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Democracy, inequality, and institutional quality☆

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ABSTRACT

Contrary to a widespread perception, there exists little evidence on the question as to whether the beneficial effect of democracy on the quality of economic institutions is eroded by excessive inequality. This article provides evidence from a variety of panel data models that documents a significant interaction between political institutions and inequality in determining the quality of economic institutions. This suggests that democracy is not necessarily associated with high quality institutions. The empirical results suggest that excessively high levels of inequality erode institutional quality even in democracies, up to the point that democracies appear not to be able to implement good institutional environments if inequality is too high.

1. Introduction

The quality of institutions granting economic freedom and liberties is generally thought to be a crucial factor for long-run development. A recent empirical literature has identified two key determinants of institutional quality. First, democracy provides constraints on those in power and is often used as a proxy for the quality of economic institutions (Acemoglu et al., 2005; Acemoglu and Johnson, 2005; Acemoglu and Robinson, 2006; Acemoglu, 2008). Second, a moderate inequality of income and economic resources limits the distributive pressures that might erode institutional quality through influence activities and informality (Chong and Calderon, 2000,Chong and Gradstein, 2007b, 2007a).

Based on intuitive reasoning, however, it has been claimed repeatedly that the beneficial effect of democracy on the quality of economic institutions might be eroded by excessive inequality. In fact, as is discussed in more detail below, a considerable theoretical literature underpins this conjecture and suggests that democracy and inequality do not affect the quality of economic institutions independently from each other. Instead, there might be important interactions between inequality and political institutions in determining institutional quality. This conjecture seems to have been present in the works by De Tocqueville (1835) as well as Lipset (1959), who saw economic equality as a central co-factor of democracy in generating good institutions. More recently, this conjecture has been rephrased in the context of the debate regarding the increasing inequality and the consequences for civil liberties and social peace (Piketty, 2014). Yet, to date, there exists little to no evidence on the question as to whether the beneficial effect of democracy on institutional quality is eroded by excessive inequality.

This paper tests if such an interaction between democracy and equality exists in shaping the de facto quality of economic institutions. The starting point of the empirical analysis is the conceptual distinction between political and economic institutions.

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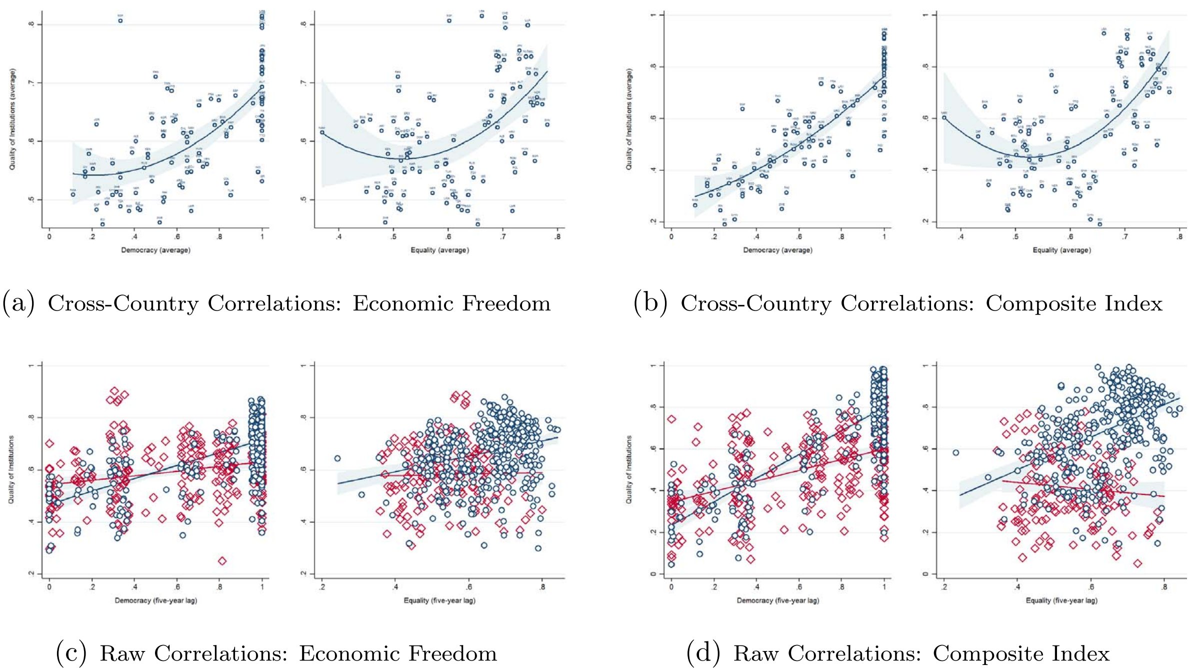
There is a widespread perception in the literature that democracy, as measured by de jure measures, such as constraints on the executive or political freedom, is equivalent to high de facto quality of institutions as experienced by individuals, particularly in the economic domain. While both conform to North's notion of “rules of the game” (North, 1990, p. 3), political institutions describe the extent to which individuals can engage and participate in the political process via elections and referendums, economic institutions comprise aspects of de facto economic freedom, as well as institutional features that directly affect the incentives for entrepreneurial activities and investment, such as bureaucratic efficiency and impartiality of the judiciary. There are important conceptual differences, which refer to the nature of institutions, as well as their perception. Economic institutions are mostly implemented by laws that have been passed by the government and reflect de facto liberties of individual citizens in the economic domain. In contrast, political institutions, in terms of democracy, the constraints on the executive, or the ability to vote, reflect legally codified, constitutional rules. In this sense, political institutions can be seen as determinants of economic institutions, but not vice versa (see, e.g., Acemoglu et al., 2005). Likewise, some authors have pointed out the inherently different nature of institutions by emphasizing the different functions of political institutions as constraints for politicians and the government, as opposed to economic institutions that enable private actors to interact and achieve their goals (see, e.g., Voigt, 2013).

