

How Much Do Rights Matter?

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Summary. — Do better political rights yield more economic development? By addressing the econometric challenges plaguing this question, we find support for a positive impact of rights on development. For a significant grouping of countries the association is nonlinear: the positive impact of rights is particularly strong at low rights levels; it is either absent or negative in an intermediate rights range; and returns to a moderate positive impact at high levels of rights. There is also evidence to suggest that transitions from autocratic political dispensations are associated with significant negative output shocks.

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1. INTRODUCTION

The connections between democracy and development have spawned a vast literature ranging from philosophy through political science to economics. A fact lies at the heart of this research: over time, measures of democratic rights and liberties and measures of per capita income have both increased across countries. But what causes what? If a given country reforms its rights and liberties, can it expect per capita income to rise even faster than the trend? Or is it that economic development brings about, as a by-product, improved institutions? The simple correlation between measures of democracy and per capita income does not tell us.

Theory is also ambiguous.

A substantial body of literature asserts that it is institutions that drive development. At its most general the argument is Coasian: sound institutions lower transactions costs, thereby accelerating the rate at which exchange transactions among agents can grow. This proposition has been advanced narrowly with respect to property rights,¹ broadly to the incentives that are associated with the rules of interaction imposed by institutional dispensations,² with respect to neoliberal political dispensations favorable to economic development,³ in relation to the formal legal structures adopted by societies,⁴ and with respect to the informal social capital that generates trust.⁵ Empirically, the link has been defended as being both strong,⁶ and as more robust and important than competitor explanations.⁷

But the reverse direction of causation has also been asserted. Modernization theory advances the proposition that economic development brings with it the requirement for institutional evolution—and that if development is to be sustained, institutional development will itself be inevitable.⁸

So, in theory, causality can run both ways.

The empirical estimation game reflects the theoretical uncertainty. In the influential paper by Acemoglu *et al.* (2001), the potential endogeneity of measures of institutional quality (in their instance: expropriation risk) is dealt with by instrumen-

ting on Settler mortality in the 19th century (shown to be strongly correlated with expropriation risk at the close of the 20th century, and presumably exogenous to economic performance in 2000). This strategy, while widely emulated, has been questioned on the grounds of the reliability of the measures of Settler mortality. Albouy (2012) argues that a significant proportion of the sample of 64 countries in the Acemoglu *et al.* (2001) data set is inferred from data outside of current national borders, that Settler mortality is inferred from military sources, and that results are sensitive to implied data corrections—though see the detailed response by Acemoglu *et al.* (2012). The general concern with the strength and validity of instruments,⁹ has certainly found repeated echoes in relation to growth regressions.¹⁰

In terms of the reverse direction of causality, the evidence is no less contested. Acemoglu *et al.* (2008) find no evidence of an independent, or causal, relationship between a country's per capita income and various measures of democracy. While the simple correlation is strong, and over time there is a tendency toward more democracy and more income, they nonetheless do not support a causal effect of income on democracy, and instead interpret the evidence as the result of societies embarking on divergent development paths at critical junctures (Acemoglu *et al.*, 2008, p. 813). But Gundlach and Paldam (2008) criticize Acemoglu *et al.*'s methods. They argue that a small change in the estimation process immediately reveals the strong effect of income on democracy. And a newer paper by Heid *et al.* (2011) does find evidence of a statistically significant positive relation between income and democracy, argued to be robust across different specifications and choices of instrumental variables.

How does one make progress with empirical evidence under these circumstances?

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In this paper we proceed as follows. We examine the link between institutions and growth at its most general, by considering the impact of political rights and civil liberties on per capita real output. Our choice of rights is motivated both theoretically and practically. In terms of theory, securely anchored democratic rights on average are likely to render more specific freedoms such as property rights more credible, and hence effective as drivers for growth—see Leblang (1996). There is also evidence to suggest that they foster a higher rate of technological innovation—see Aghion *et al.* (2006). And some authors argue that higher levels of social capital, hence lower transactions costs emerge under democratic institutions—see Paxton (2002) who report an interdependence. Our focus is on whether rights matter for economic performance rather than the reverse.

We then show transparently the impact of estimating the relationship under a range of alternative estimators, being explicit about the assumptions that require satisfaction under the estimators, and about whether they are likely satisfied in empirical application. In doing so, we are able to respond explicitly to concerns regarding omitted variables in estimation, and to potential endogeneity of regressors. Above all, the reader is able to establish how much difference the use of alternative estimation methodologies makes to inference—in short whether the debates regarding appropriate estimation approaches carries practical significance.

Our methodological finding is that choice of estimation approach matters a great deal. Of strongest concern is endogeneity bias, and bias that results from pooling countries that are heterogeneous.

