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Political versus economic institutions in the growth process

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ABSTRACT

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After a decade of research on the relationship between institutions and growth, there is no consensus about the exact way in which these two variables interact. In this paper we re-examine the role that institutions play in the growth process using data for developed and developing economies over the period 1975–2005. Our results indicate that the data is best described by an econometric model with two growth regimes. Political institutions are the key determinant of which regime an economy belongs to, while economic institutions have a direct impact on growth rates within each regime. These findings support the hypothesis that political institutions are one of the deep causes of growth, setting the stage in which economic institutions and standard covariates operate. *Journal of Comparative Economics* **42** (1) (2014) 212–229. Aix-Marseille University (Aix-Marseille School of Economics), CNRS & EHESS, GREQAM-EHESS, Centre de la Vieille Charité, 2 rue de la Charité, 13002 Marseille, France.

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1. Introduction

Over the last decade a heated debate has taken place over the role of institutions for economic growth. Although simple correlations indicate that growth and institutional quality are closely related, there is no consensus about the exact way in which these two variables interact. On the one hand, the evidence on cross-country income gaps has found that income levels are strongly correlated with economic institutions, while political institutions have been argued to be 'deep' causes of development, acting through their impact on policies and economic institutions. On the other, studies of the determinants of growth rates have focused on the role of political institutions, particularly that of democracy, and find that while the level of institutional quality has no impact on growth rates, changes in the political framework do.[1] In this paper we reconsider the relationship between institutions and growth and argue that both political and economic institutions are crucial determinants of growth rates albeit in very different ways.

The motivation for our approach is the idea that there are deep and proximate causes of growth, and that political institutions are likely to be part of the deep causes of economic performance.[2] Such an argument has been proposed by Acemoglu

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[1] See, amongst others, Hall and Jones (1999),Acemoglu et al. (2001), Easterly and Levine (2003) and Eicher et al. (2006) on the impact of institutions on development and growth. Barro (1996),Persson (2004) and Persson and Tabellini (2006) examine the effect of democracy on growth rates.

[2] See Galor (2005) for a discussion of deep and proximate causes of growth.

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et al. (2005) through the *hierarchy of institutions hypothesis* which argues that political institutions 'set the stage' in which economic institutions can be devised. As such, their role is indirect and operates through their impact on the economic institutions that a country chooses or on the effect that economic policies and institutions have on growth.

Several authors, such as De Long and Shleifer (1993),Jones and Olken (2005) and Larsson and Parente (2011), have argued that autocrats are not all alike in their objectives and policies, and that their choices have a major impact on economic performance. Meanwhile, Glaeser et al. (2004) emphasize that often poor countries growth because of the policies implemented by dictators. In fact, given the restrictions that autocratic regimes impose on economic agents, it is possible that the importance of the economic institutions that they choose is greater than in democratic regimes, where individuals have greater freedom to pursue growth-enhancing activities. The idea that institutions may operate at various levels has also been formalized by Davis (2010) who models the difference between institutional quality and institutional flexibility, where the latter permits improvements in institutional quality in response to economic conditions. Davis (2010) then argues that these two concepts capture, respectively, economic and political institutions. The role of political institutions in shaping the effect of other variables has also been explored by Aidt et al. (2008), who examine how the impact of corruption on growth varies across political regimes.

While there is evidence that political institutions determine the choice of economic institutions,[3] no work has been done on whether the impact of the latter on growth depends on the broader institutional context. We hence focus on this second mechanism and argue that while economic institutions affect growth rates in the same way as standard variables such as investment or education, political institutions are one of the deep causes of growth. To test this hypothesis we follow recent work which emphasizes the existence of different growth regimes such that standard growth determinants have different marginal effects on growth across regimes.[4]

Our approach consists of using a finite mixture of regression models, a semi-parametric method for modeling unobserved heterogeneity in the population that allows us to relax the hypothesis of one growth model. This method offers much greater flexibility than alternative approaches that divide the data into groups. Indeed, using a dummy variable to divide the sample is equivalent to arbitrarily allocating each country to one specific group with probability one. Rather than splitting the sample based on *a priori* arbitrary choices, mixture models generate endogenous group membership and permit explaining group membership with several covariates. Countries are hence endogenously allocated to a group, and each has its own probability of belonging to one or another group. This framework allows us to test whether political institutions rather than having a direct impact, determine which regime a country belongs to.

We estimate mixture regressions on a panel of developed and developing countries over the period 1975–2005. Our results indicate that the data is best described by a two-regime model, with roughly a third of countries in a stable-growth group and the rest in a group with much more dispersed growth rates. Political and economic institutions play very different roles. The former are the key determinant of regime membership, while economic institutions are important in determining growth rates *within* each of the two regimes, supporting the hypothesis that political institutions are one of the deep causes of growth but economic institutions are not. The impact of economic institutions on growth is substantial, although its magnitude differs across groups. In the high-democracy group, an increase of one standard deviation of the economic institutions index results in an increase in growth of 0.3 percentage points, while in the low-democracy group the same increase raises growth by 1.3 percentage points. Our results hence suggest that when political institutions are weak, growth is more sensitive to the choice of economic institutions than when the former are strong.

The paper contributes to the literature on the relationship between growth and institutions, dating back to the work of North (see North, 1981). Empirical analyses linking institutions and growth rates have focused extensively on the effect of the degree of democratization, yet the evidence for a significant effect is weak; see Barro (1996). Recent work, such as Persson and Tabellini (2006),Persson and Tabellini (2008), Rodrik and Wacziarg (2005) and Nannicini and Ricciuti (2010), has found that it is not *being* a democracy but rather *becoming* one what matters for growth. For example, Persson and Tabellini (2008) find that the transition from autocracy to democracy increases a country's annual growth rate by 1 percentage point. Moreover, Persson and Tabellini (2006) maintain that the difficulty in identifying the impact of political regimes from within-country variations is that democracy is too broad a concept. They focus on three specific situations in which democratic reform impacts growth: the correlation between democratizations and economic liberalizations, instances where democratic institutions influence fiscal and trade policies, and allowing for 'expected political reforms' that anticipate actual reforms. In all these cases they find a stronger growth effect of democracy than is obtained in more standard growth regressions. [5] Our approach is complementary to these studies in two aspects. On the one hand, our aim is to find a role for the level of political institutions in the growth process, rather than for changes. On the other, we postulate that their impact is not a direct one but rather operates indirectly as they determine to which growth regime a country belongs to.

Our work is also related to empirical analyses of the effect of institutions on cross-country income differences, such as Knack and Keefer (1995),Hall and Jones (1999) and Acemoglu et al. (2001), which although methodologically different, ask conceptually similar questions. A major difference between the two approaches is that while looking at the level of

[3] See Persson (2004) and Eicher and Leukert (2009).

[4] See Owen et al. (2009),DiVaio and Enflo (2011) and Bos et al. (2010).

[5] Some of this work has also considered the question of parameter heterogeneity when examining the impact of transitions on growth rates. Persson and Tabellini (2008) and Nannicini and Ricciuti (2010) examine the different impact of transitions into and out of democracy. There is also evidence that democracy may induce changes in the level of economic institutions and through these affect growth; see the discussion and the references in De Haan et al. (2006).

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