

Is Institutional Improvement Possible?

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-Abstract-

A substantial literature shows that economic prosperity is dependent on the quality of economic institutions. Countries with low-quality institutions remain poor while countries with high-quality institutions prosper. Improvement in institutional quality brings with it economic growth. Poor countries must improve their economic institutions to escape poverty, so if a poor country's institutional structure is unlikely to improve, that suggests dismal prospects for economic growth and an escape from poverty. An examination of institutional quality over 30 years indicates that countries with low-quality institutions have improved their institutional quality, which demonstrates that poor countries are not stuck with low-quality institutions. They can improve their institutions, and consequently, can generate economic growth and escape poverty.

Keywords: Institutions; economic freedom; institutional improvement
JEL codes: O17; O43; P10

Introduction

A substantial literature documents the close connection between the quality of economic institutions and prosperity (Mokyr, 1990; North, 1991; Olson, 1996; Landes, 1998; and Acemoglu and Robinson, 2012). Nations with high-quality institutions prosper while those with low-quality institutions remain poor. The Fraser Institute's Economic Freedom of the World Index (EFW), compiled by Gwartney, Hall, and Lawson (2013) is a good measure of institutional quality, because it is closely correlated with economic performance, as Berggren (2003), De Haan, Lundstrom, and Sturm (2006), and Faria and Montesinos (2009) document. This literature concludes that prosperity requires the establishment of high-quality economic institutions, and documents the specific institutional features that lay the foundation for prosperity. A more difficult question is how poor countries can improve the quality of their institutions, or whether institutional improvements are even possible.

Diamond (1997) argues that geographical factors are important determinants of development potential, and Acemoglu, Johnson, and Robinson (2001) conclude that the colonial histories of nations affect their current potentials for development through the establishment of inclusive and extractive institutions. Similarly, Klerman et al. (2011) argue that irrespective of the legal structure, colonial origins do affect economic growth. Landes (1998) places a heavy emphasis on culture as a factor that determines institutional quality. If a nation's geography, history, or culture are major factors that determine institutional quality, this would suggest a reason for being pessimistic about the potential for economic development in countries with low-quality institutions. A nation's geography, history, and perhaps culture, cannot be changed, so if institutional quality is determined by those factors, nations saddled with disadvantages in those areas would appear to have serious handicaps for making the institutional improvements that would be necessary to generate prosperity.

[Insert Table 1 Here]

Table 1 examines this question and illustrates the bottom quartile of countries per the EFW index in 1980 and shows their change in EFW and change in quartile ranking by 2013. The first thing to notice is that every single country in the bottom quartile of EFW in 1980 experienced an increase in their overall rating of EFW by 2013. More importantly, most countries experienced a large enough increase in their EFW rating to push them into a higher EFW quartile in 2013. Nine countries exhibited no change and thus remained in the bottom quartile by 2013. However, 15 countries did experience at least a one quartile improvement in their EFW ranking. Seven countries moved up

one quartile by 2013, five countries moved up two quartiles by 2013, and three countries moved up three quartiles by 2013. These rankings clearly illustrate that countries are not destined to be stuck at the bottom and institutional improvements can and do occur.

Results

[Insert Table 2 Here]

Table 2 undertakes a statistical analysis to control for additional variables that might influence institutional change. The dependent variable in all regressions is ΔEFW , the change in the EFW index over a decade. Thus, where data is available, each country could have up to four observations, one for each decade from 1970-80, 1980-90, 1990-2000, and 2000-2010. The key independent variable is the initial level of EFW, IEFW, so for example, for the decade from 1970-80, IEFW is EFW in 1970. Column (1) in the table estimates the regression, $\Delta EFW = \alpha + \beta_1 IEFW + \beta_2 X + \epsilon_i$ and shows that IEFW is negative and statistically significant. Higher initial values of EFW are associated with lower values for ΔEFW , which indicates convergence.

Legal origins are included to separate countries with French, German, and Scandinavian backgrounds. Geographic factors are the number of land neighbors the country has, whether it is landlocked, and distance from the equator. A country's initial Polity2 score is included to reflect political institutions. Controls are also added to include the primary religion in a country: Catholic, Muslim, or Protestant.