Substantively, we find that improvements in rights do lead to increases in national income, though recognizing country heterogeneity and choice of appropriate estimation technique is crucial in isolating the effect. For a significant grouping of countries the positive impact of improvements in rights on output is strongest at low levels of rights, at intermediate levels of rights improvements in rights can lead to lower levels of income, while the positive impact of rights on output reemerges at higher rights levels.¹¹

These findings carry important implications for any conceptualization of the interaction of rights and economic development. Under both very poor rights dispensations, and under the best rights, the results suggest that there are significant efficiency gains to be realized from improvements in rights, without the generation of negative externalities significant enough to offset the positive gains in economic performance. However, here exists some intermediate range of the rights measures, over which the positive efficiency gains either disappear, or perhaps are reversed. This may be due to the generation of significant levels of uncertainty that inhibit investment and other future discounting behavior, until a new stable institutional dispensation has been reached. While this posited mechanism is conjectural, the evidence certainly suggests the existence of a significant qualitative differentiation between “low-level” and “high-level” rights, and that the transition from one to the other is costly.

(a) *The question of this paper and core associated empirical methodological challenges*

In our introduction we have pointed to the active theoretical discussion of the link between rights and economic development. Yet despite both its history and the burgeoning nature of this literature, there is no theoretical agreement about measures or causal models. Under such conditions, how might we proceed with scientific rigor? Our approach is not only to heed theory insofar as it provides guidance—but also to allow feedback from empirical findings to theoretical reflection.¹²

In this spirit, consider a general specification:

$$Y_{it} = Y(K_{it}, R_{it}) + \varepsilon_{it} \quad (1)$$

where Y_{it} denotes real output of country i in period t , K a vector of independent variables (we might think of these as capital stocks of various sorts, physical, human, financial, and labor factor services—and whatever else might be thought relevant), R the measure or measures of rights we employ, and ε an unobserved error term. Our question is first whether $\partial Y / \partial R \neq 0$, $\partial Y / \partial R > 0$ in particular, and the strength (if any) of the $\partial Y / \partial R \neq 0$ effect.

Estimation in such a context introduces a relatively under-theorized dimension (rights) into estimation, and thereby stands under the suspicion of being subject to unobserved effects,¹³ such that the true specification of (1) is in fact:

$$Y_{it} = Y(K_{it}, R_{it}, C_{it}) + \varepsilon_{it} \quad (2)$$

where C_{it} denotes an unobserved random variable, a vector of characteristics that also impact on output. Under time-invariant unobserved effects, $C_{it} = C_i$, given that it is consistent even where $\text{cov}(C_i, K_{it}) \neq 0$, and/or $\text{cov}(C_i, R_{it}) \neq 0$, the Fixed Effects (FE) estimator is the obvious choice. In the present study we employ the within version of the estimator.¹⁴

The direct advantage of the FE estimator is thus that it directly corrects for omitted variables bias. In the present study we further check for the potential impact of omitted variables by controlling for a range of additional potential determinants of output.

However, the FE estimator imposes an exogeneity assumption, such that explanatory variables in each time period are uncorrelated with the errors in each time period,¹⁵ in order for the estimators to be consistent. In our context, feedback effects from the dependent variable at least to future values of the explanatory variables are plausible. For instance, shocks to output may well carry implications for the stability of political dispensations, and hence the level and quality of rights. Empirical research on the impact of governance on development has spent considerable effort on dealing with this endogeneity problem. In accordance with the classic statistical prescription, researchers have sought instruments that are uncorrelated with errors in each period. For instance, Acemoglu *et al.* (2001) rely on 19th century Settler mortality.¹⁶

Unfortunately, Bazzi and Clemens (2013) show how fundamentally fraught all the instrumentation strategies proposed in the literature are. The issue is that precisely when instruments are *strong* (highly correlated with the endogenous variable), they are likely to be *invalid* (correlated with variables that materially affect growth, other than the variable being instrumented for). Thus any instrument Z_{it} , which is strong (for instance $\text{corr}(R_{it}, Z_{it}) \neq 0$), but for which there is an association with another channel which affects growth not controlled for in estimation, $\text{cov}(C_{it}, Z_{it}) \neq 0$, since the error term in estimating (2) is given by $v_{it} = C_{it} + \varepsilon_{it}$, it follows that $\text{cov}(Z_{it}, v_{it}) \neq 0$, such that the instrument is invalid, leaving parameter estimates biased to an unknown degree and in an unknown direction. The solution might appear to be the inclusion of C_{it} in the estimation of (2). But this comes at the cost of requiring unique instruments for each of the endogenous RHS variables, each of which is valid and strong. Thus for the two instruments Z_{it} , $\tilde{Z}_{it}$, we require $\text{cov}(Z_{it}, v_{it}) = \text{cov}(\tilde{Z}_{it}, v_{it}) = 0$, and $\text{corr}(R_{it}, Z_{it}) \neq 0$, $\text{corr}(C_{it}, \tilde{Z}_{it}) \neq 0$. In short, ensuring instrument validity, may render the instruments weak.

Fundamentally the issue here is that reliance on the range of instruments proposed in the growth literature suffers from theory open-endedness. Given the range of theories of

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