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Do island states have better institutions?

Heather Congdon Fors

School of Business, Economics and Law, University of Gothenburg, Box 640, 405 30 Gothenburg, Sweden

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ABSTRACT

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Since the end of World War II, the number of countries in the world has increased dramatically. Many of these newly independent countries are small both in terms of population and geography, and several are islands. The purpose of this paper is to explore the effects of island status and country size on institutional quality, and to determine if these institutional effects can explain the relatively strong economic performance of islands and small countries. I distinguish between political institutions (*Democracy*) and economic institutions (*Rule of Law*). One of the main findings of this paper is that the relationship between island status and institutional quality is significantly positive, and that these results are robust to the inclusion of a number of control variables. Further, I find that country size is negatively related to institutional quality, which is in keeping with previous results. These results provide further support for the hypothesis that institutions account for these countries' relatively better economic performance. *Journal of Comparative Economics* **42** (1) (2014) 34–60. School of Business, Economics and Law, University of Gothenburg, Box 640, 405 30 Gothenburg, Sweden.

1. Introduction

The purpose of this paper is to explore the effects of island status and country size on institutional quality. The process of decolonization that has been in motion since the end of the Second World War has led to a significant increase in the number of countries in the world. Indeed, by the end of the Second World War, the number of independent countries was 76; today, there are 193 United Nations Member States (Alesina, 2003; United Nation, 2012). This creation of new countries has led to a significant increase in the number of small states, many of which are island nations. Small country size and island status are particularly relevant characteristics in the case of development economics, as many of these recently formed small countries are developing countries. As a case in point, the Small Island Developing States (SIDS) are officially recognized by the United Nations as a distinct group of 52 developing countries and territories that face a range of special development challenges (UN-OHRLLS, 2011). Further, Alesina (2003) argues that the globalization of the past few decades, coupled with the expansion of democracy in the world and relative stable peace, is likely to contribute to maintaining the trend towards more, and smaller, states.

The emergence of a number of new small states has stimulated an interest among social scientists in the effects of country size and, to a lesser extent, island status on economic development. Interestingly, the conclusions reached in much of the existing theoretical and empirical literature regarding these effects tend to diverge. In the theoretical literature, small countries are thought to suffer from their small labor force, limited internal markets and high per capita costs of public goods provision, while islands are thought to face the disadvantages of isolation, remoteness and the greater transportation costs that arise as a result (Briguglio, 1995; Alesina and Spolaore, 2003; Albouy, 2012; Winters and Martins, 2004). Therefore, the

E-mail address: heather.fors@economics.gu.se

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general conclusion of the theoretical literature is that small country size and island status act to impede economic growth. The empirical evidence indicates, however, that islands do not face a significant disadvantage in terms of economic development (Armstrong and Read, 2003) and that small countries may actually perform better economically than larger countries (Easterly and Kraay, 2000).

In this paper, I argue that islands and small countries exhibit significantly better institutional quality than their larger, non-island counterparts. An overview of the theoretical literature on the influence of country size and island status on institutional quality is presented in Section 2 below; however, the primary focus of this paper is on exploring the empirical relationship between these variables. The empirical analysis in this paper is structured as follows: The impact of island status and country size on institutional quality in a full sample of independent countries is examined, drawing on previous theoretical and empirical research. I am interested in determining whether or not small countries and islands do in fact have stronger institutions on average. While theoretical and empirical research exists that indicates that small country size and island status are positively related to democratic institutions (Diamond and Tsalik, 1999; Clague et al., 2001; Srebrnik, 2004), there is little research into the effect of country size and island status on economic institutions.[1] This is particularly true in the case of islands. Therefore, one contribution of this paper is to establish whether or not small countries and islands have relatively better economic institutions. In addition, the impact of island status and country size on institutional quality in a sub-sample of former European colonies is examined. The reason for this is twofold: first, the overwhelming majority of island nations are former colonies and as such, factors relating to the colonial experience are likely to be important in understanding the relationship between island status and institutional quality. Second, a focus on former colonies is in keeping in with much of the existing literature on the determinants of institutional quality, where the colonial experience is thought to play a key role (Sokoloff and Engerman, 2000; Acemoglu et al., 2001, Acemoglu et al., 2002; Bertocchi and Canova, 2002; Lange, 2004).[2]

As many islands countries are small both in terms of population and geographical area, I believe that it is important to consider both size and island status in the analysis simultaneously in order to rule out the possibility that islands perform better on measures of institutional quality due purely to their relatively small size.[3] Further, while country size is often measured in terms of population, there are also strong arguments for measuring it in terms of geographical area. Therefore, both measures of country size are included in the analysis. In addition, two different types of institutions are analyzed. The first of these is political institutions, which is captured by the variable *Democracy*, taken from the Freedom House measure of Political Rights. The second is the World Bank governance indicator *Rule of Law*, which serves as my measure of economic institutions. The reason for examining two different measures of institutional quality is that while democracy is important in its own right, there is evidence that it is not as strongly related to economic development as other measures of institutions, such as *Rule of Law* (Barro, 1996; Rodrik et al., 2004).

One of the main findings of this paper is that the relationship between island status and institutional quality is significantly positive. Further, these results are robust to the inclusion of a number of control variables in the case of *Rule of Law*, while the results for *Democracy* are only robust for the former colony sub-sample. In keeping with previous results, country size is negatively related to institutional quality. In the case of *Democracy*, however, country size becomes insignificant when a control for island status is included in the former colony sub-sample regressions. Therefore, country size appears to be less powerful in explaining *Democracy* compared to *Rule of Law* in former colonies. The relationship between island status and institutional quality is found to be strongest for both *Democracy* and *Rule of Law* in the former colony sub-sample. Finally, island status is found to have a greater impact on *Rule of Law* than *Democracy*.

The remainder of the paper is organized as follows. Section 2 presents a brief overview of the existing theoretical and empirical literature related to the effects of country size and island status on institutions and economic growth, providing a background for the empirical section. The data and empirical model are presented in Section 3, while the results of the empirical analysis are discussed in Section 4. Section 5 provides an analysis of the results in Sections 4, and 6 concludes the paper.

2. Country size, islands and institutional quality

While the focus of this paper is empirical, I provide a brief overview of the theoretical literature on the role of country size and island status in institutional quality in the sub-sections below.

2.1. Country size

The idea that country size may be related to institutional quality is not new. The Greek philosophers Plato and Aristotle believed that a small population was essential for a well-functioning polity. Such beliefs about the optimality of small population were also found in the works of later philosophers, including Montesquieu and Rousseau.[4] As a result, most political scientists and economists interested in the effects of country size on democracy or economic growth measure country

[1] One exception is the paper by Olsson and Hansson (2011), which provides evidence that small countries (in terms of geographical area) score significantly better on the World Bank governance indicator *Rule of Law* than their larger counterparts.

[2] This is not to say that only former colonies have been analyzed in the literature; some research has focused on the historical explanations of institutional quality in Europe, for example (North, 1990; Glaeser et al., 2002; Acemoglu et al., 2005).

[3] Indeed, there is a tendency in the literature to focus on the specific case of SIDS, further confounding these two effects (see Briguglio (1995), for example).

[4] This is not to say that there has been universal agreement that small country size is optimal; both James Madison and David Hume have argued that larger countries are better suited to dealing with preference heterogeneity and avoiding the tyranny of the majority (Dahl and Tufte (1973)).