Column (2) repeats this exercise but this time divide the IEFW variables into the top 20%, the bottom 20%, and the middle 60% of countries by initial EFW rating. This allows a comparison of the amount of convergence among the three groups. One striking result is that all nine of the IEFW coefficients in the last three regressions are highly statistically significant. Looking at the magnitude of the coefficients, the coefficient on the bottom 20 percent has a larger absolute value than the coefficients for the other two groups in all regressions. This shows that there is as much institutional convergence in the bottom 20 percent of countries as there is for all of the countries in the dataset. Columns 3-8 report robustness tests that use multiple specifications of our baseline model. All of our specifications point to the same finding: Countries with the worst institutions are not necessarily stuck at the bottom. Many have been able to improve their institutional quality, which supports our analysis conducted in Table 1.

If there is a stochastic element in institutional quality, there will be a tendency for a country's institutional quality to regress toward the mean, which may explain the institutional convergence documented here. To attribute some causal relationship risks committing Galton's fallacy, the tendency of data to regress towards the mean, and there is a literature discussing Galton's fallacy as it applies to income convergence (Galton 1886; Quah 1992; Friedman 1992; Bliss 1999). Even if these results are due to a tendency of regression toward the mean, the optimistic conclusion still holds. The determinist view that geography, history, and culture determine institutional quality and are not easily changed suggests that institutional quality will not regress toward the mean, so those with low-quality institutions are stuck with them.

Conclusion

The poorest countries, with the lowest-quality economic institutions, are not condemned to stay there. Looking back to 1980, Table 2 shows that countries at the bottom are more institutionally mobile than those with higher institutional quality, and that deterministic factors are not keeping them at the bottom. This conclusion is also a cautionary tale for those countries that rank high in institutional quality. They are mobile too, and can have declines in institutional quality which, the literature shows, can lead to declines in economic growth and to lower per capita incomes than if they had maintained the quality of their institutions. The institutional convergence shown in Table 2 means institutional quality is not deterministic, and that nations do have the ability to collectively choose their institutional qualities. The challenge lies in the collective choice process—making the political choices that produce, in the terminology of Acemoglu and Robinson (2012), inclusive rather than extractive economic institutions.

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Table 1. Changes in the Bottom Quartile of EFW Since 1980

Bottom Quartile EFW in 1980	EFW 1980	EFW 2013	Δ EFW	Quartile in 2013	Δ Quartile Ranking
Algeria	4	5.2	1.2	Q4	0
Argentina	4.3	5.2	0.9	Q4	0
Bolivia	4.1	6.5	2.4	Q3	+1
Brazil	4.2	6.3	2.1	Q3	+1
Burundi	4	5.8	1.8	Q4	0
Congo, Dem. R.	3	5.7	2.7	Q4	0
Egypt	4.4	6.3	1.9	Q3	+1
El Salvador	4.1	7.3	3.2	Q2	+2
Ghana	2.9	6.2	3.3	Q4	0
Hungary	4.1	7.3	3.2	Q2	+2
Iran	3.6	5.4	1.8	Q4	0
Israel	3.5	7.4	3.9	Q1	+3
Jamaica	4	7.3	3.3	Q2	+2
Kuwait	3.8	7.5	3.7	Q1	+3
Madagascar	3.9	6.7	2.8	Q3	+1
Morocco	4.4	6.5	2.1	Q3	+1
Myanmar	3.9	5.6	1.7	Q4	0
Nicaragua	3.5	7.4	3.9	Q1	+3
Nigeria	3.5	6.4	2.9	Q3	+1
Peru	3.7	7.3	3.6	Q2	+2
Syria	3.8	5.2	1.4	Q4	0
Togo	4	5.7	1.7	Q4	0
Turkey	3.7	6.9	3.2	Q3	+1
Uganda	2.8	7.3	4.5	Q2	+2

Note - Q1 = highest quartile, Q2= second highest quartile, Q3 = third highest quartile, Q4 = bottom quartile

