



Do Institutions Cause Growth?

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We revisit the debate over whether political institutions cause economic growth, or whether, alternatively, growth and human capital accumulation lead to institutional improvement. We find that most indicators of institutional quality used to establish the proposition that institutions cause growth are constructed to be conceptually unsuitable for that purpose. We also find that some of the instrumental variable techniques used in the literature are flawed. Basic OLS results, as well as a variety of additional evidence, suggest that (a) human capital is a more basic source of growth than are the institutions, (b) poor countries get out of poverty through good policies, often pursued by dictators, and (c) subsequently improve their political institutions.

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1. Introduction

Today, both the United States and the international community face two major development challenges around the world, from Iraq, to Haiti, to sub-Saharan Africa: how to ignite growth and how to establish democracy. Economic research has identified two broad approaches to confronting these challenges. The first approach emphasizes the need to start with democracy and other checks on government as the mechanisms for securing property rights. With such political institutions in place, investment in human and physical capital, and therefore economic growth, are expected to follow. The second approach emphasizes the need for human and physical capital accumulation to start the process. It holds that even pro-market dictators can secure property rights as a matter of

policy choice, not of political constraints. From the vantage point of poor countries, it sees democracy and other institutional improvements as the consequences of increased education and wealth, not as their causes.

Both approaches to development have extensive intellectual pedigree. The importance of constraining government was stressed by Montesquieu (1748) and Smith (1776), as well by the new institutional economics literature (Buchanan and Tullock, 1962; North and Thomas, 1973; North, 1981, 1990). DeLong and Shleifer (1993) supplied early empirical support for this view using data on urbanization of European regions during the last millennium, which showed faster city growth under more limited governments. More recently, the literature on economic growth, starting with early contributions by Knack and Keefer (1995) and Mauro (1995), has turned to the effects of good institutions on economic growth. It is fair to say that recent work, including Hall and Jones (1999), Acemoglu et al. (2001, 2002), Easterly and Levine (2003), Dollar and Kraay (2003), and Rodrik et al. (2004), has reached close to an intellectual consensus that the political institutions of limited government cause economic growth.

The reverse idea, namely that growth in income and human capital causes institutional improvement, is most closely associated with the work of Lipset (1960), who, however, himself gives credit to Aristotle. Lipset believed that educated people are more likely to resolve their differences through negotiation and voting than through violent disputes. Education is needed for courts to operate and to empower citizens to engage with government institutions. Literacy encourages the spread of knowledge about the government's malfeasance. According to this view, countries differ in their stocks of human and social capital—which can be acquired through policies pursued even by dictators—and institutional outcomes depend to a large extent on these endowments (see Djankov et al., 2003). This line of work seems to accord well with the experiences of South Korea, Taiwan, and China, which grew rapidly under one-party dictatorships, the first two eventually turning to democracy. Empirically, Lipset's hypothesis—that growth leads to better political institutions—has received considerable support in the work of Przeworski and his associates (Alvarez et al., 2000) and Barro (1999).

The two views of economic and political development share some important similarities. They both emphasize the need for secure property rights to support investment in human and physical capital, and they both see such security as a public policy choice. However, the institutional view sees the pro-investment policies as a consequence of political constraints on government, whereas the development view sees these policies in poor countries largely as choices of their—typically unconstrained—leaders.

In this paper, we revisit these two broad approaches to development in an effort to assess each one's empirical validity. Our view is shaped to some extent by the experiences of North and South Korea, illustrated in Figure 1. Prior to the Korean war, the two countries were obviously part of one, so it is difficult to think of them as having different histories. They were both exceptionally poor in 1950. Between the end of the Korean war and 1980, both countries were dictatorships. If institutions are measured by Polity's "constraints on the executive," which, as we discuss below, is probably the best of the measures commonly used in the literature, then between 1950 and 1980 North Korea had an average score of 1.71, and South Korea 2.16 (out of 7). Yet South Korean dictators chose capitalism and secure property rights and the country grew rapidly, reaching per capita