Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development*

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We estimate the respective contributions of institutions, geography, and trade in determining income levels around the world, using recently developed instrumental variables for institutions and trade. Our results indicate that the quality of institutions "trumps" everything else. Once institutions are controlled for, conventional measures of geography have at best weak direct effects on incomes, although they have a strong indirect effect by influencing the quality of institutions. Similarly, once institutions are controlled for, trade is almost always insignificant, and often enters the income equation with the "wrong" (i.e., negative) sign. We relate our results to recent literature, and where differences exist, trace their origins to choices on samples, specification, and instrumentation.

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Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufactures, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government.

Adam Smith, *Wealth of Nations*

* The views expressed in this paper are the authors’ own and not of the institutions with which they are affiliated.
1. Introduction

Average income levels in the world’s richest and poorest nations differ by a factor of more than 100. Sierra Leone, the poorest economy for which we have national income statistics, has a per capita GDP of $490, compared to Luxembourg’s $50,061. What accounts for these differences, and what (if anything) can we do to reduce them? It is hard to think of any question in economics that is of greater intellectual significance, or of greater relevance to the vast majority of the world’s population.

In the voluminous literature on this subject, three strands of thoughts stand out. First, there is a long and distinguished line of theorizing that places geography at the center of the story. Geography is a key determinant of climate, endowment of natural resources, disease burden, transport costs, and diffusion of knowledge and technology from more advanced areas. It exerts therefore a strong influence on agricultural productivity and the quality of human resources. Recent writings by Jared Diamond and Jeffrey Sachs are among the more notable works in this tradition (see Diamond, 1997; Gallup et al., 1998; Sachs, 2001).

A second camp emphasizes the role of international trade as a driver of productivity change. We call this the integration view, as it gives market integration, and impediments thereof, a starring role in fostering economic convergence between rich and poor regions of the world. Notable recent research in this camp includes Frankel and Romer (1999) and the pre-geography work of Sachs (Sachs and Warner, 1995). It may be useful to distinguish between “moderate” and “maximal” versions of this view. Much of the economics profession would accept the hypothesis that trade can be an underlying source of growth once certain institutional pre-requisites have been fulfilled. But a more extreme perspective, and one that has received wide currency in public debates, is that trade/integration is the major determinant of whether poor countries grow or not. It is the latter perspective that characterizes such widely cited papers as Sachs and Warner (1995) and Dollar and Kraay (2004).

Finally, a third group of explanations centers on institutions, and in particular the role of property rights and the rule of law. In this view, what matters are the rules of the game in a society and their conduciveness to desirable economic behavior. This view is associated most strongly with Douglass North (1990). It has received careful econometric treatment recently in Hall and Jones (1999), who focus on what they call “social infrastructure,” and in Acemoglu et al. (2001), who focus on the expropriation risk that current and potential investors face.

Growth theory has traditionally focussed on physical and human capital accumulation, and, in its endogenous growth variant, on technological change. But accumulation and technological change are at best proximate causes of economic growth. No sooner have we ascertained the impact of these two on growth—and with some luck their respective roles

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1 These are figures for 2000, and they are expressed in current “international” dollars, adjusted for PPP differences. The source is the World Development Indicators CD-ROM of the World Bank.

2 One can question whether it is appropriate to treat trade as one of the ultimate determinants of economic prosperity, but here we are simply following a long literature that has attached central causal importance to it.