage in natural competition within the tourism industry by offering programs designed to attract tourists to their attractions.

The impact of tourism on local communities is inherently paradoxical. On one hand, tourism can stimulate the development of native culture and even revive nearly forgotten cultural elements. On the other hand, tourism can transform the motivations behind various cultural elements, such as rituals originally performed for traditional purposes, into commercially motivated activities.

Discussing the supply aspects of tourism itself inevitably involves job creation. The workforce required consists of individuals with technical skills and managerial know-how. This means they must understand the intricacies of the tourism world, rather than being novices, and must be professionals. Thus, the nature of the education and training required should be specialized rather than broad. The author emphasizes that the workforce plays a crucial role in developing

Indonesia's tourism industry. In addition to a sufficient workforce, infrastructure also plays a vital role in creating a profitable tourism industry.

In recent decades, the contribution of tourism to the economy has been significant, impacting not only the overall economy but also social, cultural, management, architectural services, and various other fields. Specifically, in the economic realm, tourism contributes 15% to GDP, supports 18 million jobs, and saw investments amounting to IDR 20.1 trillion in 2019.

In the context of research on institutional economics within the tourism sector, the focus is on how tourism policy approaches can contribute to community welfare through various economic and social scientific disciplines. This approach goes beyond purely quantitative methods as used previously, employing a mixed-methods approach. This will provide a comprehensive view of the broad economic impacts of tourism activities. Therefore, for the dissertation research, the author will examine the socio-economic impacts of tourism on communities using an institutional economics approach.

Conclusion

Contemporary economic thought has shifted from Classical and Neoclassical schools towards more holistic mixed approaches. While Classical and Neoclassical theories, each emphasizing free market mechanisms and optimal equilibrium, provide important foundations in economics, they also face significant criticism and limitations. In particular, their inability to address extreme wealth inequality and the social impacts of unregulated markets has led to a need for more comprehensive approaches. Criticism of Neoclassical economics has led to the development of Institutional Economics, which emphasizes the importance of institutional and cultural factors in determining economic behavior. This approach accounts for the roles of norms, history, and social context in shaping the economy, offering a broader and multidimensional perspective compared to previous approaches. In the context of tourism, the Institutional Economics approach is highly relevant. Tourism has extensive impacts, both positive and negative, on the economy and society. These impacts include economic growth, job creation, and cultural preservation, but can also lead to changes in motivation and the commodification of culture. Therefore, a more thorough and institutionally-based approach is necessary to understand and manage the effects of tourism effectively, and to ensure that its benefits are distributed fairly across society. Overall, using an Institutional Economics approach to analyze and design tourism policies can provide deeper and more comprehensive insights, helping to create strategies that not only focus on economic efficiency but also consider social welfare and cultural preservation.

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Author contributions

SK and BJK conceptualized the study and improved the quality of the manuscript. FF collected data and analyzed.

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