Fig. 1 provides a first indication that democracy and institutional quality are not necessarily equivalent. Panels (a) and (b) illustrate the correlation of country averages of democracy and equality with institutional quality over the time period 1970–2010. Institutional quality is measured either in terms of an index of Economic Freedom or in terms a composite index that is based on the first principal component of the Economic Freedom and the Civil Liberties indices. Panels (c) and (d) plot the respective raw data for the same time frame in terms of five-year averages, which is the variation in the data used in the empirical analysis below (jittered for better visibility). The figure on the left in each panel plots the quality of economic institutions against the extent of democracy, proxied by constraints on the executive. In the figure on the right, the quality of economic institutions is plotted against equality, proxied by $(1 - \text{Gini})$. Henceforth, we refer to this measure as the reversed Gini coefficient. All variables are normalized to range between 0 and 1 with higher values indicating a higher institutional quality, more democracy, or more equality, respectively.

The data reveal the expected positive correlation between institutional quality and democracy, but contrary to the widespread assumption that democracy and high quality institutions are essentially synonyms, there is substantial variation in institutional quality, even conditional on the same level of democracy. In particular, the figures illustrate that there are countries that exhibit very democratic political institutions but that at the same time have low scores of institutional quality, such as India. Other countries with autocratic regimes (i.e., low democracy scores) score high in terms of the quality of economic institutions. Examples are Jordan, Panama, or Singapore, which achieved a considerably high quality of institutions despite relatively low levels of democracy. When looking beyond country averages, another interesting case is Brazil, which scored high on institutional quality during the military dictatorship during the 1980s.[1] Incidentally,



(a) Cross-Country Correlations: Economic Freedom

(b) Cross-Country Correlations: Composite Index

(c) Raw Correlations: Economic Freedom

(d) Raw Correlations: Composite Index

Fig. 1. Correlation between Institutional Quality and Democracy or Income Equality Notes: Institutional Quality is measured either by the Economic Freedom index or by a composite index based on the first principal component of the Economic Freedom and the Civil Liberties indices, respectively. Democracy is measured in terms of Constraints on the Executive. Income Equality is $(1 - \text{Gini})$. Variables and data sources are described in more detail in Section 3, see also Table A1. (a) Cross-Country Correlations: Economic Freedom (b) Cross-Country Correlations: Composite Index (c) Raw Correlations: Economic Freedom (d) Raw Correlations: Composite Index.

[1] Similar levels of economic institutions have been achieved only during the boom years between 2005 and 2010, fueled by revenues from the state owned oil